ECONOMIC REVIEW

Hong Kong remained in the grip of recession during the first half of 2002. GDP fell by 0.9% year-on-year in the first quarter, the third successive quarter of contraction. Unemployment hit a record high of 7.7% in June, compared to 6.1% at the end of 2001. This has contributed to a 300% increase in the number of voluntary personal bankruptcy petitions, a matter of concern to the community as a whole. The consumer price index continued its decline, extending the fall in prices for 44 consecutive months through June. Retail sales were volatile, up in one month and down the next. Property values remained soft, with the property index down 3%. Standard & Poor's reduced the ratings for several major property companies and changed the outlook to negative for others because of a lack of demand and supposed weakening of those companies' finances, although this was sharply disputed. The government's budget deficit exceeded forecasts from last year, with the final figure for the year ended 31 March 2002 being HK$63.3 billion, the worst shortfall in Hong Kong's history. The question of structural versus cyclical deficits became an issue with rating agencies which, while maintaining Hong Kong's rating of A+/Stable/A-1 (long term/outlook/short term respectively), warned that failure to address the shortfall would eventually lead to a downgrade.

Stock market performance reflected the malaise that pervaded Hong Kong. The Hang Seng Index has drifted lower in line with global equity markets this year. Turnover was down 18% compared to 2001. The number of new listings also fell, but the pipeline of large IPOs is long, with an estimated HK$122 billion due to be raised in the market this year. Unit trust sales and purchases rose 37% in the first quarter of the year. Bond sales were also strong as investors attempted to diversify their portfolio risk. Local banks were at the forefront of selling these products to their customers through specialized offices. Interest rates remained subdued as liquidity pervaded the market. Hong Kong Dollar Prime was unchanged at 5.125% following the last cut in mid-December. After rising slightly in March in anticipation of a rapid recovery in the US, interbank rates softened again when it became clear that US growth was spotty. Economists did detect some encouraging signs when exports picked up in March and April, but business is aware that the strong trade figures in 2000 did not translate into domestic consumption or improved profits going forward.

Banks, operating for the first full year in a completely deregulated market, saw little loan demand. Hong Kong dollar loans rose a meager 0.7% in the first quarter of the year. Hong Kong dollar deposits declined by 1.2% during the same period. Without strong loan demand, most banks have not been overly aggressive in soliciting deposits. The low interest rates paid on deposits have encouraged disintermediation, with consumers investing in corporate bonds, quasi-government paper and unit trusts. This is likely to lead to a narrowing of net interest margins, which combined with the lack of loan growth, has limited the growth in net interest income. The fee income picture is also mixed, with an increase in revenues from sales of investment products, but pressure on trade finance commissions and loan fees. Operating expenses are up slightly as the cost of technology remains a factor. The increase in personal bankruptcies reported above has resulted in increased provisions, although corporate loan quality seems to be holding up. Banks have not benefited as much from gains on securities portfolios given the different interest rate scenario compared to 2001. Analysts are forecasting a very challenging year for banks.

IBA PERFORMANCE

IBA continued to strengthen its balance sheet, diversify revenue sources and carve out a niche as an innovative institution, preparing itself for a hoped for upturn in the economy. Through a judicious approach to asset and liability management, net interest income rose 1.4% to HK$374 million despite lower loan outstandings and pressure on pricing. The net interest margin actually rose from 2.69% in the first half of 2001 to 2.89% for the first half of 2002. This resulted from an emphasis on consumer and hire purchase loans, and the very successful introduction of the Magic Money Manager checking account in July 2001. This has now attracted more than 30,000 customers and over HK$2 billion in low cost deposits. IBA has one of the highest net interest margins in the industry, and is one of the few banks which has been able to boost this margin in the face of extraordinary pricing pressure.

Other operating income of HK$81 million was up 12%, although some of the traditional sources of fee income were affected by the weak economy. By fully exploiting IBA's different sales channels, IBA has expanded both the range of products and the customer base, offsetting the decline in stock market turnover and trade finance. IBA Wealth Management Centers, which now number seven after the inauguration of the new Hunghom Wealth Management Center in July, provide our growing list of customers with equity, bond, unit trust, equity-linked note and insurance investment opportunities. The professionalism of staff and the convenience of execution distinguish IBA from its bank and non-bank competitors. Operating income reached HK$455 million, an increase of 3%. Operating expenses fell by 1.4% to HK$222 million as the implementation of revisions in processing procedures and the early introduction of Six Sigma methodology, so successful in firms such as Motorola, General Electric and Citigroup, begin to pay dividends. Operating profit before provisions and gains on disposals of investments in securities rose to HK$233 million, an 8% increase over the first half of 2001.

Provisions for bad and doubtful debts were HK$187 million, a reflection of difficult economic times for the consumer. Most of the increase was due to the surge in bankruptcy petitions and a decision to accelerate provisions, adopting a conservative policy of providing 100% of the outstanding balances at the time individuals file a petition for bankruptcy, although the outcome of the petition and the amount of assets available for distribution are not known at the time of the filing. Despite the stable interest rate environment, which contrasted with the steady cut in rates over 2001, gains on disposal of investments in securities reached HK$61 million, demonstrating that the new treasury team established at the beginning of the year is capable of reading market trends and is able to capture the value in our portfolio. Net profit for the half year was HK$101 million, compared to HK$162 million for the comparable period in 2001.

The cost-to-income ratio declined to 48.7% as expense controls and leveraging of the revenue base started to kick in. Non-interest income increased as a percentage of operating income to 17.7%, more than 100 basis points higher than the previous year. Return on assets stood at 0.71% and return on average equity was 5.55%, reflecting the very strong capital base, with a capital adequacy ratio of 20.78% compared to the statutory minimum requirement of 8%.

Net loans outstanding as of 30 June 2002 were HK$15.5 billion, a decline of 12% from June 2001. As noted, there was growth in higher yielding consumer loans and hire purchase advances, with a decline in housing loans where market pricing is under the greatest pressure. Non-performing loans continued to decline, falling to 3.3% of the portfolio. Cash and placements with banks reached HK$6.1 billion, producing an average liquidity ratio of 53.98%, versus the statutory requirement of 25%. The investment portfolio, comprised primarily of Hong Kong Government Exchange Fund paper and US Treasuries, along with some highly-rated corporate bonds and other banks' certificates of deposit, rose to HK$5 billion. This high quality, liquid portfolio has become an integral part of IBA's business operations.

The most notable development in the liability structure was the shift into lower cost current and savings accounts, which now comprise 14% of the total customer deposit base of HK$24 billion. Although many consumers are investing in alternative instruments to enhance yield, resulting in an overall decline in the banking system deposits, IBA's loan to deposit ratio and the attraction of new customers on the basis of product features rather than pricing has produced a loan to deposit ratio of 64%, a very comfortable level. In June IBA launched three different callable CD issues aimed at individual investors. Through the use of an interest rate swap, these innovative instruments provide an attractive return to the public while providing the Bank with medium term funding at an interest rate below HIBOR. The issues, which were comprised of 3-year CDs callable after one year and 4-year CDs callable after two years, raised a total of HK$477 million, and generated attractive selling commissions while attracting hundreds of new customers to IBA, solidifying our reputation for innovative financial services.

During the first half of 2002 IBA continued to exploit technology. A fully automated stock order system was installed in all the wealth management centers, providing automatic order checking and execution, enhancing our ability to serve customers and monitor our business. A data warehouse overlain with sophisticated customer relationship management software was installed, and linked to the IBA Call Center. The system not only allows us to conduct highly segmented marketing campaigns, but also to conduct in depth analysis of the customer base, activity trends, and credit exposure. We will build on this in the second half of the year to increase revenues.

In addition to the seventh wealth management center opened in Hunghom in July, IBA added a new consumer finance center in Shatin, bring the total to five. Ideally placed, the centers have exceeded budget in attracting new business.

With the addition of new personnel in corporate banking, credit card operations and support units, IBA has strengthened the management team in preparation for a new period of growth. Not simply focusing on growth in revenues and credit quality, IBA has devoted considerable resources to staff training and corporate governance. Continuing its partnership with DePaul University of Chicago, one of the premier institutions for business study in the United States, a third MBA program and a second BA program are in progress. IBA will also be establishing a Leadership and Management Center to ensure that key staff are fully prepared to meet the challenges of the rapidly evolving banking industry. The appointment of a Corporate Governance and Compliance Officer last year was timely. The officer and her support staff have initiated a wide range of training and consultative programs to ensure that transparency, accuracy and ethics continue to be the hallmark of IBA.

The directors have approved an interim dividend of 4 Hong Kong cents per share compared to 4 Hong Kong cents per share for the corresponding period of 2001.

Mike M. Murad
Vice Chairman, Managing Director and Chief Executive Officer

3 August 2002