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Management's Discussion and Analysis

This section provides an analysis of the performance, financial position and risk management of the Group, as well as the overall impact of adopting the new and revised Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards (hereafter collectively referred to as "new accounting standards"). The following analysis should be read in conjunction with the accounts and the notes included in this Annual Report.

Performance Measurement

The Group continued to deliver strong financial results in 2005, the third consecutive year of double-digit growth since IPO. The following table summarizes the overall performance achieved in 2005.

Financial Indicators	Performance	Result Highlights
ROE ¹ and ROA ²	<ul style="list-style-type: none"> Profit attributable to shareholders increased by 12.8% to HK\$13,494 million. ROE decreased marginally from 18.58% in 2004 to 18.24% mainly due to increase in shareholders' funds on the adoption of the new accounting standards and revaluation of premises. ROA rose from 1.56% in 2004 to 1.66% in 2005. 	<ul style="list-style-type: none"> ROE: 18.24% ROA: 1.66%
Dividend payout ratio	The proposed final dividend plus interim dividend represent a total payout ratio of 63.31%, which is within the range set out in the Group's dividend policy.	<ul style="list-style-type: none"> Dividend payout ratio: 63.31%
Interest margin and non-interest income ³	<ul style="list-style-type: none"> Net interest margin rose from 1.55% in 2004 to 1.71% in 2005, mainly due to the rise in contribution from net free fund and improvement in net interest spread. Non-interest income increased by 7.7%, primarily driven by the adoption of the new accounting standards. Non-interest income to total operating income ratio decreased by 1.35 percentage points to 28.06% due to a higher increase in net interest income relative to non-interest income. 	<ul style="list-style-type: none"> Net interest margin: 1.71% Non-interest income to total operating income ratio: 28.06%
Cost efficiency	Cost to income ratio was further lowered by 2.70 percentage points to 32.02% mainly due to a faster increase in operating income relative to operating expenses. Total income increased by 12.9% while operating expenses increased by 4.1%. The latter was kept low as a result of effective cost containment efforts.	<ul style="list-style-type: none"> Cost to income ratio: 32.02%
Asset quality	Formation of new impaired loans ⁴ remained at a low level of 0.5% of total loans. Impaired loan ratio fell significantly by 1.67 percentage points from 2.95% in 2004 to 1.28% in 2005.	<ul style="list-style-type: none"> Impaired loan ratio: 1.28%
Capital strength and liquidity	Capital adequacy ratio and liquidity ratio remained strong.	<ul style="list-style-type: none"> Capital adequacy ratio: 15.37% Liquidity ratio: 42.02%

(1) ROE represents return on average capital and reserves attributable to the equity holders of the Company.

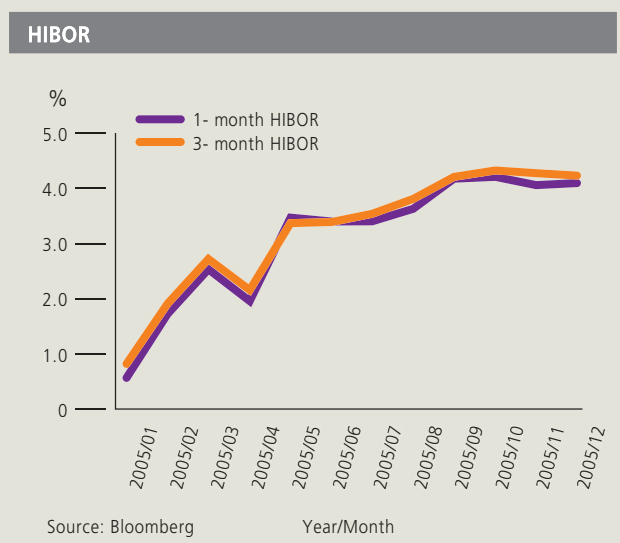
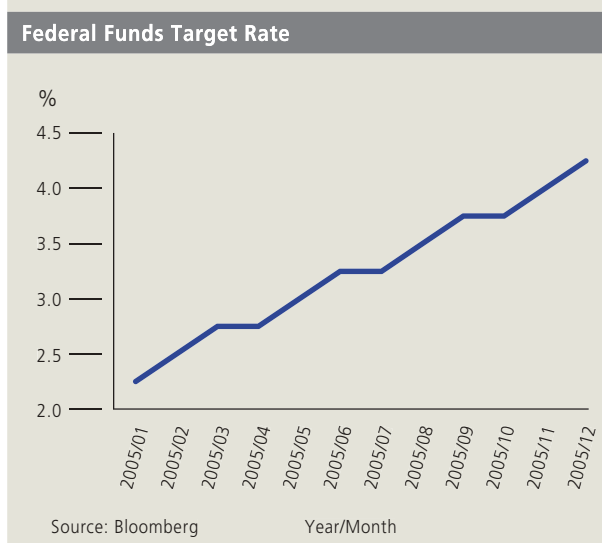
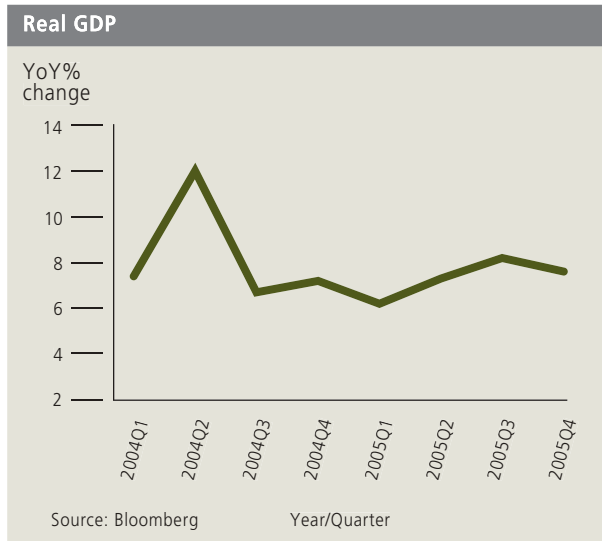
(2) ROA represents return on average total assets and is defined in "Financial Highlights".

(3) Non-interest income represents other operating income.

(4) Impaired loans are advances to customers which have been classified as "substandard", "doubtful" and "loss" under the Group's classification of loan quality.



Business Environment



The Hong Kong economy continued to experience broad-based growth in 2005, underpinned by a stable global economy and in the healthy growth of the Mainland economy. For 2005, Hong Kong's GDP recorded a growth of 7.3% in real terms, driven primarily by the upsurge in merchandise exports and domestic consumption. The unemployment rate dropped to about 5% towards the end of the year while labour income steadily increased.

During the year, the US Federal Funds Target Rate was raised by an aggregate of 200 basis points to 4.25%. In line with the US rate hike, average 1-month and 3-month HIBOR soared to 2.94% and 3.09% respectively, compared to 0.30% and 0.46% in 2004. The yield curve flattened, as evidenced by the narrowing of the interest spread between 2-year Exchange Fund notes and its 10-year counterparts, from 254 basis points at end-2004 to 19 basis points at end-2005.

The interest rate differential between USD and HKD narrowed sharply after the adoption by the HKSAR government of the refinement measures on the linked exchange rate mechanism in May 2005. By year-end, most banks in Hong Kong had increased their prime lending rates by a total of 250 basis points, outstripping the 125-basis-point increase in the US Federal Funds Target Rate for the same period.

The local property market, under the pressure of higher interest rate, began to consolidate both in terms of transaction volume and price in the second half of 2005. However, the ratio of negative equity residential mortgage loans, which increased slightly in the second half, was still lower than the year before. The local banking sector was able to capitalise on the better economic environment, and credit quality improved as collateral values had been rising with real estate prices.

Consolidated Financial Review

The Group's 2005 financial statements have been prepared in accordance with the new accounting standards. For this reason, some of the 2005 figures shown here cannot be compared directly with corresponding figures for 2004. These differences are noted elsewhere in this report where appropriate.

For the year ended 31 December 2005, the Group's profit attributable to shareholders was HK\$13,494 million, up HK\$1,531 million or 12.8% from 2004. Earnings per share were HK\$1.2763, up HK\$0.1448. Return on average total assets grew by 0.10 percentage point to 1.66% whereas return on average shareholders' funds fell slightly by 0.34 percentage point to 18.24%. Operating profit before impairment/provisions improved on the back of higher operating income. Attributable profit was further boosted by a substantial loan impairment allowance write-back and investment property revaluation gain.

Financial Highlight

HK\$m, except percentage amounts	2005	2004
Operating income	17,896	15,857
Operating expenses	(5,730)	(5,505)
Operation profit before impairment/ provisions on advances	12,166	10,352
Reversal of impairment allowances/ write-back of provisions	2,645	1,628
Others	1,557	2,272
Profit before taxation	16,368	14,252
Profit attributable to equity holders of the Company	13,494	11,963
Net interest margin	1.71%	1.55%
Non-interest income ratio	28.06%	29.41%
Cost-to-income ratio	32.02%	34.72%

Analyses of the financial performance, business operations and risk management of the Group for 2005 are set out in the following sections.



Significant Changes in Accounting Policies

The new accounting standards that have the most significant impact on the Group's financial results are summarized below:

Standards and interpretation	Significant impact for 2005
<ul style="list-style-type: none"> HKAS 39: "Financial Instruments – Recognition and Measurement" 	<ul style="list-style-type: none"> The treatment of certain types of interest income, fees and commission income, net trading income and the calculation of loan impairment allowances The classification of certain types of assets and liabilities
<ul style="list-style-type: none"> HKAS 40: "Investment Property" 	<ul style="list-style-type: none"> Transfer of revaluation reserve of investment properties to retained earnings in the opening balance adjustment Change in fair value of investment properties was recognised directly in the profit and loss account
<ul style="list-style-type: none"> HKAS 12: "Income Taxes" – HKAS Interpretation 21 	<ul style="list-style-type: none"> Provision of deferred tax on the revaluation surplus of investment properties

In this Management's Discussion and Analysis, the impact of the new accounting standards is described where appropriate. For details of the change in accounting policies, please refer to the Notes to the Accounts.

Net Interest Income and Margin		
HK\$m, except percentage amounts	2005	2004
Interest income	25,875	15,678
Interest expense	(13,001)	(4,485)
Net interest income	12,874	11,193
<i>Net interest income – comparable basis * (see notes)</i>	<i>13,131</i>	<i>11,193</i>
Average interest-earning assets	752,257	721,402
Net interest spread	1.48%	1.46%
<i>Net interest spread – comparable basis * (see notes)</i>	<i>1.49%</i>	<i>1.46%</i>
Net interest margin	1.71%	1.55%
<i>Net interest margin – comparable basis * (see notes)</i>	<i>1.74%</i>	<i>1.55%</i>

Net interest income increased by HK\$1,681 million, or 15.0%, to HK\$12,874 million from a year ago. Average interest-earning assets grew by HK\$30,855 million, or 4.3%, to HK\$752,257 million. Net interest spread and net interest margin were 1.48% and 1.71% respectively. The improvement of net interest spread by 2 basis points together with 14 basis points improvement in contribution from net free fund resulted in 16 basis points improvement in net interest margin.

* Notes:

If the impact of the new accounting standards were removed, the comparable net interest income was HK\$13,131 million, HK\$1,938 million or 17.3% higher than last year. Similarly, net interest spread was 1.49%, or 3 basis points higher than that of 2004, while net interest margin was 1.74%, or 19 basis points higher than that of 2004 on a comparable basis.

The negative impact of applying the new accounting standards on the Group's net interest income amounted to approximately HK\$257 million. Net interest income was affected in the following ways:

- Interest accrued on impaired loans using effective interest rate was not recognised under the previous accounting regime.
- Swap points on foreign exchange swap contracts previously accounted for as interest was reported as net trading income under the new accounting standards.
- Directly attributable loan fees and costs previously recognised as commission income and expenses were reported as interest income using the effective interest rate calculation.



The interest rate environment in 2005 was very different from that in 2004. After the HKSAR government's announcement of measures to refine the operation of the linked exchange rate mechanism, one-month HIBOR increased noticeably from 1.96% at end-April to 4.48% in mid-October. By the end of 2005, it was 4.10%. Average one-month HIBOR increased to 2.94% as compared to 0.30% for 2004 while average one-month LIBOR increased by 189 basis points to 3.39%. In contrast, the average prime rose to 6.17% from 5.02% in 2004, causing the average prime to one-month HIBOR spread to narrow to 3.23% from 4.72% in 2004.

The Group's gross yield on average loans increased by 139 basis points year-on-year, benefiting from higher market interest rates as well as the increase in higher yielding loans. However, the weighted average yield on residential mortgage portfolio, excluding Government Home Ownership Scheme (GHOS) mortgages, declined by 33 basis points, to 2.52% from 2.19% below best lending rates a year ago. Gross yield on debt securities rose by 109 basis points as the Group continued to diversify its investment portfolio to enhance yield. However, improvements in net contribution from the debt securities portfolio were held back by the flattening yield curve. While deposit spread widened as a result of the Group's conscious effort in managing funding costs, higher saving interest rates and HIBOR resulted in a higher overall funding cost. For example, average interest rates on savings and time deposits increased by 85 basis points and 146 basis points respectively.

Second Half Performance

Compared to the first half of 2005, net interest income increased by HK\$1,152 million, or 19.7%. Net interest margin rose by 24 basis points. Net interest spread was 10 basis points higher on the back of higher interest rates and improvement in fixed deposit spread. Contribution of net free funds also improved by 14 basis points. Gross yields on average loans and debt securities rose by 173 and 90 basis points respectively. The improvement in loan spreads was held back as the yield on residential mortgages continued to narrow in a very competitive environment. The weighted average yield on residential mortgage, before accounting for cash rebates, was 13 basis points lower than that in the first half of 2005. Fixed deposit spreads improved due to higher market interest rates and the Group's active pricing strategy.



The summary below shows the average balances and average interest rates of individual assets and liabilities in 2005 as compared with 2004:

ASSETS				
	Year ended 31 December 2005		Year ended 31 December 2004	
	Average balance HK\$'m	Average yield %	Average balance HK\$'m	Average yield %
Loans to banks	164,825	2.45	188,073	1.33
Interest earning securities	241,868	3.35	204,325	2.26
Loans & advances to customers	325,345	4.00	307,915*	2.61
Other interest earning assets	20,219	3.61	21,089	2.46
Sub-total	752,257	3.44	721,402	2.17
Non Interest-earning assets	69,422	–	55,390	–
Total assets	821,679	3.15	776,792	2.02

LIABILITIES				
	Year ended 31 December 2005		Year ended 31 December 2004	
	Average balance HK\$'m	Average rate %	Average balance HK\$'m	Average rate %
Deposits and balances of banks and other financial institutions	33,022	2.26	43,955	1.01
Current, fixed, savings and other deposits	598,146	1.93	554,679	0.63
Certificate of deposits issued	3,800	2.95	2,967	2.76
Other interest-bearing liabilities	27,372	2.12	27,682	1.77
Total interest bearing liabilities	662,340	1.96	629,283	0.71
Non interest-bearing deposits	33,911	–	34,291	–
Shareholders' fund** & non interest-bearing liabilities	125,428	–	113,218	–
Total liabilities	821,679	1.58	776,792	0.58

* Y2004 average balance of loans & advances to customers would have been restated to HK\$298,803 million in conformity with the new accounting standards.

** Shareholders' fund represents capital and reserves attributable to the equity holders of the Company.



Net Fees and Commission Income		
HK\$'m	2005	2004
Bills commissions	532	547
Loan commissions	263	490
Wealth management income	1,243	1,361
Securities brokerage	714	836
Asset management	183	233
Life insurance	226	194
Bonds	120	98
General Insurance	103	120
Trust services	107	75
Payment services	381	349
Credit cards	737	666
Others	744	699
Fees and commission income	4,110	4,307
Fees and commission expenses	(1,057)	(1,086)
Net fees and commission income	3,053	3,221
<i>Net fees and commission income – comparable basis</i>	3,199	3,221

Net fees and commission income decreased by HK\$168 million, or 5.2%, to HK\$3,053 million. The new HKAS 39 requires that directly attributed loan fees be amortised to interest income over the expected life of the loans as part of the effective interest rate calculation. This resulted in a reduction of HK\$146 million in net loan commissions. Excluding the said impact, net fees and commission income would have registered a small fall of HK\$22 million, or 0.7%.

HK\$'m	2005	Comparable basis	HKAS39 Impact
Fees and commission income	4,110	4,334	224
Loan commissions	263	487	224
Fees and commission expenses	(1,057)	(1,135)	(78)
<i>Net Fees and Commission Income – comparable basis</i>	3,053	3,199	146

Loan commissions fell by HK\$227 million, or 46.3%. Upon adoption of the new accounting standards, directly attributable loan fees of HK\$224 million were amortised to interest income over the expected life of the loans as part of the effective interest rate calculation. At the same time, HK\$78 million in cash rebates were also amortised to interest income in 2005, resulting in a reduction of HK\$146 million in net loan commissions. Excluding the impact of the new accounting standards, gross loan commission income would have registered a slight decrease of HK\$3 million, or 0.6%.

Income from asset management fell by HK\$50 million due to the sluggish sales of the capital guaranteed funds under the rising interest rate environment. On the other hand, the growing popularity for structured notes boosted the income from bond sales. Commission from life insurance also grew by HK\$32 million after the successful launch of a number of short-to-medium term insurance products. Stock-broking fee fell by HK\$122 million due to the fall in customers' transaction activities.

Fees from card business recorded a growth of 10.7%, as cardholder spending and merchant acquisition volume increased by 17.4% and 17.3% respectively. Fees from trust services, payment services and RMB-related services also registered a satisfactory growth of 42.7%, 9.2% and 65.4% respectively.

Second Half Performance

Compared to the first half of 2005, net fees and commission income increased by HK\$59 million, or 3.9%, mainly attributable to increases in stock-broking, payment services, loans and bills commissions.

Net Trading Income		
HK\$'m	2005	2004
Foreign exchange and foreign exchange products	1,464	1,064
Interest rate instruments	146	(22)
Equity instruments	12	26
Commodities	52	55
Net trading income	1,674	1,123
<i>Net trading income – comparable basis</i>	969	<i>1,123</i>

Net trading income increased by HK\$551 million, or 49.1%, to HK\$1,674 million, mainly due to the adoption of the new accounting standards. On a comparable basis, after the exclusion of the HK\$705 million gains for the change in fair value of foreign exchange swap contracts and interest rate instruments recognized under the new accounting standards, net trading income would have decreased by 13.7%.

Net trading income from foreign exchange and foreign exchange related products grew to HK\$1,464 million, representing an increase of HK\$400 million or 37.6%. This was largely attributable to accounting gains from adoption of the new accounting standards. This increase was partly offset by a fall in foreign exchange dealing profits caused by the decline in customer trading volume. Excluding the gains from the new accounting standards, net trading income from foreign exchange and foreign exchange related products would have been HK\$983 million. The uncertain interest rate environment, together with the weakening trend of the US dollar during the year held back customer interest in the foreign currency market.

Net trading income from interest rate instruments included changes in fair value of trading securities, other financial assets at fair value through profit or loss, available-for-sale securities designated as fair value hedges, interest rate derivatives and financial liabilities at fair value through profit or loss. In 2005, net trading income from interest rate instruments posted a net gain of HK\$146 million as compared to a net loss of HK\$22 million in 2004. The increase in income was mainly derived from the change in fair values of interest rate derivatives and retail certificate of deposits designated at fair value through profit or loss. On a comparable basis, net trading income from interest rate instruments would show a loss of HK\$78 million if the previous accounting treatment was applied.

Compared to the first half of 2005, net trading income for the second half rose by HK\$182 million or 24.4%, mainly due to the increase in the fair value of foreign exchange swap contracts.

Operating Expenses		
HK\$m, except percentage amounts	2005	2004
Staff costs	3,470	3,291
Premises and equipment expenses (excluding depreciation)	743	725
Depreciation on owned fixed assets	566	585
Other operating expenses	951	904
Operating expenses	5,730	5,505
<i>Operating expenses – comparable basis</i>	<i>5,927</i>	<i>5,505</i>
Cost to income ratio	32.02%	34.72%
<i>Cost to income ratio – comparable basis</i>	<i>33.69%</i>	<i>34.72%</i>

Operating expenses increased by HK\$225 million, or 4.1%, to HK\$5,730 million primarily due to increase in staff costs. Various new human resources initiatives were introduced and a general salary increase of 3.7% took place in April 2005. Headcount measured in full time equivalent decreased, from 12,976 at end-2004 to 12,838 at end-2005. Human resources initiatives introduced in 2005 included new sales incentive schemes and a special salary adjustment for key positions to align with the market.

Depreciation on owned fixed assets decreased by HK\$19 million, or a fall of 3.2%, to HK\$566 million in 2005. The Group adjusted the estimation of the useful life of premises by using the lease terms of the land element as the depreciation period. This was based on the fact that a large part of property value in Hong Kong is attributed to land price. This new policy effectively reduced the Group's annual depreciation charges. However, this was largely offset by the rise in the value of the premises.

Second Half Performance

Compared to the first half of 2005, operating expenses in the second half rose by HK\$378 million or 14.1%. This was primarily due to the seasonal trend and was considered a normal business cycle also observed in prior years. In 2004, the increase in operating expenses in the second half was 6.4% higher than the first half.



Loan Impairment Release		
HK\$'m	2005	2004
Loan impairment release/(charge)		
Individual assessment		
– new allowances	(1,304)	–
– releases	1,042	–
– recoveries of loans previously written off	1,639	–
Collective assessment		
– new allowances	(11)	–
– releases	1,279	–
– recoveries of loans previously written off	–	–
Specific provisions		
– new provisions	–	(1,520)
– releases	–	1,851
– recoveries of loans previously written off	–	1,356
General provisions	–	(59)
Net credit/(charge) to profit and loss account	2,645	1,628

Under the new accounting standards, loan impairment allowances of individually significant loans and advances showing objective evidence of impairment are calculated using a discounted cash flow method (Individual Assessment – IA). For the remaining loans and advances, impairment allowances are collectively assessed by using statistical models on portfolios of loans and advances grouped by similar credit characteristics (Collective Assessment – CA). As a consequence of these accounting changes, the Group adjusted the total balance of the allowances calculated under the previous accounting method to the new balance calculated under the new standards (the “new opening balance”) on 1 January 2005. The differences between these two methods were adjusted to the retained earnings account on 1 January 2005. Compared to the new opening balances, the Group reported a release of allowances of HK\$2,321 million in 2005. The release was the result of improvement in asset quality due to a better economy, lower bad debt migration rate and rise in collateral values. This release was partially offset by HK\$1,315 million of new impairment allowances. Additional allowances were needed to cover the formation of new impaired loans and further deterioration of existing impaired accounts.

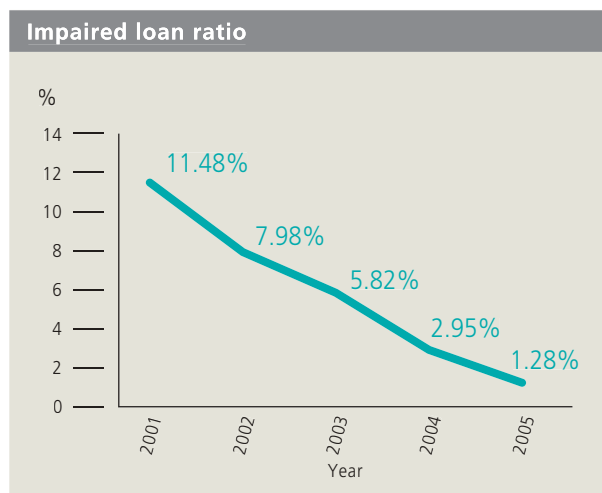
The Group recorded a net charge of HK\$262 million impairment allowances on individually assessed loans as the recovery of advances to New Nongkai Group was offset by allowances provided on other commercial lending. On the other hand, collective assessment contributed a net release of HK\$1,268 million based on statistical calculation using three-year historical loss data.

The Group also made remarkable progress in the recovery of loans that were previously written off, benefiting from improved borrowers' debt servicing capability and higher collateral values. Recoveries totaled HK\$1,639 million, up HK\$283 million or 20.9% from 2004.

Compared to the first half of 2005, net release of loan impairment allowances in the second half was HK\$225 million less due to lower level of recoveries of loans previously written off.

With low impaired loan formation and strong collection efforts, impaired loans* were reduced by HK\$4,983 million, or 53.9%, in 2005. Impaired loan ratio fell from 2.95% in 2004 to 1.28% at year-end 2005.

Over the past five years, the Group has shown substantial improvement in asset quality. Impaired loans were reduced at a compound annual rate of 42%. Impaired loan ratio decreased substantially from 11.48% in 2001 to 1.28% in 2005.



* Impaired loans represented advances which have been classified as "substandard", "doubtful" and "loss" under the Group's classification of loan quality.

Property Revaluation

Under the new HKAS40, the aggregate impact of property revaluation on profit and loss account was HK\$1,445 million, of which HK\$1,382 million came from investment properties revaluation. Gain on revaluation of bank premises was HK\$63 million. The surge in gain from disposal of/fair value adjustments on investment properties in 2005 was largely due to adoption of HKAS 40 that allows revaluation gain or loss from investment properties be booked directly through the profit and loss account. The related deferred tax charge on revaluation of investment properties amounted to HK\$339 million. The net impact on the Group's attributable profit in 2005 was HK\$1,043 million.

Compared to the first half of 2005, gain from revaluation of investment properties fell by HK\$454 million in the second half, which was in line with the movement of local property prices.

HK\$'m	First Half 2005	Second Half 2005
Net gain on revaluation of premises	–	63
Net gain on fair value adjustments on investment properties	918	464
Deferred tax	155	184
Net gain on fair value adjustments on investment properties, after tax	763	280



Estimation of the effect on adoption of new accounting standards

Year 2005 was the first full year of using the new accounting standards, namely HKAS 39 "Financial Instruments – Recognition and Measurement", HKAS 40 "Investment Property" and HKAS 12 "Income Taxes" – HKAS Interpretation 21. Estimates of their full-year impact on profit and loss account are highlighted below:

HK\$'m	Full-year ended 31 December 2005	Note
Effective yield and others	137	i
Hedging and asset classification	165	ii
Revaluation of investment properties	1,382	iii
Taxation	(579)	
Subtotal	1,105	
Loan impairment allowance	1,169	iv

The main differences were attributable to the adoption of HKAS 39 and HKAS 40. The key impact is summarised in the following notes:

- i. HKAS 39 requires the use of effective yield on interest income recognition for directly attributable loan fees and costs. This new standard affected both net interest income and net fees and commission income.
- ii. Certain derivative financial instruments that were previously not marked to market are now stated at fair value under HKAS 39. On 1 January 2005, the Group reclassified certain held-to-maturity securities to available-for-sale securities and to financial instruments at fair value through profit or loss. The Group also designated certain financial liabilities at fair value through profit or loss. In 2005, the changes in fair value of these financial instruments were reflected in the profit and loss account. Differences arising from hedging and asset classification mainly affected net interest income and net trading income.
- iii. HKAS 40 requires fair value changes in investment properties to be reported directly in the profit and loss account. Previously, changes in the value of investment properties were treated as a movement in the investment properties revaluation reserve on a portfolio basis. Under the previous accounting standards, there would have been no impact on the profit and loss account arising from investment property revaluation.
- iv. Under HKAS 39, individual (IA) and collective assessment (CA) models are used to determine the impairment allowances for loans and advances. Using this new methodology, the total impairment allowances required on 31 December 2005 was lower than the total allowances established at the beginning of the year resulting in a net write-back. The reduction of the loan impairment allowances was made possible by the continual improvement in the quality of the Group's loan portfolio. Under the previous accounting standards, there would have been an increase in general provisions regardless of the improvement in asset quality.



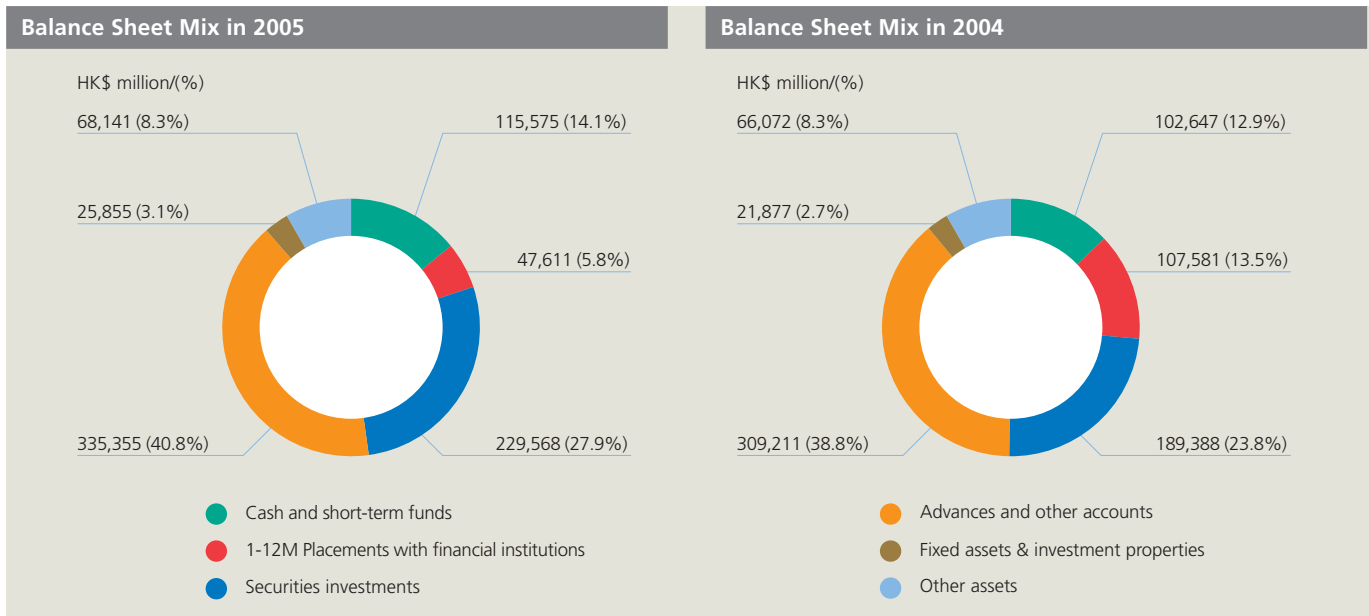
Financial Position

HK\$'m, except percentage amount	At 31 December 2005	At 31 December 2004
Cash and short-term funds	115,575	102,647
Placements with banks and other financial institutions maturing between one and twelve months	47,611	107,581
Certificates of deposit held	19,464	22,338
Hong Kong SAR Government certificates of indebtedness	32,630	34,760
Securities investments*	229,568	189,388
Advances and other accounts	335,355	309,211
Fixed assets & investment properties	25,855	21,877
Other assets **	16,047	8,974
Total assets	822,105	796,776
Hong Kong SAR currency notes in circulation	32,630	34,760
Deposits and balances of banks and other financial institutions	40,655	34,440
Deposits from customers	633,091	631,330
Certificates of deposit issued	3,965	3,788
Other accounts and provisions	31,031	22,698
Total liabilities	741,372	727,016
Minority interests	1,298	1,239
Capital and reserves attributable to the equity holders of the Company	79,435	68,521
Total liabilities and equity	822,105	796,776
Loan-to-deposit ratio	52.23%	49.61%

* At 31 December 2005, securities investments comprise investment in securities, trading securities and other financial instruments at fair value through profit or loss based on the classification required under the new accounting standards. At 31 December 2004, securities investments include held-to-maturity securities, investment securities and other investments in securities.

** Trade bills, investments in associates and derivative financial instruments are included in other assets.





The Group's total assets were HK\$822,105 million as at 31 December 2005, up HK\$25,329 million or 3.2%, from the end of 2004:

- Interbank placements maturing between one and twelve months dropped by HK\$59,970 million, or 55.7%.
- Securities investments rose by HK\$40,180 million, or 21.2%, to HK\$229,568 million.
- The Group continued to actively manage the balance sheet. As a result, short-term surplus funds were reduced and uses of funds by our lending business and securities investment portfolios increased.

Advances to customers				
HK\$'m, except percentage amounts	At 31 December 2005		At 31 December 2004*	
	2005	%	2004*	%
Loans for use in Hong Kong	279,826	83.8	270,666	86.4
Industrial, commercial and financial	151,903	45.5	145,979	46.6
Individuals	127,923	38.3	124,687	39.8
Trade finance	16,080	4.8	13,279	4.2
Loans for use outside Hong Kong	38,108	11.4	29,281	9.4
Total advances to customers	334,014	100.0	313,226	100.0

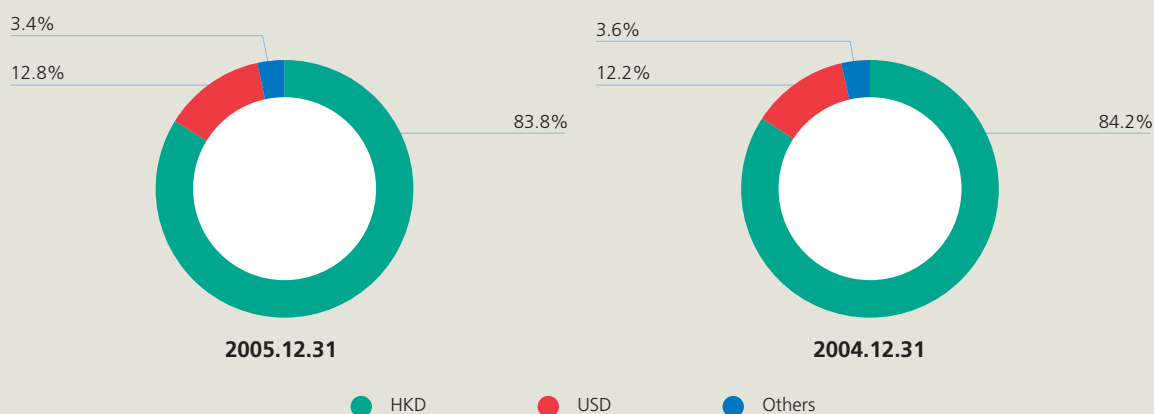
* Certain comparative amounts have been reclassified to conform with the current year's presentation.

Total advances to customers grew by 6.6% year-on-year. Loans for use in Hong Kong rose by 3.4%:

- Lending to industrial, commercial and financial sectors increased by HK\$5,924 million, or 4.1%, driven by loans for property investment and financial concerns. In particular, our SME loan portfolio increased by HK\$4,049 million, or 9.1%.
- Residential mortgage loan (excluding those under the government-sponsored Home Ownership Scheme) increased by HK\$3,564 million, or 3.7%, to HK\$99,179 million.
- Card advances grew by HK\$412 million, or 9.7%, to HK\$4,668 million as a result of an increase in cardholder spending.

Trade finance recorded an encouraging growth of HK\$2,801 million, or 21.1%, on the back of double-digit growth in merchandise exports and strong local demand. Loans for use outside Hong Kong increased by 30.1%, mainly due to the strong growth of our Mainland operation's corporate lending business. Loans extended by our Mainland branches grew by 61.4% to HK\$15,093 million.

Total advances to customers by currency mix (%)



In terms of currency mix, HK dollar and US dollar advances to customers accounted for 83.8% and 12.8% respectively. Other currency advances to customers accounted for 3.4% only. There was no significant change in currency mix between 2004 and 2005.

Deposits from customers

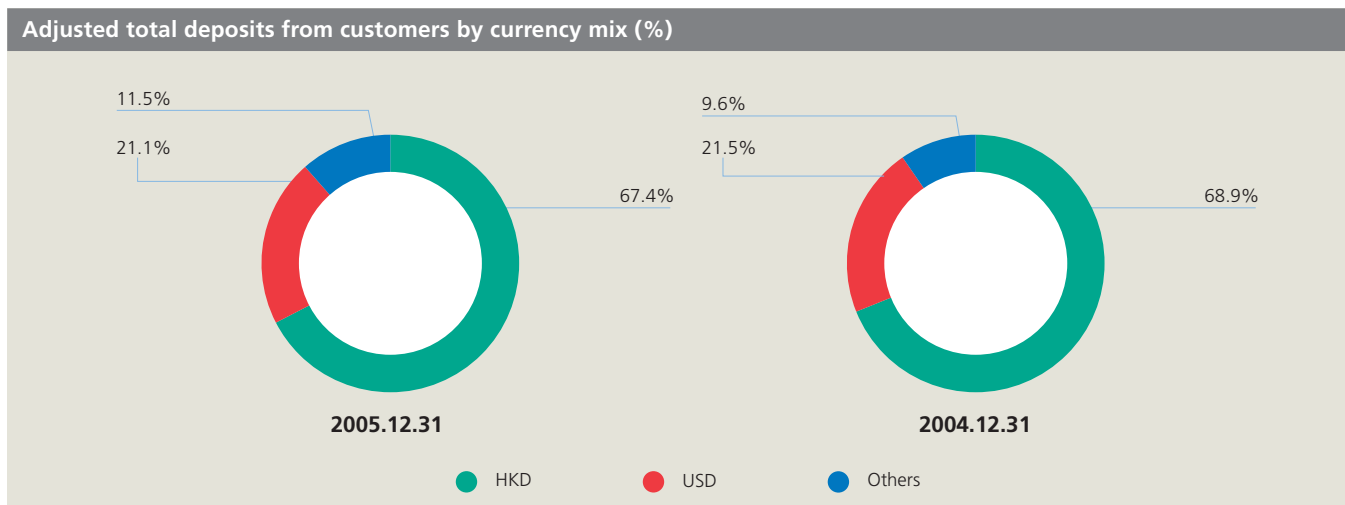
HK\$m, except percentage amounts	At 31 December 2005		At 31 December 2004	
	2005	%	2004	%
Demand deposits and current accounts	28,949	4.5	32,470	5.1
Savings deposits	216,552	33.9	296,462	47.0
Time, call and notice deposits	387,590	60.6	302,398	47.9
Total deposits from customers	633,091	99.0	631,330	100.0
Interest rate related structured deposits	6,373	1.0	N/A	0.0
Adjusted total deposits from customers	639,464	100.0	631,330	100.0

Deposits from customers increased marginally by HK\$1,761 million, or 0.3%, to HK\$633,091 million compared to 2004. The Group's strategy to optimise funding costs by actively controlling interest rates on fixed deposits affected the deposit growth rate. Given the Group's low loan to deposit ratio, the Group's strategy was to tightly control over deposit rates while remaining competitive among peer group banks. The result was an increase in the loan to deposit ratio from 49.6% in 2004 to 52.2% in 2005.



As depositors chased for higher returns, switching from current and savings deposits to fixed deposits were obvious throughout 2005. Time, call and notice deposits rose by HK\$85,192 million or 28.2%, whereas savings deposits dropped by HK\$79,910 million or 27.0%. While this had a negative impact on the Group's overall funding costs, this impact was mitigated by other cost reduction strategies mentioned above.

There was a growing popularity in structured deposits, a hybrid of retail deposit and derivatives that gives a higher nominal interest rate to depositors. The Group successfully launched a number of structured deposits in 2005 such as interest rate and currency linked structured deposits, bullion linked deposits and equity linked deposits with call option. These new offerings were warmly received by our customers. Interest rate related structure deposits amounted to HK\$6,373 million by the end of 2005, representing about 1% of the adjusted total deposits from customers.



In terms of currency mix, HK dollar and US dollar deposits from customers accounted for 67.4% and 21.1% respectively. Other currency deposits from customers accounted for 11.5%. The Group's HK dollar loan to deposit ratio rose to 64.9% in 2005 from 60.6% in 2004 mainly due to increase in HK dollar advances to customers.

Asset Quality		
HK\$'m, except percentage amounts	At 31 December 2005	At 31 December 2004
Advances to customers	334,014	313,226
Impaired loan ratio ^{&}	1.28%	2.95%
Impairment allowances	1,714	–
Regulatory reserve for general banking risks	3,526	–
Total allowances and regulatory reserve	5,240	–
General provisions	–	5,465
Specific provisions	–	2,320
Total provisions	–	7,785
Total allowances/provisions as a percentage of advances to customers	0.51%	2.49%
Total allowances and regulatory reserve/provision as a percentage of advances to customers	1.57%	2.49%
Impairment allowances on impaired loan ratio ^{##}	29.77%	–
Specific provision on classified loan ratio	–	25.09%
Total coverage (including collateral values) ^{##}	99.88%	91.66%
Residential mortgage loans [*] – delinquency ^{**} and rescheduled loan ratio	0.30%	0.61%
Card advances – delinquency ratio ^{**#}	0.32%	0.38%
	2005	2004
Card advances – charge-off ratio [#]	2.67%	3.96%

[&] Impaired loans represented advances which have been classified as “substandard”, “doubtful” and “loss” under the Group’s classification of loan quality. Upon adoption of HKFRS 5, repossessed assets are initially recognized at the lower of their fair value or the amortized cost of the related outstanding loans on the date of repossession. The related loans and advances are deducted from loans and advances. Details of the accounting policies are set out in the Notes to the Accounts.

^{*} Residential mortgage loans exclude those under the Home Ownership Scheme and other government-sponsored home purchasing schemes.

^{**} Delinquency ratio is measured by a ratio of total amount of overdue loans (more than three months) to total outstanding loans.

[#] Exclude Great Wall cards and computed according to the HKMA’s definition.

^{##} Only include impairment allowances on loans classified as “substandard”, “doubtful” and “loss” under the Group’s classification of loan quality.

The term “impaired loan” is now used as a replacement for the terms “Non-performing Loans” and “Classified Loans”. However, the Group has continued to use the 3 Classifications (“Sub-standard”, “Doubtful” and “Loss”) to categorize impaired loans.

Movement of gross impaired advances to customers		
In HK\$ bln	2005	2004
Beginning balance	9.2	18.0
New impaired loans	1.7	2.4
Upgraded impaired loans	(1.2)	(1.0)
Collection	(3.8)	(7.3)
Write-off	(1.1)	(2.9)
Others	(0.5)	–
Ending balance	4.3	9.2

In 2005, the Group's impaired loans decreased substantially by HK\$4,983 million, or 53.9% compared to 2004. Impaired loan ratio improved by 1.67 percentage points to 1.28% due to strong collection and recovery efforts. Total collections amounted to approximately HK\$3.8 billion. Write-offs of impaired loans amounted to HK\$1.1 billion. About HK\$0.4 billion of the reduction in impaired loans was due to the treatment of repossessed assets as a direct offset against the impaired loans outstanding, as prescribed by HKFRS 5.

Total impairment allowances, including both IA and CA, amounted to HK\$1,714 million. Impairment allowances for impaired loan ratio was 29.77%. If the value of underlying collateral was included, the total coverage ratio would increase to 99.88%. The Group also held a regulatory reserve amounting to HK\$3,526 million. This regulatory reserve balance was created by a transfer of HK\$3,410 million from retained earnings at the beginning of the financial year plus an increase of HK\$116 million during the year. The latter increase was created also by a transfer from the retained earnings and had no impact on the attributable profit of the Group.

The quality of the Group's residential mortgage loans continued to improve. The combined delinquency and rescheduled loan ratio decreased from 0.61% at end-2004 to 0.30%. The quality of card advances also improved, with the delinquency ratio and charge-off ratio dropping from 0.38% and 3.96% to 0.32% and 2.67% respectively.

Capital and Liquidity Ratios		
HK\$m, except percentage amounts	At 31 December 2005	At 31 December 2004
Tier 1 capital	64,213	60,905
Tier 2 capital	3,991	5,049
Unconsolidated investment and other deductions	(1,004)	(1,257)
Total capital base after deductions	67,200	64,697
Risk-weighted assets		
On-balance sheet	412,851	369,875
Off-balance sheet	30,713	34,045
Deductions	(6,450)	(3,091)
Total risk-weighted assets	437,114	400,829
Total risk-weighted assets adjusted for market risk	438,213	400,977
Capital adequacy ratios (banking group level)		
Before adjusting for market risk		
Tier 1	14.69%	15.19%
Total	15.37%	16.14%
After Adjusting for market risk		
Tier 1 *	14.65%	15.19%
Total *	15.33%	16.13%
	Full-year ended 31 December 2005	Full-year ended 31 December 2004
Average liquidity ratio	42.02%	36.03%

* The capital adequacy ratios take into account market risks and are calculated in accordance with the relevant HKMA guidelines.

Total capital base of the Group after deduction continued to rise and ended the year with an increase of HK\$2,503 million or 3.9% over the balance at 31 December 2004 mainly due to increase in retained earnings. However, the consolidated capital adequacy ratio of the banking group fell to 15.37% from 16.14% in 2004 because of the 9.1% increase in total risk-weighted assets. This was the result of an increase in loan advances to customers and securities investment, which was partially offset by the reduction in interbank placements.



The impact of the new accounting standards on capital base was not significant at both the Group and the bank levels. In accordance with the HKMA guideline "Impact of the New Hong Kong Accounting Standards on Authorized Institutions' Capital Base and Regulatory Reporting", collective assessment allowances of HK\$731 million and regulatory reserve of HK\$3,571 million appropriated from retained earnings were included as Tier 2 capital. At 31 December 2004, general provisions eligible as Tier 2 capital were HK\$5,049 million.

Average liquidity ratio rose to 42.02%, compared to 36.03% in 2004. Although the Group managed to lengthen average asset duration for yield enhancement, liquefiable liabilities with remaining maturities less than one month also decreased drastically as deposits migrated from demand and savings to fixed deposits ultimately helped return a stronger liquidity position.

Business Review

This section covers the review of the Group's business lines together with their respective financial results. Certain year-on-year figures in the following business segment analysis are not strictly comparable because of the adoption of the new accounting standards.

Retail banking			
	Full-year ended 31 December 2005	Full-year ended 31 December 2004	Increase/ (decrease)
HK\$m, except percentage amounts			
Net interest income	7,371	5,445	+35.4%
Other operating income	2,634	2,578	+2.2%
Operating income	10,005	8,023	+24.7%
Operating expenses	(4,446)	(3,897)	+14.1%
Operating profit before impairment/ provisions on advances	5,559	4,126	+34.7%
Loan impairment release/(charge) for bad and doubtful debts	956	28	+3,314.3%
Others	(12)	(1)	+1,100.0%
Profit before taxation	6,503	4,153	+56.6%
	At 31 December 2005	At 31 December 2004	Increase/ (decrease)
Segment assets	157,892	132,790	+18.9%
Segment liabilities	551,428	567,309	- 2.8%

Note: For additional segmental information, see Note 52 to the Accounts.

Results

Retail Banking posted a 56.6% growth on profit before taxation to HK\$6,503 million mainly due to the increase in deposit spread and an increase in loan impairment release.

Net interest income rose by 35.4% to HK\$7,371 million. Although the narrowing of the prime-HIBOR spread reduced the overall profitability of prime based loan, which formed the majority of Retail Banking's loan assets, the higher interbank rates increased the yield of low-cost deposits, thereby increasing the segment's overall net interest income. Other operating income consisted mainly of net fees and commissions. Net fees and commissions income was up slightly by 1.6% or HK\$33 million. Growth of insurance commissions and credit card commissions outweighed the declines in commissions from stock-broking and sales of funds.

The segment also reported a net loan impairment release of HK\$956 million in 2005, compared to only HK\$28 million in 2004. The substantial increase of the loan impairment release was largely attributable to lower delinquency ratio and higher collateral values.

Advances and other accounts, including mortgage loans and card advances, increased by 4.6% to HK\$127,462 million from end-2004. Customer deposits decreased slightly by 1.8% to HK\$533,639 million.

Growth of fee income from wealth management

Wealth management was one of the top priorities in the Group's 2005 business development strategies. Despite the interest rate hike and keen market competition, the Group's wealth management customers and assets under management grew by 64% and 50% respectively compared to 2004. Although the sales of capital guaranteed funds were inactive, the sales of open-end funds and structured notes recorded satisfactory growth of 70% and 27% respectively. The Group's insurance business was boosted by the success of several innovative insurance products such as "Get-Free Insurance Plan" and "Supreme Saver 5 Year Life Endowment Plan".

Leadership maintained in mortgages

Through effective marketing and wider assortment of mortgage products, mortgage loan balance managed to increase by 3.7% in the midst of fierce market competition. The Group maintained its position as the market leader in residential mortgage business in 2005. To enhance profitability, the Group adjusted its mortgage pricing strategy in the second half of the year. As mentioned above, the asset quality of residential mortgage improved, while negative equity ratio at the end of 2005 dropped further due to appreciating property prices.

Focus on high net worth customers

Wealth Management Prime and Wealth Management VIP services were launched in December 2004 and January 2005 respectively. These products are customized to provide professional wealth management services to customers with assets under management of above HK\$500,000 and HK\$2,000,000 respectively. Currently, 92 Wealth Management Prime and 13 Wealth Management VIP centres have been set up, providing an exclusive and comfortable service environment for valued customers.



Continued growth of credit card business

The Group's card business maintained its growth momentum in 2005 in terms of customer base and service range. Card advances increased by 9.7% and the number of cards issued grew by 6.9% from end of 2004. Cardholder spending volume and merchant acquiring volume registered double-digit growth of 17.4% and 17.3% respectively. The Group's outstanding performance and service quality were duly recognised by the industry. During the year, the Group won 19 awards from MasterCard International, Visa International, the Hong Kong Trade Development Council and the International Licensing Industry Merchandisers' Association. The Group also looked for development opportunities in other Asian countries. In conjunction with the Bank of China, the Group successfully launched the new BOC VISA and BOC MasterCard in Singapore in June 2005. In Thailand, the Group started the China UnionPay card acquiring business in January 2005.

Rationalization of branch network

To cope with the rapid expansion and development of its wealth management business, the Group continued its channel rationalization by adding three more branches to its network. The Group also revamped 43 wealth management locations, which included 34 Wealth Management Centres and 9 VIP Centres. By the end of 2005, the total number of branches located in Hong Kong was 286 and the total number of ATMs was 456.

Other achievements

The Group remained the market leader in the Renminbi (RMB) personal banking services and continued to achieve satisfactory results in various RMB related businesses. RMB deposits grew sharply by 74% in 2005. RMB credit card spending recorded a remarkable increase of 265%. The number of ATMs providing RMB withdrawal service increased to 236 in 2005.

The Group was one of the leading banks in Hong Kong that extended RMB services to corporate customers. New services included "RMB Merchant Link", a one-stop RMB notes collection service for designated merchants; and "BOC Remittance Plus" Service which allows same-day fund transfer to designated locations in the Mainland.

Continuous progress was made on e-channel developments by enhancing and expanding iTS internet banking functions, especially in the area of investment services. In view of rising concern on internet security, the Group launched the two-factor authentication function in June 2005 to safeguard the use of online banking.

Corporate banking			
	Full-year ended 31 December 2005	Full-year ended 31 December 2004	Increase/ (decrease)
HK\$m, except percentage amounts			
Net interest income	3,966	3,643	+8.9%
Other operating income	1,115	1,201	– 7.2%
Operating income	5,081	4,844	+4.9%
Operating expenses	(1,300)	(1,211)	+7.3%
Operating profit before impairment/ provisions on advances	3,781	3,633	+4.1%
Loan impairment release/write-back of bad and doubtful debts	1,689	1,600	+5.6%
Others	(1)	1	N/A
Profit before taxation	5,469	5,234	+4.5%
	At 31 December 2005	At 31 December 2004	Increase/ (decrease)
Segment assets	211,834	187,947	+12.7%
Segment liabilities	101,710	90,054	+12.9%

Note: For additional segmental information, see Note 52 to the Accounts.

Results

Corporate Banking reported a 4.5% rise in profit before taxation to HK\$5,469 million. Net interest income increased by 8.9% to HK\$3,966 million whereas other operating income fell by 7.2% to HK\$1,115 million. Operating expenses were up 7.3% to HK\$1,300 million.

The rise in net interest income was helped by the expansion of the sector's balance sheet despite pressure on loan spread. Other operating income decreased as the new accounting standards requires the amortization of directly attributable loan fees as interest income using effective interest rate calculation, thereby reducing the syndicated loan fees.

Loan impairment release was HK\$1,689 million, up by HK\$89 million or 5.6% from a year ago. Asset quality of the corporate loan portfolio continued to improve with lower new impaired loan formation and higher collateral values resulting from stable property prices. Recoveries remained strong under the favourable market conditions.

Corporate Banking sector achieved satisfactory growth in loans and advances in 2005. Advances and other accounts increased by 10.1% to HK\$205,066 million. Customer deposits increased by 13.3% to HK\$99,452 million.



Leadership maintained in syndicated lending

The Group remained the market leader in arranging and participating in syndicated loans in the Hong Kong and Macau market, and was ranked No.1 on the top-tier arranger list.

Growth of market share in SME business

In 2005, a new SME Business Model was implemented to better serve SME clients. Through the establishment of the Credit Management Division, SME loan approval was expedited. The Group launched a number of products such as SME Quick Loan and seasonal trade financing facility arrangement to cater for the needs of SME clients. As a result of these initiatives, the total volume of SME loans increased by 9.1%.

Growth of trade finance and enhancement of capability in cash management

Trade finance and bills processing volume registered solid growth despite increasing competition. During the year, bills processing volume rose by 12.6%. This was largely attributed to the upgrading of services through the Group's new trade services system. The new system not only improves workflow and efficiency in customer service, but also provides a solid operating platform for the future growth of the Group's trade finance business.

In 2005, the cash management system was successfully linked to the systems of BOC overseas branches. This facilitates customers to access real-time consolidated worldwide information, thus making it infinitely more convenient for large corporate clients in terms of cash management.

Enhancement of e-banking services, CBS Online

In 2005, the number of CBS Online customers continued to grow as several valued-added services were added. The Group's CBS e-banking service enables corporate customers to process various banking transactions and obtain account information online effectively.

Mainland Branches

Following the growth in 2004, the Group's Mainland branches continued to report strong results in 2005. Operating profit before provisions increased by 106% to HK\$303 million. Total advances to customers of our Mainland branches rose significantly by 61.4% to HK\$15,093 million while customer deposits increased by 1.4% to HK\$2,316 million.

During the year, there was further consolidation of the Group's new China business model and matrix management model whereby a head office based in Shanghai would coordinate the China business conducted respectively by BOCHK's Mainland branches, Nanyang Commercial Bank and Chiyu Banking Corporation.

Overall sales capabilities and services in various regions were expanded. By the end of 2005, the Group had nine Mainland branches that were permitted to participate in RMB business. All 14 branches now have the license to provide insurance agency services. In the second half of the year, the Mainland branches introduced the "Structure Deposits Service", "Wealth Management" service and "Option Linked Deposits".

Persistent efforts have been made in the integration of business operation of the Group's retail and corporate banking units in China. Meanwhile, collaboration with BOC has been further strengthened to jointly develop mutually rewarding business. These efforts have solidified the Group's foundations in China and accelerated cross-border services. In 2005, more than 150 cross border customers were referred bilaterally.



Treasury			
HK\$'m, except percentage amounts	Full-year ended 31 December 2005	Full-year ended 31 December 2004	Increase/ (decrease)
Net interest income	2,529	2,153	+17.5%
Other operating income	1,048	533	+96.6%
Operating income	3,577	2,686	+33.2%
Operating expenses	(308)	(296)	+4.1%
Operating profit before impairment/ provisions on advances	3,269	2,390	+36.8%
Others	(96)	2	N/A
Profit before taxation	3,173	2,392	+32.7%
	At 31 December 2005	At 31 December 2004	Increase/ (decrease)
Segment assets	426,790	453,457	- 5.9%
Segment liabilities	84,049	68,485	+22.7%

Note: For additional segmental information, see Note 52 to the Accounts.

Results

For 2005, Treasury reported a profit before taxation of HK\$3,173 million, an increase of 32.7% due to higher operating income.

Net interest income increased by HK\$376 million or 17.5%. Although the flattening yield curve had a negative impact on net interest income, enhanced yields from short-tenor debt securities helped mitigate the effects of the interest rate abnormality and protected the growth of interest income.

Other operating income increased by HK\$515 million or 96.6% due to favourable changes in the fair values of foreign exchange swap contracts, interest rate derivatives and other financial instruments.

Investment portfolio diversification to maximize return on residual funds

The Group diversified its medium to long-term investments with mortgage-backed securities, covered bonds and corporate bonds in an attempt to maximize the return on residual funds. This diversification also helped in reducing concentration risks.

Development of sophisticated and customized treasury products

The Group continued to expand its treasury product offerings by introducing a variety of structured deposits geared towards customers' needs such as Gold Linked Deposits (GLD) and Equity Linked Deposits (ELD). The development of these new products significantly enhanced the Group's wealth management capability and directly contributed to the expansion of the size and business volume of the wealth management customer base. This also helped broaden the Group's corporate client base and enriched clients' portfolio.

Leverage on retail and corporate distribution channels

The Group continued to expand the size of its treasury customer base. This was achieved through closer co-operation with the retail and corporate distribution channels, supported by Treasury's strengthened sales and customer services team. A special unit was also formed to provide more personalized support to treasury customers. The number of treasury customers increased by 46% in 2005.



Risk Management

Overview

Risk management is a vital part of the Group's corporate governance framework. The Group believes that sound risk management is a key success factor for any organisation. As such, in its daily operation, the Group emphasises that risk management is the foundation of healthy business development and that a balance must be achieved between risk control and business growth. The principal types of risk inherent in the Group's business are reputation risk, legal and compliance risk, strategic risk, credit risk, market risk, interest rate risk, liquidity risk and operational risk. The Group's risk management objective is to enhance shareholder value while maintaining risk exposures within acceptable limits.

Risk Management Governance Structure

The Group's risk management governance structure is designed to cover the whole process of all businesses and ensure various risks are properly managed and controlled in the course of business. The Group has a sound risk management organisational structure as well as comprehensive policies and procedures to identify, measure, monitor and control various risks across the organisation. These risk management policies and procedures are regularly reviewed and modified to reflect changes in markets and business strategies. Various groups of risk takers assume their respective responsibilities for risk management.

The Board of Directors, representing the interests of shareholders, has the ultimate responsibility for risk management. The Board, with the assistance of its committees, has the primary responsibility for the determination of risk management strategies and for ensuring that the Group has an effective risk management system to implement these risk management strategies. The Risk Committee ("RC"), established by the Board of Directors as a standing committee, is responsible for approving major risk management policies and procedures and major asset and liability management policies.

The Chief Executive's ("CE") responsibility is to ensure the proper implementation of the policies and procedures and various risk limits in accordance with the risk management strategies set by the Board, and to oversee the effectiveness of managing and controlling risk in the day-to-day management. The Chief Risk Officer ("CRO") and the Chief Financial Officer ("CFO") assist the CE to manage various types of risks. The CRO oversees the management of reputation risk, legal and compliance risk, credit risk, market risk and operational risk. The CFO is responsible for strategic risk, interest rate risk and liquidity risk.

BOCHK's principal banking subsidiaries, Nanyang and Chiyu, are managed under risk policies that are consistent with those of the Group. These subsidiaries execute their risk management strategy independently and report to BOCHK's management on a regular basis.

Reputation Risk Management

Reputation risk is the risk that negative publicity regarding the Group's activities, factual or otherwise, may cause a potential decline in the Group's business or lead to costly litigation. Reputation risk is inherent in every aspect of the Group's business operation and covers a wide spectrum of issues.

In order to mitigate reputation risk, the Group has formulated and implemented a Reputation Risk Management Policy. This policy establishes standards to prevent and to manage reputation risk proactively at an early stage. It requires constant monitoring of external reputation risk incidents and published failures of risk incidents within the financial industry.



Legal and Compliance Risk Management

Legal risk is the risk that unenforceable contracts, lawsuits or adverse judgments may disrupt or otherwise negatively affect the operations or financial condition of the Group. Compliance risk is the risk of legal and regulatory sanctions, which may directly result in financial loss, or affect the reputation of the Group caused by non-compliance to applicable laws, regulations and best industry practices. By establishing and maintaining appropriate policies and guidelines, the CRO, working through the Legal and Compliance Department, is responsible for proactively identifying and managing these risks.

Strategic Risk Management

Strategic risk generally refers to the risks that may induce current or future negative impacts on the financial and market positions of the Group because of poor strategic decisions, improper implementation of strategies and lack of response to the market. The Group has developed a Strategic Risk Management Policy that clearly defines the management and oversight of such risks.

Credit Risk Management

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract that it has entered into with the Group. Credit risk arises principally from the Group's lending, trade finance and treasury activities.

Risk Management Department (RMD), under the supervision of CRO, provides centralized management of credit risk within the Group. Credit policies and procedures are formulated by RMD and are approved by the RC and the Board of Directors. Such policies include setting controls over the maximum level of the Group's exposure to customers and customer groups and other risk concentrations in selected market sectors, industries and products. These credit policies and procedures are regularly updated and serve as guidance to business units as to the risk appetite of the Group from time to time.

RMD also undertakes independent review and objective assessment of credit facilities originated by business units. Different credit approval and control procedures are adopted according to the level of risk associated with the customer or transaction. Currently, a credit scoring system is used to process retail credit transactions, including residential mortgage loans, personal loans and credit cards. The Credit Risk Assessment Committee comprising experts from credit and other functions of the Group is responsible for making an independent assessment of all credit facilities which require the approval of Deputy Chief Executives or above.

The Group adopts an eight-grade facility grading structure according to HKMA's loan classification requirement. RMD provides regular credit management information reports and ad hoc reports to members of Management Committee, RC, AC and Board of Directors.

Market Risk Management

Market risk is the risk associated with the movements of foreign exchange rates, interest rates or equity and commodity prices on the earnings of the Group. The Group's market risk arises from customer-related business and from position taking. Trading positions are subject to daily marked-to-market valuation. Market risk is managed within the risk limits approved by the RC. The overall risk limits are divided into sub-limits by reference to different risk factors, including interest rate, foreign exchange rate, commodity price and equity price.

The Market Risk Division in RMD is responsible for the daily oversight of the Group's market risk. The Division ensures that the overall and individual market risk positions are within the Group's risk tolerance.



VaR is a statistical technique which estimates the potential losses that could occur on risk positions taken over a specified time horizon within a given level of confidence. The Group uses historical movements in market rates and prices, a 99% confidence level and a 1-day holding period to calculate portfolio and individual VaR.

The following table set out the VaR for all trading market risk exposure of BOCHK.

HK\$m		At 31 December	Minimum during the year	Maximum during the year	Average for the year
VAR for all market risk	– 2005	1.8	1.2	5.8	2.6
	– 2004	2.9	0.9	5.6	3.2
VAR for foreign exchange risk	– 2005	1.2	0.6	5.2	1.9
	– 2004	2.3	0.5	5.0	2.2
VAR for interest rate risk	– 2005	1.4	0.9	3.7	2.1
	– 2004	1.9	0.5	4.4	2.4
VAR for equity risk	– 2005	0.1	0.0	0.5	0.1
	– 2004	0.1	0.1	2.6	0.5

For the year ended 31 December of 2005, the average daily revenue of BOCHK earned from market risk related trading activities was HK\$2.0 million (2004: HK\$2.1 million). The standard deviation of these daily trading revenues was HK\$1.8 million (2004: HK\$2.3 million).

The RMD is also responsible for monitoring foreign exchange exposure and related stop-loss limits on a day-to-day basis as well as the credit risk exposure arising from foreign exchange transactions.

Interest Rate Risk Management

The Group's interest rate risk exposures are mainly structural driven. The major types of structural positions are:

- repricing risk – mismatches in the maturity or repricing periods of assets and liabilities
- basis risk – different pricing basis for different transactions so that yield on assets and cost of liabilities may change by different amounts within the same repricing period

The Group's Asset and Liability Management Committee ("ALCO") maintains oversight of interest rate risk and the RC sanctions the interest rate risk management policies formulated by the ALCO. The Finance Department identifies, measures and monitors interest rate risk on a daily basis.

Gap analysis is one of the tools used to measure the Group's exposure to repricing risk. This provides the Group with a static view of the maturity and repricing characteristics of its balance sheet positions. The Group uses interest rate derivatives to hedge its interest rate exposures and in most cases, plain vanilla interest rate swaps are used.

Sensitivities of earnings and economic value to interest rate changes (Earnings at Risk and Economic Value at Risk) are assessed through hypothetical interest rate shock of 200 basis points across the yield curve on both sides. Earnings at Risk and Economic Value at Risk are respectively controlled within an approved percentage of the projected net interest income for the year and the latest capital base as sanctioned by the RC. The Finance Department reports the results to the ALCO and the RC on a regular basis.

The impact of basis risk is gauged by the projected change in net interest income under scenarios of imperfect correlation in the adjustment of the rates earned and paid on different instruments. Ratios of assets to liabilities with similar pricing basis are established to monitor such risk.

Stress tests on repricing risk and basis risk are conducted regularly. The ALCO monitors the results of stress tests against limits and decides whether remedial action should be taken.

Liquidity Risk Management

The goal of liquidity management is to enable the Group, even under adverse market conditions, to meet all its maturing repayment obligations on time and to fund all of its asset growth and strategic opportunities, without forced liquidation of its assets at short notice.

The Group funds its operations principally by accepting deposits from retail and corporate depositors. In addition, the Group may issue certificates of deposit to secure long-term funds. Funding may also be secured through adjusting the asset mix in the Group's investment portfolio. The Group deposits in the interbank market and uses the majority of funds raised to extend loans, to purchase debt securities or to conduct interbank placements.

The primary goal of the Group's asset and liability management strategy is to achieve optimal return while ensuring adequate levels of liquidity and capital within an effective risk control framework and ALCO is responsible for establishing these policy directives (including the liquidity contingency plan), and the RC sanctions the liquidity management policies. The Finance Department closely monitors the liquidity risk of the Group using cash flow analysis and by examining deposit stability, concentration risk, loan to deposits ratio and liquidity profile of the investment portfolio reports to the Management and ALCO regularly.

Operational Risk Management

Operational risk relates to the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events. An Operational Risk Management Division is set up within the RMD to oversee the entire operational risk management framework of BOCHK.

The Group has put in place an effective internal control process which requires the establishment of detailed policies and control procedures for all the key activities. Proper segregation of duties and independent authorisation are the fundamental principles followed by the Group. Business line management is responsible for managing and reporting operational risks specific to their business units on a day-to-day basis by identifying, assessing and controlling the risks inherent in business processes, activities and products. These are followed by periodic monitoring and ongoing review of changes by the RMD. The RMD formulates corporate-level policies and procedures concerning operational risk management which are approved by the RC. The RMD evaluates the operational risk profile, records operational risk data and reports operational risk issues to the RC and senior management.

Business continuity plans are in place to support business operations in the event of disasters. Adequate backup facilities are maintained and periodic drills are conducted. The Group also arranges insurance cover to reduce potential losses in respect of operational risk.

Capital Management

The major objective of capital management is to maximize total shareholders' return while maintaining a strong capital position. The Group periodically reviews its capital structure and adjusts the capital mix where appropriate to achieve the lowest overall cost of capital. The ALCO, with the assistance of the Finance Department, monitors the Group's capital adequacy. The Group has complied with all the statutory capital standards for all the periods presented in the report.

Stress Testing

The Group supplements the analysis of various types of risks with stress testing. Stress testing is a risk management tool for estimating the Group's risk exposures under stressed conditions arising from extreme but plausible market or macroeconomic movements. These tests are conducted on a regular basis and the results are reported.

