# Notes to Consolidated Financial Statements

For the year ended 30 June 2002 (All amounts are expressed in thousands of dollars unless otherwise stated)

## NOTE 1: Significant Accounting Policies

These consolidated financial statements are prepared in accordance with accounting principles generally accepted in Bermuda and Canada. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the financial statements. Estimates also affect the reported amounts of income and expenses for the reporting period. Actual results could differ from those estimates. The significant accounting policies followed in the preparation of these consolidated financial statements are summarised below:

**(a) Basis of Consolidation:** The consolidated financial statements include the assets, liabilities and results of operations of the Bank and all of its subsidiaries. Subsidiaries are companies which the Bank controls and are normally those in which the Bank owns directly or indirectly more than 50% of the voting shares. Effective 1 July 2001 the Bank adopted the revised recommendations of the Canadian Institute of Chartered Accountants (CICA) on accounting for business combinations. The new standard requires the use of the purchase method to account for all business combinations and requires the recognition of certain other intangible assets acquired in a business combination apart from goodwill. On transition, for business combinations completed before 1 July 2001, where the carrying amount of acquired intangible assets does not meet the criteria for separate recognition, the assets should be reclassified to goodwill while items meeting the definition of intangibles but originally recorded as goodwill should be reclassified and accounted for as intangible assets. The difference between the acquisition cost of an investment and the fair value of the net assets (including certain intangible assets) acquired represents goodwill. The Bank's interest in joint ventures is recognised using the proportionate consolidation method. Under this approach the Bank's share of the joint venture's assets, liabilities, revenues and expenses is reported on a line-by-line basis.

**(b) Goodwill and Other Intangible Assets:** Effective 1 July 2001 the Bank adopted the revised recommendations of the CICA on accounting for goodwill and other intangible assets. Under the new standard, goodwill is no longer amortised but will be subject to a revised annual impairment test to identify any potential goodwill impairment. A goodwill impairment loss will be recognised if the fair value of the goodwill of a reporting unit is less than its carrying amount. The Bank will continue to amortise to income intangible assets other than goodwill with a definite life over their estimated useful lives on a straight-line method, not to exceed 20 years, as provided for in the new standard.

**(c) Translation of Foreign Currencies:** Assets and liabilities arising from foreign currency transactions are translated into Bermuda dollars at the rates of exchange prevailing at the balance sheet date while associated revenues are translated into Bermuda dollars at the average rates of exchange prevailing throughout the year.

Resulting gains or losses are included as foreign exchange income in the Consolidated Statement of Income. Assets and liabilities of the Bank's foreign operations are translated into Bermuda dollars at the rates of exchange prevailing at the balance sheet date while associated revenues and expenses are translated into Bermuda dollars at the average rates of exchange prevailing throughout the year. Exchange gains and losses arising from the translation of net investment positions and from the results of hedging these positions are reported in retained earnings.

**(d) Investments:** Investment portfolio securities are debt securities where the Bank's original intention is to hold to maturity and equity securities where the Bank's original intention is to hold for the long term. They are carried at cost or amortised cost, adjusted to recognise other than temporary impairment in the underlying value, except for money market mutual funds which are carried at market value, which approximates cost plus accrued and reinvested interest since acquisition. Investments held in the trading portfolio are intended to be held for a short period of time and are carried at market value and any adjustments to market value of these investments are included in the Consolidated Statement of Income. Venture capital investments are equity or debt investments where the Bank's original intention is to dispose of its interest in the medium term. They are initially recorded at cost, with subsequent adjustments recognised as gains or losses in investment income as a result of meaningful third-party transactions in the private market which indicate increases or decreases in fair value.

Dividend and interest income on all securities, including amortisation of premiums and discounts on debt securities held for investment, are included in investment income in the Consolidated Statement of Income.

**(e) Loans:** Loans are stated net of any unearned income and of an allowance for credit losses. Interest income is accounted for on the accrual basis for all loans other than impaired loans.

A loan is classified as non-accrual when, in management's opinion, there has been a deterioration in credit quality to the extent that there is no longer reasonable assurance of timely collection of the full amount of principal and interest. If an interest payment on a loan becomes contractually 90 days in arrears, the loan will be classified as non-accrual, if not already classified as such, unless the loan is fully secured, the collection of the debt is in process and the collection efforts are reasonably expected to result in repayment of the loan and overdue interest in full. Any credit card loan that has a payment that is contractually 210 days in arrears is classified as non-accrual. All non-accrual loans are considered impaired loans. When a loan is classified as non-accrual, recognition of interest ceases. Interest received on non-accrual loans is credited to the carrying value of the loan. Loans are generally returned to accrual status when the timely collection of both principal and interest is reasonably assured and all delinquent principal and interest payments are brought current.

**(f) Allowance for Credit Losses:** The Bank maintains an allowance for credit losses, which in management's opinion is adequate to absorb all credit-related losses in its portfolio relating to on and off balance sheet financial instruments. The allowance for credit losses consists of specific provisions and a general provision, each of which is reviewed on a regular basis. The allowance for credit losses is included as a reduction of the related asset category.

Specific provisions, except those relating to credit card loans, are determined on an item-by-item basis and reflect the associated estimated credit loss. In the case of loans, the specific provision is the amount that is required to reduce the carrying value of an impaired loan to its estimated realisable amount. Generally, the estimated realisable amount is measured by discounting the expected future cash flows at the effective interest rate inherent in the loan at the date of non-accrual. The change in the present value attributable to the passage of time on the expected future cash flows is reported as a reduction of the provision for credit losses in the Consolidated Statement of Income. When the amounts and timing of future cash flows cannot be measured with reasonable reliability, either the fair value of any security underlying the loan, net of expected costs of realisation and any amounts legally required to be paid to the borrower, or the observable market price for the loan is used to measure the estimated realisable amount. Specific provisions for credit card loans are equal to the total balance of credit card loans where payments are contractually 210 days in arrears.

A general provision is established in respect of the Bank's core business lines where a prudent assessment by the Bank of past experience and existing economic and portfolio conditions indicate that losses have occurred, but where such losses cannot be determined on an item-by-item basis. The general provision is determined by using historical trends in loss experience, weighted to emphasise recent periods, and the current portfolio profile together with management's evaluation of other conditions existing at the balance sheet date which are not reflected in historical trends. As the general provision principally relates to loans it is deducted from loans in the Consolidated Balance Sheet.

**(g) Land, Buildings and Equipment:** Land is carried at cost. Buildings, equipment and leasehold improvements are carried at cost less accumulated depreciation and/or amortisation. Depreciation and amortisation are calculated using the straight-line method over the estimated useful lives of the related assets, which are up to 50 years for buildings, up to 10 years for furniture, up to 5 years for computers and equipment and, in the case of leasehold improvements, the term of the lease.

Gains and losses on disposal are reported in other income in the Consolidated Statement of Income.

**(h) Employee Future Benefits:** The Bank maintains trusteed pension plans for substantially all employees including a non-contributory defined benefit and a number of defined contribution plans. Benefits under the defined benefit plan are primarily based on the employee's years of credited service and average annual salary during the final years of employment as defined in the plans. The Bank also provides post-retirement medical benefits for substantially all retired Bermuda based employees.

Effective 1 July 2000, the Bank adopted the revised recommendations of the CICA on accounting for pension benefits and on accounting for employees' future benefits. This standard requires the use of current market interest rates to estimate the present value of the liability and the use of current market prices for valuing the pension plan assets, whereas in previous years, an estimated long-term interest rate was used to determine the present value of the pension and medical benefits obligation. The change in accounting policy for employees' future benefits has been adopted prospectively such that the change in the net pension asset and the medical benefits liability at 1 July 2000, arising from adoption of the standard are being amortised over the relevant remaining service life of the employees covered by the defined benefit pension plan and the post-retirement medical benefits plan.

Expense for the defined benefit pension plan and the post-retirement medical benefits plan is comprised of (a) the actuarially determined benefits for the current year's service, (b) imputed interest on the actuarially determined liability of the plan, (c) in the case of the defined benefit pension plan, the expected investment return on the market value of plan assets and (d) amortisation of certain items over the expected average remaining service life of employees, in the case of the defined benefit pension plan, and the expected average remaining service life to full eligibility age of employees covered by the plan, in the case of the post-retirement medical benefits plan. The items amortised are amounts arising as a result of experience gains and losses, changes in assumptions, plan amendments and the change in the net pension asset or post-retirement medical benefits liability arising on adoption of the revised accounting standard on 1 July 2000.

For the defined benefit pension plan the cumulative difference between the funding contributions and the expense is reported in other assets. For the post-retirement medical benefits plan, the liability recognised for accounting purposes is reported in other liabilities.

The defined contribution pension plans provide for an annual contribution based on each participating employee's pensionable earnings. Amounts paid are expensed in the year.

**(i) Derivatives:** Derivatives are used for asset and liability management and proprietary trading purposes and also to provide clients with the ability to manage their own market risk exposures. The most frequently used derivative products are foreign exchange contracts and interest rate swaps.

Asset and liability management derivatives are used to manage the Bank's own exposure to interest rate and foreign exchange risks which arise from the Bank's balance sheet positions. Income and expense on these derivatives are recognised over the life of the related position as an adjustment to net interest income. Gains or losses on these derivatives are deferred and amortised over the remaining life of the related positions. Accrued income and expense and deferred gains and losses are included in other assets and other liabilities, as appropriate in the consolidated balance sheet. Unrealised gains and losses are not recognised. Proprietary trading derivatives are marked to market and realised and unrealised gains and losses are included in other income.

**(j) Securities Sold Under Agreements to Repurchase:** Securities sold under agreements to repurchase arise on the sale of a security, with the commitment by the Bank to repurchase the security at a specified price. The obligation to repurchase is recorded at the value of the cash received on sale adjusted for the amortisation of the difference between the sale price and the agreed repurchase price. The amortisation of this amount is recorded as an interest expense.

**(k) Loan to Stock Option Trust:** The loan made to finance the acquisition of shares by the Stock Option Trust is shown as a deduction from shareholders' equity. Dividends paid on the acquired shares are deducted in arriving at dividends paid reflected in the Statements of Changes in Shareholders' Equity and Cash Flows. The weighted average number of shares outstanding used in the calculation of earnings per share is calculated after deducting the shares held by the Stock Option Trust during the year.

**(l) Stock-based Compensation:** The Bank has a Stock Option Plan for all eligible employees. The Bank follows the intrinsic value method of accounting for stock options. Since the exercise price is set at an amount equal to the closing price on the day prior to the grant of the stock options, no compensation expense is recognised on the day of the grant. When options are exercised the proceeds received are credited to the loan to Stock Option Trust.

**(m) Earnings Per Share:** Earnings per share has been calculated using the weighted average number of shares outstanding during the year adjusted as described in 1(k) above and adjusted for the stock dividend declared during the year. (See also Note 22.) Fully diluted earnings per share, calculated after giving effect to the potential dilution arising from the existence of stock options, is not materially different from the earnings per share disclosed in the Consolidated Statement of Income. Effective 1 July 2001 the Bank adopted the revised recommendations of the CICA on accounting for earnings per share. The new standard requires the use of the treasury stock method, whereby the proceeds received from the exercise of stock options are assumed to be used to repurchase shares.

**(n) Future Accounting Policies:** In December 2001 the CICA issued Accounting Guideline 13 (AcG 13), “Hedging Relationships”, which addressed the identification, designation, documentation and effectiveness of hedging relationships for the purpose of applying hedge accounting. Effective 1 July 2002, the guideline requires the Bank to identify, document and demonstrate the effectiveness of all hedging relationships for which derivative instruments are used as cash flow or fair value hedges. Positions hedged with derivative instruments meeting AcG 13 requirements will continue to be accounted for using accrual accounting as described in note 1 (i). Otherwise they must be marked to market with realised and unrealised gains and losses being included in other income. The adoption of this standard is not considered to have a significant effect on the Bank's Consolidated Financial Statements. In November 2001, the CICA issued a new CICA handbook section 3870, “Stock-based Compensation”, which will be effective for the Bank in fiscal 2003. The new standard requires the use of a fair-value-based method to account for certain stock-based compensation arrangements. Options granted by the Bank to employees and directors are not required under the new standard to be accounted for using a fair value based method. Accordingly, there will be no change to the Bank's existing accounting policies for these options. Pro-forma fair value based income and Earnings per share disclosures will be required under the new standard.

## NOTE 2: Cash and Deposits with Banks

A summary of cash and deposits with banks as at 30 June follows:

| | 2002 | 2001 |
|---|---|---|
| Cash and demand deposits | **42,256** | 87,692 |
| Term deposits maturing within six months | **1,850,377** | 1,542,935 |
| Term deposits maturing within six to twelve months | **133,061** | 59,383 |
| Term deposits maturing after twelve months | **1,531** | 1,413 |
| **Total** | **2,027,225** | 1,691,423 |

## NOTE 3: Significant Acquisitions and Significant Disposals

On 26 July 2001, the Bank's Guernsey subsidiaries, Bank of Butterfield International (Guernsey) Limited and Butterfield Fund Managers (Guernsey) Limited, acquired all of the outstanding common shares of CIBC Bank and Trust Company (Channel Islands) Limited, Canadian Imperial Bank of Commerce Trust Company (Channel Islands) Limited and CIBC Fund Managers (Guernsey) Limited (collectively referred to as CIBC's Guernsey operations). The total consideration in respect of this purchase was paid in cash. The acquisition was accounted for by the purchase method and the results of CIBC's Guernsey operations have been included in the Consolidated Statement of Income from the date of acquisition.

The principal activities of the CIBC Guernsey operations include: (a) private client business comprising the administration of private companies and trusts, the provision of multi-currency deposits, foreign exchange, credit facilities, securities trading and portfolio management services for high net worth individuals, and (b) institutional business comprising administered banking, managed trust companies, institutional custody and fund administration services. The details of the acquisition are as follows:

| | 2002 |
|---|---|
| **Fair value of assets acquired** | |
| Total cash and deposits with banks | **372,217** |
| Investments | **3,139** |
| Loans | **38,901** |
| Premises and equipment | **515** |
| Intangible asset - customer list | **21,401** |
| | **436,173** |
| **Fair value of liabilities assumed** | |
| Deposits | **396,240** |
| Other liabilities | **3,864** |
| | **400,104** |
| **Fair value of identifiable net assets acquired** | **36,069** |
| **Total purchase consideration** | **36,069** |

On 6 June 2002 the Bank sold its controlling interest in its Hong Kong subsidiaries to Dexia Banque Internationale à Luxembourg (Dexia BIL) for cash and realised a gain of $17.0 million. Net income up to the date of sale totalled $1.4 million and is included in the Consolidated Statement of Income.

The Bank's Hong Kong subsidiaries, established in 1986, consisted of Butterfield Trust (Hong Kong) Limited and Butterfield Corporate Services (Hong Kong) Limited. Dexia BIL has acquired a majority interest in the Trust and Corporate Services operations and will take over the business of the Bank's restricted licence branch once regulatory approval is received.

## NOTE 4: Investments

**(a) Maturity:** A summary of investments as at 30 June follows:

| 2002 | Within 1 Year | 1 To 3 Years | 3 To 5 Years | 5 To 10 Years | Over 10 Years* | Total |
|---|---|---|---|---|---|---|
| **Marketable Securities** | | | | | | |
| US Government and agencies | **2,000** | **41,737** | **23,003** | **12,917** | **9,002** | **88,659** |
| Other OECD Governments | **-** | **5,996** | **5,218** | **-** | **-** | **11,214** |
| Financial institution debt | **270,894** | **611,816** | **307,393** | **26,971** | **-** | **1,217,074** |
| Corporate and asset backed debt | **72,080** | **86,965** | **106,503** | **35,680** | **157,067** | **458,295** |
| Non OECD Governments | **145** | **1,554** | **2,946** | **11,022** | **140** | **15,807** |
| Mutual fund/equity investments | **-** | **-** | **-** | **-** | **40,093** | **40,093** |
| **Total** | **345,119** | **748,068** | **445,063** | **86,590** | **206,302** | **1,831,142** |

| 2001 | Within 1 Year | 1 To 3 Years | 3 To 5 Years | 5 To 10 Years | Over 10 Years* | Total |
|---|---|---|---|---|---|---|
| **Marketable Securities** | | | | | | |
| US Government and agencies | - | 37,801 | 114,986 | 67,795 | 28,905 | 249,487 |
| Other OECD Governments | 22,516 | 1,039 | - | 11,941 | 2,557 | 38,053 |
| Financial institution debt | 393,467 | 488,435 | 216,350 | - | - | 1,098,252 |
| Corporate and asset backed debt | 95,460 | 192,515 | 101,063 | 35,909 | 40,491 | 465,438 |
| Non OECD Governments | - | - | - | 12,348 | - | 12,348 |
| Mutual fund/equity investments | - | - | - | - | 18,901 | 18,901 |
| **Total** | 511,443 | 719,790 | 432,399 | 127,993 | 90,854 | 1,882,479 |

* Mutual funds and equity investments have no specific maturity date and are listed as Over 10 Years.

All of the above amounts are held in the investment portfolio and are carried at amortised cost with the exception of the trading portfolio which amounts to $18,345 ($Nil in 2001), venture capital investments which amount to $18,921 ($17,555 in 2001), and certain other equity investments aggregating $6,619 ($1,346 in 2001). Actual maturities may differ from the stated maturities reflected above because certain investments may have call or prepayment features and asset backed securities are shown at their legal final maturity and not their weighted average life, which will normally be under five years.

**(b) Market Value Summary** as at 30 June:

| | **2002** | | | | 2001 | | | |
|---|---|---|---|---|---|---|---|---|
| | **Carrying Value** | **Unrealised Gain** | **Unrealised (Loss)** | **Market Value** | Carrying Value | Unrealised Gain | Unrealised (Loss) | Market Value |
| **Marketable Securities** | | | | | | | | |
| US Government and agencies | **88,659** | **1,075** | **-** | **89,734** | 249,487 | 557 | (143) | 249,901 |
| Other OECD Governments | **11,214** | **265** | **-** | **11,479** | 38,053 | 49 | (28) | 38,074 |
| Financial institution debt | **1,217,074** | **1,320** | **(664)** | **1,217,730** | 1,098,252 | 1,034 | (433) | 1,098,853 |
| Corporate and asset backed debt | **458,295** | **1,231** | **(482)** | **459,044** | 465,438 | 1,647 | (3,699) | 463,386 |
| Non OECD Governments | **15,807** | **86** | **-** | **15,893** | 12,348 | 350 | (153) | 12,545 |
| Mutual fund/equity investments | **40,093** | **-** | **-** | **40,093** | 18,901 | 98 | - | 18,999 |
| **Total** | **1,831,142** | **3,977** | **(1,146)** | **1,833,973** | 1,882,479 | 3,735 | (4,456) | 1,881,758 |

Marketable Securities, excluding mutual funds and equity investments include $251,622 ($345,163 in 2001) of fixed rate instruments and $1,539,426 ($1,518,414 in 2001) of floating rate instruments. The approximate yield on the floating rate securities as at 30 June 2002 was 2.93% (4.58% in 2001), while the approximate yield on the fixed rate securities was 4.18% (6.20% in 2001). Unrealised gains were $3,977 ($3,735 in 2001) and unrealised losses were $1,146 ($4,456 in 2001). During the year the Bank reduced the carrying value of certain venture capital investments by $726 ($3,522 in 2001) and corporate and asset backed investments by $1,890 ($Nil in 2001).

## NOTE 5: Loans, Letters of Credit, Guarantees and Commitments

**(a) Loans outstanding** as at 30 June :

The Bank's loans net of unearned income and the allowance for credit losses in respect of loans are as follows:

| | 2002 | 2001 |
|---|---|---|
| Residential mortgages | 656,007 | 627,421 |
| Personal and credit cards | 304,362 | 356,114 |
| Business and government | 760,861 | 493,020 |
| Sub-total loans | 1,721,230 | 1,476,555 |
| Allowance for credit losses | (24,455) | (24,782) |
| **Net loans** | **1,696,775** | 1,451,773 |

The principal means of securing residential mortgages, personal, credit card and business loans are charges over assets and guarantees. Mortgage loans are generally repayable over fifteen years and personal, credit card, business and government loans are generally repayable over terms not exceeding five years. The effective yield on total loans as at 30 June 2002 is 5.9% (8.3% as at 30 June 2001).

**(b) Impaired Loans** as at 30 June follows:

| | 2002 | | | | 2001 |
|---|---|---|---|---|---|
| | Gross | Specific Provisions | General Provisions | Net | Net |
| **By loan type:** | | | | | |
| Residential mortgages | 4,935 | (190) | - | 4,745 | 439 |
| Personal and credit cards | 4,807 | (1,820) | - | 2,987 | 2,744 |
| Business | 15,061 | (1,860) | - | 13,201 | 2,147 |
| General provisions | - | - | (20,585) | (20,585) | (20,575) |
| **Total impaired loans** | 24,803 | (3,870) | (20,585) | 348 | (15,245) |
| **By geography:** | | | | | |
| Bermuda | 15,745 | (3,206) | - | 12,539 | 4,206 |
| Cayman | 8,540 | (542) | - | 7,998 | 1,124 |
| Guernsey | 518 | (122) | - | 396 | - |
| Sub-total before general provisions | 24,803 | (3,870) | - | 20,933 | 5,330 |
| General provisions | - | - | (20,585) | (20,585) | (20,575) |
| **Total impaired loans** | 24,803 | (3,870) | (20,585) | 348 | (15,245) |

**(c) Allowance for Credit Losses** as at 30 June follows:

| | 2002 | | | 2001 |
|---|---|---|---|---|
| | **Specific Provisions** | **General Provisions** | **Total** | Total |
| Beginning of year | **4,207** | **20,575** | **24,782** | 22,350 |
| New acquisitions | **122** | **328** | **450** | 565 |
| Write-offs | **(3,196)** | **-** | **(3,196)** | (8,549) |
| Recoveries/transfers | **2,737** | **(2,488)** | **249** | (160) |
| Provisions this year | **-** | **2,159** | **2,159** | 11,366 |
| Other, including exchange movement | **-** | **11** | **11** | (790) |
| Carried forward | **3,870** | **20,585** | **24,455** | 24,782 |

**(d) Credit Exposure** as at 30 June follows:

The following table summarises the credit exposure* of the Bank to governments, individuals and businesses by sector:

| | **2002** | 2001 |
|---|---|---|
| Primary industry and manufacturing | **43,673** | 27,297 |
| Commercial and merchandising | **601,703** | 512,050 |
| Real estate | **78,221** | 80,910 |
| Transport and communication | **41,070** | 41,968 |
| Banks and financial services | **711,441** | 734,960 |
| Governments | **32,964** | 6,430 |
| Individuals | **1,005,238** | 718,292 |
| Sub-Total | **2,514,310** | 2,121,907 |
| General provisions | **(20,585)** | (20,575) |
| **Total** | **2,493,725** | 2,101,332 |

* Credit exposures include loans, guarantees and acceptances, letters of credit and commitments for undrawn lines of credit.

**(e) Off-Balance Sheet items:** The Bank was contingently liable for letters of credit, guarantees, and other contracts amounting to $480,286 as at 30 June 2002 ($379,046 in 2001) of which $443,300 was fully collateralised ($356,588 in 2001). The Bank's commitment for undrawn lines of credit amounted to $316,665 as at 30 June 2002 ($257,671 in 2001).

## NOTE 6: Land, Buildings and Equipment

A summary of land, buildings and equipment as at 30 June follows:

| | **Cost** | **Accumulated Depreciation** | **Net Book Value 2002** | Net Book Value 2001 |
|---|---|---|---|---|
| Land | **12,361** | **-** | **12,361** | 11,523 |
| Buildings | **84,608** | **23,643** | **60,965** | 59,588 |
| Equipment | **82,129** | **56,919** | **25,210** | 26,579 |
| **Total** | **179,098** | **80,562** | **98,536** | 97,690 |

Depreciation charged to operating expenses for the year ended 30 June 2002 was $10,769 ($10,355 in 2001).

## NOTE 7: Intangible Assets

| | Cost | Accumulated Amortisation | Net Book Value 2002 | Net Book Value 2001 |
|---|---|---|---|---|
| **Amortised intangible assets** | | | | |
| Customer list | **30,210** | **2,249** | **27,961** | 7,434 |
| | **30,210** | **2,249** | **27,961** | 7,434 |

The aggregate amortisation expense for the year ended 30 June 2002 was $1,898 ($531 in 2001). Pursuant to the revised recommendations of the CICA as described in Note 1(b), the Bank reclassified $7,434 of Other Assets to Intangible Assets. These intangible assets are amortised over their definite useful lives of 15 years as determined by the Bank using the straight-line method.

## NOTE 8: Deposits

An analysis of deposits as at 30 June follows:

### (a) By Maturity

| | 2002 | 2001 |
|---|---|---|
| Demand deposits | **2,047,495** | 1,891,094 |
| Term deposits maturing within six months | **2,841,599** | 2,437,415 |
| Term deposits maturing within six to twelve months | **134,428** | 99,324 |
| Term deposits maturing after twelve months | **192,844** | 272,890 |
| **Total** | **5,216,366** | 4,700,723 |

### (b) By Type and Location

| | Payable On Demand | Payable on A Fixed Date | 2002 | 2001 |
|---|---|---|---|---|
| **Bermuda:** | | | | |
| Customers | **1,254,464** | **1,381,044** | **2,635,508** | 2,704,418 |
| Banks | **-** | **206,559** | **206,559** | 136,875 |
| **Cayman:** | | | | |
| Customers | **493,235** | **443,218** | **936,453** | 836,468 |
| Banks | **-** | **137,238** | **137,238** | 91,445 |
| **Guernsey:** | | | | |
| Customers | **269,269** | **588,655** | **857,924** | 584,164 |
| Banks | **-** | **-** | **-** | 4,177 |
| **Other International:** | | | | |
| Customers | **30,527** | **326,816** | **357,343** | 339,329 |
| Banks | **-** | **85,341** | **85,341** | 3,847 |
| **Total** | **2,047,495** | **3,168,871** | **5,216,366** | 4,700,723 |

The effective yield on deposits as at 30 June 2002 was 1.8% (3.3% at 30 June 2001).

## NOTE 9: Employee Future Benefits

The Bank maintains trusteed pension plans including a non-contributory defined benefit plan and a number of defined contribution plans, and provides post-retirement medical benefits to its qualifying retirees The defined benefit provisions under the pension plan are generally based upon years of service and average salary during the final years of employment. The defined benefit plan is non-contributory and the funding required is provided by the Bank, based upon the advice of an independent actuary.

Effective 1 September 2000, the Bank implemented a defined contribution pension plan for its Bermuda based employees. Funding of the plan is determined based upon the provisions of the plan and is shared with the employees. All employees under age 45 were transferred into this plan. All Bermuda based employees joining the Bank after this date will automatically join this defined contribution plan.

Substantially all of the pension assets are invested in equity, fixed income and other marketable securities.

The following table presents the financial position of the Bank's defined benefit pension plans and the Bank's post-retirement medical benefit plan:

| | Pension Plans | | Post-Retirement Medical Benefit Plan | |
|---|---|---|---|---|
| | **2002** | 2001 | **2002** | 2001 |
| **Change in benefit obligation** | | | | |
| Benefit obligation at beginning of year | **52,331** | 67,366 | **24,759** | 26,104 |
| Effect of change in accounting policy | **-** | (11,071) | **-** | (4,528) |
| Benefit obligation at beginning of year as adjusted | **52,331** | 56,295 | **24,759** | 21,576 |
| Service cost | **1,290** | 1,340 | **688** | 577 |
| Interest cost | **3,797** | 3,772 | **1,811** | 1,683 |
| Benefits paid | **(6,956)** | (2,700) | **(1,993)** | (878) |
| Amount transferred on settlement | **-** | (12,398) | **-** | - |
| Amount transferred on curtailment | **-** | 1,360 | **-** | - |
| Past service cost | **-** | 1,340 | **-** | - |
| Actuarial losses | **1,538** | 3,322 | **2,098** | 1,801 |
| **Benefit obligation at end of year** | **52,000** | 52,331 | **27,363** | 24,759 |
| | | | | |
| **Change in plan assets** | | | | |
| Fair value of plan assets at beginning of year | **63,131** | 76,033 | **-** | - |
| Actual return on plan assets | **(3,808)** | 1,119 | **-** | - |
| Employer contribution | **-** | 1,077 | **-** | - |
| Benefits paid | **(6,956)** | (2,700) | **-** | - |
| Amount transferred on settlement | **-** | (12,398) | **-** | - |
| **Fair value of plan assets at end of year** | **52,367** | 63,131 | **-** | - |
| | | | | |
| **Funded Status** | | | | |
| Excess (deficit) of plan assets over benefit obligation at end of year | **367** | 10,800 | **(27,363)** | (24,759) |
| Unamortised transitional asset | **(10,263)** | (11,289) | **(9,395)** | (9,948) |
| Unamortised net actuarial loss | **17,397** | 7,297 | **3,989** | 1,801 |
| Unamortised past service cost | **1,133** | 1,246 | **-** | - |
| **Accrued benefit asset (liability), included in other assets (liabilities)** | **8,634** | 8,054 | **(32,769)** | (32,906) |
| | | | | |
| **Annual benefit (credit) expense** | | | | |
| Service cost | **1,290** | 1,340 | **688** | 577 |
| Interest cost | **3,797** | 3,772 | **1,811** | 1,683 |
| Expected return on plan assets | **(4,817)** | (5,094) | **-** | - |
| Gain on settlement | **-** | (3,275) | **-** | - |
| Amortisation of past service cost | **113** | 95 | **-** | - |
| Amortisation of actuarial loss | **63** | - | **-** | - |
| Amortisation of transitional asset | **(1,026)** | (1,091) | **(553)** | (553) |
| Defined benefit (credit) expense | **(580)** | (4,253) | **1,946** | 1,707 |
| Defined contribution expense | **3,925** | 2,748 | **-** | - |
| **Total benefit (credit) expense** | **3,345** | (1,505) | **1,946** | 1,707 |

| | Pension Plans | | Post-Retirement Medical Benefit Plan | |
|---|---|---|---|---|
| | **2002** | 2001 | **2002** | 2001 |
| **Actuarial assumptions** | | | | |
| Year-end discount rate for benefit obligation | **7.00%** | 7.25% | **7.00%** | 7.25% |
| Expense discount rate | **7.25%** | 7.75% | **7.00%** | 7.75% |
| Long-term rate of return on plan assets | **7.75%** | 7.75% | **-** | - |
| Rate of compensation increases, excluding merit increases | **4.50%** | 4.50% | **4.50%** | 4.50% |
| Annual increase in the per capita cost of post retirement benefits | **-** | - | **8% to 5% over 4 years** | |

## NOTE 10: Assets Under Administration

Securities and properties (other than cash deposits directly with the Bank and its subsidiaries) held in a trust, agency or fiduciary capacity for customers, including mutual funds, are not included in the Consolidated Balance Sheet as they are not the property of the Bank or its subsidiaries. The value of assets under administration as at 30 June 2002 was estimated to be $44.9 billion ($39.2 billion in 2001).

## NOTE 11: Contingent Liabilities

There are a number of actions and legal proceedings pending against the Bank and its subsidiaries, which arose in the normal course of its business. Management, after reviewing all actions proceeding, pending against or involving the Bank and its subsidiaries, considers that the resolution of these matters would not be material to the consolidated financial position of the Bank.

## NOTE 12: Segmented Information

**(a) Operating Segments:** For management reporting purposes, the operations of the Bank are grouped into the following five business segments based upon the geographic location of the Bank's operations: Bermuda (which is further sub-divided based on products and services into Community Banking, Asset Management & Administration, and Real Estate), Cayman, Guernsey, the United Kingdom, and Hong Kong. Accounting policies of the reportable segments are the same as those described in Note 1.

The Bermuda Community Banking segment provides a full range of retail and corporate services. Retail services are offered to individuals and small to medium sized businesses through five branch locations and through telephone banking, Internet banking, Automated Teller Machines (ATMs) and debit cards. Retail services include deposit services, consumer and mortgage lending, credit cards and personal insurance products. Corporate services include commercial lending and mortgages, cash management, payroll services, remote banking, and letters of credit. Community Banking also includes Treasury operations and the Bank's proportionate share of the assets, liabilities, income and expenses of its joint venture, ProServe Bermuda Limited.

The Bermuda Asset Management and Administration segment provides a wide selection of investment products and services through a sales force of financial professionals. Services include discretionary portfolio management for institutional and private clients, full service mutual and hedge fund administration, and trust, estate and pension administration.

The Cayman segment provides a comprehensive range of community and commercial banking services to private and corporate customers. The Cayman segment also provides discretionary portfolio management, stock brokerage, trust and company administration which includes managed bank business, and mutual fund and pension administration.

The Guernsey segment provides a broad range of services to private clients and financial institutions including investment management and custody, banking and treasury, trust services and third-party fund administration. With the recent acquisition of the Guernsey operations of the Canadian Imperial Bank of Commerce, services also include administered bank services and trust business for institutional clients.

The United Kingdom segment provides a wide range of customer services including deposit taking, secured lending, foreign exchange, and global custody of securities.

The Hong Kong segment provided trust and custody services, third-party fund administration, and other corporate services such as business introductions.

Operating segment information follows:

| **Total Assets** | **2002** | **2001** |
|---|---|---|
| Community Banking | **2,997,077** | 3,026,200 |
| Asset Management and Administration | **20,140** | 15,785 |
| Real Estate | **57,500** | 54,368 |
| **Total Bermuda** | **3,074,717** | 3,096,353 |
| Cayman | **1,204,894** | 1,060,816 |
| Guernsey | **952,586** | 644,691 |
| United Kingdom | **357,000** | 297,288 |
| Hong Kong | **148,847** | 98,656 |
| **Total** | **5,738,044** | 5,197,804 |

### Business Area Analysis for 2002

| | Net Interest Income Customer | Intersegment | Provisions for Loan Losses | Fees and Other Income | Total Income | Other Expenses | Depreciation and Amortisation | Total Expenses | Net Income |
|---|---|---|---|---|---|---|---|---|---|
| Community Banking | 72,939 | (2,531) | (1,784) | 31,119 | 99,743 | 65,414 | 5,241 | 70,655 | 29,088 |
| Asset Management and Administration | - | 185 | - | 37,308 | 37,493 | 26,596 | 510 | 27,106 | 10,387 |
| Real Estate | - | (1,231) | - | 8,656 | 7,425 | 4,829 | 1,627 | 6,456 | 969 |
| **Total Bermuda** | 72,939 | (3,577) | (1,784) | 77,083 | 144,661 | 96,839 | 7,378 | 104,217 | 40,444 |
| Cayman | 17,932 | 1,204 | (200) | 21,193 | 40,129 | 19,953 | 2,236 | 22,189 | 17,940 |
| Guernsey | 4,331 | 2,951 | (174) | 18,124 | 25,232 | 17,994 | 2,820 | 20,814 | 4,418 |
| United Kingdom | 3,556 | (608) | - | 834 | 3,782 | 3,599 | 29 | 3,628 | 154 |
| Hong Kong | 638 | 30 | (1) | 6,223 | 6,890 | 5,239 | 204 | 5,443 | 1,447 |
| **Total Overseas** | 26,457 | 3,577 | (375) | 46,374 | 76,033 | 46,785 | 5,289 | 52,074 | 23,959 |
| Sale of subsidiaries | - | - | - | 17,013 | 17,013 | - | - | - | 17,013 |
| **Total Income** | 99,396 | - | (2,159) | 140,470 | 237,707 | 143,624 | 12,667 | 156,291 | 81,416 |
| less: Inter-segment eliminations (principally rent and management fees) | - | - | - | (14,135) | (14,135) | (14,135) | - | (14,135) | - |
| Sub-Total | 99,396 | - | (2,159) | 126,335 | 223,572 | 129,489 | 12,667 | 142,156 | 81,416 |
| Discontinued Operations | 422 | - | - | 1,155 | 1,577 | 704 | - | 704 | 873 |
| **Total** | 99,818 | - | (2,159) | 127,490 | 225,149 | 130,193 | 12,667 | 142,860 | 82,289 |

### Business Area Analysis for 2001

| | Net Interest Customer | Income Intersegment | Provisions for Loan Losses | Fees and Other Income | Total Income | Other Expenses | Depreciation and Amortisation | Total Expenses | Net Income |
|---|---|---|---|---|---|---|---|---|---|
| Community Banking | 72,992 | (3,271) | (4,182) | 30,350 | 95,889 | 63,708 | 5,527 | 69,235 | 26,654 |
| Asset Management and Administration | 3,777 | 386 | - | 32,381 | 36,544 | 24,407 | 416 | 24,823 | 11,721 |
| Real Estate | - | (1,808) | - | 9,094 | 7,286 | 4,615 | 2,109 | 6,724 | 562 |
| **Total Bermuda** | 76,769 | (4,693) | (4,182) | 71,825 | 139,719 | 92,730 | 8,052 | 100,782 | 38,937 |
| Cayman | 22,449 | 2,739 | (756) | 17,925 | 42,357 | 18,161 | 1,631 | 19,792 | 22,565 |
| Guernsey | 4,014 | 2,259 | (385) | 7,825 | 13,713 | 8,914 | 946 | 9,860 | 3,853 |
| United Kingdom | 1,358 | (45) | - | 427 | 1,740 | 1,365 | 20 | 1,385 | 355 |
| Hong Kong | 950 | (260) | (4) | 5,638 | 6,324 | 5,065 | 237 | 5,302 | 1,022 |
| **Total Overseas** | 28,771 | 4,693 | (1,145) | 31,815 | 64,134 | 33,505 | 2,834 | 36,339 | 27,795 |
| **Total Income** | 105,540 | - | (5,327) | 103,640 | 203,853 | 126,235 | 10,886 | 137,121 | 66,732 |
| less: Inter-segment eliminations (principally rent and management fees) | - | - | - | (11,865) | (11,865) | (11,865) | - | (11,865) | - |
| Sub-Total | 105,540 | - | (5,327) | 91,775 | 191,988 | 114,370 | 10,886 | 125,256 | 66,732 |
| Discontinued Operations | 205 | - | (6,039) | 14 | (5,820) | 170 | - | 170 | (5,990) |
| **Total** | 105,745 | - | (11,366) | 91,789 | 186,168 | 114,540 | 10,886 | 125,426 | 60,742 |

Included in other expenses is $1,123 ($5,505 in 2001) relating to the cost of developing new systems. Included within interest paid, other income and other expenses for Bermuda are releases of certain provisions aggregating ($210) ($500 in 2001) relating to the internal reconciliation process, and included within other expenses for Guernsey and UK is income tax (refund) expense of ($88), ($352 in 2001) and $70 ($150 in 2001), respectively. Transactions between operating segments principally include interbank deposits and rent which are recorded based upon market rates, and management fees, which are recorded based on the cost of the services provided.

**(b) Revenues by Products and Services:** The principal sources of revenues by products and services are disclosed separately in the Consolidated Statement of Income. Fees, commissions and service charges comprise principally fees from loans and other banking transactions.

## NOTE 13: Derivative Financial Instruments

**(a) Derivative Products used by the Bank:** The Bank's derivative contracts principally involve over-the-counter transactions that are privately negotiated between the Bank and the counterparty to the contract.

The Bank uses various off-balance sheet derivative contracts in the management of its asset and liability positions, for trading purposes and as a market maker for its clients' needs. The Bank enters into foreign exchange contracts for both asset and liability management and as a market maker for its clients' needs. Interest rate contracts are used for trading and asset and liability management purposes. Currency options are purchased for trading purposes. These contracts are financial instruments, the value of which is derived from underlying assets or interest and exchange rates. Such financial instruments used by the Bank include:

### Interest Rate Swaps

Interest rate swaps are financial transactions in which two counterparties exchange fixed or floating interest cash flows over a period of time based on rates applied to defined notional principal amounts.

### Foreign Exchange Products

Foreign exchange forward contracts are transactions in which an amount of one currency is purchased or sold in exchange for the delivery of another amount of a second currency, at a specified future date or range of dates. Spot transactions are similar to forward contracts except that settlement takes place within two business days.

### Currency Options

A currency option is a contract that gives the right, without the obligation, to buy (call option) or sell (put option) one currency against another at a specified price during a specified period. The Bank only buys currency options and, therefore, enjoys the right to exercise the option and the right not to exercise the option (i.e. to let it lapse) through the payment of an option premium or fee at the outset of the transaction.

**(b) Notional Amounts:** The following table provides the aggregate notional amounts of derivative contracts outstanding as at 30 June listed by type and divided between those used for trading and those used in managing the exposure to risk inherent in the Bank's asset and liability risk management "ALM" positions. Trading involves managing market risk positions with the expectation of profiting from favourable movements in prices, rates or indices. ALM activities include the use of interest rate swaps to adjust exposure to interest rate risk by modifying the repricing or maturity characteristics of existing and/or anticipated assets and liabilities.

The notional amounts are not recorded as assets or liabilities on the Consolidated Balance Sheet as they represent the face amount of the contract to which a rate or price is applied to determine the amount of cash flows to be exchanged. Notional amounts represent the volume of outstanding transactions and do not represent the potential gain or loss associated with market risk or credit risk of such instruments.

| | **2002** | | | 2001 | | |
|---|---|---|---|---|---|---|
| | **Trading** | **ALM** | **Total Value** | Trading | ALM | Total Value |
| **Interest Rate Contracts** | | | | | | |
| **Over-the-Counter Traded** | | | | | | |
| Interest rate swaps | **-** | **432,529** | **432,529** | 21,243 | 96,845 | 118,088 |
| **Foreign Exchange Contracts** | | | | | | |
| Spot and forwards | **1,193,086** | **93,843** | **1,286,929** | 635,501 | 24,054 | 659,555 |
| Currency options | - | - | - | 5,000 | - | 5,000 |
| **Total** | **1,193,086** | **93,843** | **1,286,929** | 640,501 | 24,054 | 664,555 |
| **Total Notional Amount of Financial Derivatives Outstanding** | **1,193,086** | **526,372** | **1,719,458** | 661,744 | 120,899 | 782,643 |

**(c) Fair Value:** Derivative instruments, in the absence of any compensating upfront cash payments, generally have no market value at inception. They obtain value, positive or negative, as relevant interest rates, exchange rates, equity or commodity prices or indices change, such that previously contracted derivative transactions have become more or less favourable than what can be negotiated under current market conditions for contracts with the same remaining period to maturity. The potential for derivatives to increase or decrease in value as a result of the foregoing factors is generally referred to as market risk. Market risk is managed within clearly defined parameters as prescribed by senior management of the Bank.

The following table shows the marked to market fair value of all derivative contracts outstanding as at 30 June. This is defined as the profit (loss) associated with replacing the derivative contracts at prevailing market prices.

| | | 2002 | | | 2001 | |
|---|---|---|---|---|---|---|
| | **Positive** | **Negative** | **Net** | Positive | Negative | Net |
| **Derivative Financial Instruments** | | | | | | |
| Interest rate swaps | **7,242** | **2,218** | **5,024** | 3,521 | 2,072 | 1,449 |
| Spot and forward foreign exchange | **20,799** | **21,321** | **(522)** | 3,316 | 3,301 | 15 |
| Currency options | **-** | **-** | **-** | - | - | - |
| **Total** | **28,041** | **23,539** | **4,502** | 6,837 | 5,373 | 1,464 |

**(d) Remaining Maturity:** The following table summarises the remaining term to maturity of the notional amounts of the Bank's derivative instruments by type:

| **2002** | **0-6 mths** | **6-12 mths** | **1-3 years** | **3-5 years** | **5-10 years** | **Total** |
|---|---|---|---|---|---|---|
| **Interest Rate Contracts** | | | | | | |
| Interest rate swaps | **75,500** | **15,250** | **194,866** | **135,000** | **11,913** | **432,529** |
| **Foreign Exchange Contracts** | | | | | | |
| Spot and forwards | **1,285,850** | **1,079** | **-** | **-** | **-** | **1,286,929** |
| Currency options | **-** | **-** | **-** | **-** | **-** | **-** |
| **Total** | **1,285,850** | **1,079** | **-** | **-** | **-** | **1,286,929** |
| **Total by Remaining Maturity** | **1,361,350** | **16,329** | **194,866** | **135,000** | **11,913** | **1,719,458** |

| 2001 | 0-6 mths | 6-12 mths | 1-3 years | 3-5 years | 5-10 years | Total |
|---|---|---|---|---|---|---|
| **Interest Rate Contracts** | | | | | | |
| Interest rate swaps | 24,776 | 20,000 | 59,744 | 701 | 12,867 | 118,088 |
| **Foreign Exchange Contracts** | | | | | | |
| Spot and forwards | 650,263 | 8,014 | 1,278 | - | - | 659,555 |
| Currency options | 5,000 | - | - | - | - | 5,000 |
| **Total** | 655,263 | 8,014 | 1,278 | - | - | 664,555 |
| **Total by Remaining Maturity** | 680,039 | 28,014 | 61,022 | 701 | 12,867 | 782,643 |

**(e) Replacement:** The following table reflects the replacement cost of all derivative contracts outstanding as at 30 June. This is defined as the cost of replacing, at current market rates, all contracts which have a positive fair value before factoring in the impact of master netting agreements. The replacement cost of an instrument is dependent upon its terms relative to prevailing market prices and will fluctuate as market prices change and as the derivative approaches its scheduled maturity.

| | | 2002 | | | 2001 | |
|---|---|---|---|---|---|---|
| | **Trading** | **ALM** | **Total Value** | Trading | ALM | Total Value |
| **Interest Rate Contracts** | | | | | | |
| Interest rate swaps | **-** | **7,242** | **7,242** | 107 | 3,414 | 3,521 |
| **Foreign Exchange Contracts** | | | | | | |
| Spot and forwards | **20,072** | **727** | **20,799** | 3,235 | 81 | 3,316 |
| **Total** | **20,072** | **727** | **20,799** | 3,235 | 81 | 3,316 |
| **Total Replacement Cost** | **20,072** | **7,969** | **28,041** | 3,342 | 3,495 | 6,837 |

**(f) Credit Risk:** As with on-balance sheet assets, derivative instruments are subject to credit risk. Credit risk arises from the possibility that counterparties may default on their obligations to the Bank. However, whereas the credit risk of on-balance sheet assets is represented by the principal amount net of any applicable allowance for credit losses, the credit risk associated with derivatives is normally a small fraction of the notional amount of the derivative instrument. Derivative contracts expose the Bank to credit loss only if changes in market rates affect a counterparty's position unfavourably and the counterparty defaults on payment. Accordingly, credit risk of derivatives is represented by the replacement value of the instrument.

Negotiated over-the-counter derivatives often present greater credit exposure than exchange-traded contracts. The net change in value of the exchange-traded contracts is normally settled daily in cash with the exchange. Holders of these contracts look to the exchange for performance under the contract. The Bank strives to limit credit risk by dealing with counterparties that it believes are creditworthy, and manages its credit risk for derivatives through the same credit risk process applied to on-balance sheet assets.

The Bank pursues opportunities to reduce its exposure to credit losses on derivative instruments. These opportunities include entering into master netting arrangements with counterparties. The Bank negotiates master netting arrangements with counterparties with which it has significant credit risk through derivatives activities. Such agreements provide for the simultaneous close out and netting of all transactions with a counterparty in an event of default. An increasing number of these agreements also provide for the exchange of collateral between parties in the event that the mark to market value of outstanding transactions between the parties exceeds an agreed threshold. Such agreements are used to accommodate business with less creditworthy counterparties, as well as to help contain the build up of credit exposure resulting from multiple deals with more active counterparties.

## NOTE 14: Fair Value of Financial Instruments

The following table shows the fair value of the Bank's financial instruments as at 30 June:

| | 2002 | | | 2001 | | |
|---|---|---|---|---|---|---|
| | **Book Value** | **Fair Value** | **Favourable (Unfavourable)** | Book Value | Fair Value | Favourable (Unfavourable) |
| **Assets** | | | | | | |
| Cash and deposits with banks | **2,027,225** | **2,027,225** | **-** | 1,691,423 | 1,691,423 | - |
| Investments | **1,831,142** | **1,833,973** | **2,831** | 1,882,479 | 1,881,758 | (721) |
| Loans | **1,696,775** | **1,704,283** | **7,508** | 1,451,773 | 1,457,403 | 5,630 |
| Accrued interest | **21,002** | **21,002** | **-** | 31,535 | 31,535 | - |
| **Liabilities** | | | | | | |
| Deposits | **5,216,366** | **5,227,662** | **(11,296)** | 4,700,723 | 4,701,402 | (679) |
| Securities sold under agreements to repurchase | **30,179** | **30,179** | **-** | 55,360 | 55,360 | - |
| Accrued interest | **9,517** | **9,517** | **-** | 12,380 | 12,380 | - |
| Subordinated debt capital | **75,000** | **74,625** | **375** | 75,000 | 73,461 | 1,539 |
| **Derivative Financial Instruments** | | | | | | |
| Interest rate swaps | **2,135** | **5,024** | **2,889** | 1,690 | 1,449 | (241) |
| Spots and forwards | **(522)** | **(522)** | **-** | 15 | 15 | - |

Fair value amounts represent estimates of the consideration that would currently be agreed upon between knowledgeable, willing parties who are under no compulsion to act and is best evidenced by a quoted market price, if one exists. Many of the Bank's financial instruments lack an available trading market. Therefore, these instruments have been valued using present value or other valuation techniques and may not necessarily be indicative of the amounts realisable in an immediate settlement of the instruments. In addition, the calculation of estimated fair value is based on market conditions at a specific point in time and may not be reflective of future fair values.

The book value of financial assets and financial liabilities held for purposes other than trading may exceed their fair value due primarily to changes in interest rates. In such instances, the Bank does not reduce the book value of these financial assets and financial liabilities to their fair values as it is the Bank's intention to hold them until maturity. The fair values disclosed exclude premises and equipment and certain other assets and liabilities as these are not financial instruments.

The following methods and assumptions were used in the determination of the fair value of financial instruments:

**Cash and Deposits with Banks:** The fair value of cash and deposits with banks, being short term in nature, is deemed to equate to the carrying value

**Investments:** The fair values of investments are based upon quoted market prices.

**Loans:** The majority of loans are variable rate and repriced in response to changes in market rates and hence the fair value has been estimated as the carrying value. For fixed rate loans, the fair value has been estimated by performing a discounted cash flow calculation using market rates for similar loans made at the balance sheet date.

**Accrued Interest:** The carrying values of accrued interest receivable and payable are assumed to approximate their fair values given their short-term nature.

**Deposits:** The fair value of fixed rate deposits has been estimated by discounting the contractual cash flows, using market interest rates offered at the balance sheet date for deposits of similar terms. The fair value of deposits with no stated maturity date is deemed to equate to the carrying value.

**Securities Sold Under Agreements to Repurchase:** The fair value of obligations relating to securities sold under repurchase agreements is considered to be equal to the carrying value given their short-term nature.

**Subordinated Debt Capital:** The fair value of the subordinated debt capital is based on current market pricing.

**Derivatives:** Fair value of exchange traded derivatives are based on quoted market prices. Fair value of over-the-counter derivatives are calculated as the net present value of contractual cash flows using prevailing market rates. The aggregate of the estimated fair value of amounts presented does not represent management's estimate of the underlying value of the Bank.

## NOTE 15: Interest Rate Risk

The following table sets out the assets, liabilities and off-balance sheet instruments on the date of the earlier of contractual maturity or repricing date. Use of this table to derive information about the Bank's interest rate risk position is limited by the fact that customers may choose to terminate their financial instruments at a date earlier than contractual maturity or repricing date. Examples of this include fixed rate mortgages, which are shown at contractual maturity but which may pre-pay earlier, and certain term deposits, which are shown at contractual maturity but which may be withdrawn before their contractual maturity and certain investments which have call or pre-payment features.

| As at 30 June 2002 (In $ millions) | Within 3 mths | After 3 mths but within 6 mths | After 6 mths but within 1 year | After 1 year but within 5 years | After 5 years | Non-interest bearing funds | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and deposits with banks | 1,677 | 184 | 133 | 1 | - | 32 | 2,027 |
| Investments | 1,510 | 42 | 8 | 162 | 81 | 28 | 1,831 |
| Loans | 1,472 | 78 | 21 | 102 | 15 | 9 | 1,697 |
| Land, buildings and equipment | - | - | - | - | - | 99 | 99 |
| Other assets | - | - | - | - | - | 84 | 84 |
| **Total Assets** | 4,659 | 304 | 162 | 265 | 96 | 252 | 5,738 |
| **Liabilities** | | | | | | | |
| Shareholders' equity | - | - | - | - | - | 335 | 335 |
| Deposits | 4,155 | 184 | 134 | 193 | - | 550 | 5,216 |
| Securities sold under agreements to repurchase | 30 | - | - | - | - | - | 30 |
| Other liabilities | - | - | - | - | - | 82 | 82 |
| Subordinated debt capital | 75 | - | - | - | - | - | 75 |
| **Total Liabilities** | 4,260 | 184 | 134 | 193 | - | 967 | 5,738 |
| **Off-balance sheet items** | (285) | (30) | 15 | 312 | (12) | - | - |
| Interest rate sensitivity gap | 114 | 90 | 43 | 384 | 84 | (715) | - |
| Cumulative interest rate sensitivity gap | 114 | 204 | 247 | 631 | 715 | - | - |

## NOTE 16: Concentrations of Credit Risk

Concentrations of credit risk exist where clients are engaged in similar activities, are located in the same geographic region or have some other form of commonality such that their ability to meet their contractual obligations would be similarly affected by changes in economic, political or other conditions.

Of the total interest earning assets of $5.49 billion as at 30 June 2002 ($4.99 billion in 2001), 17.6% (17.8% in 2001) relates to the Bermuda market, 3.2% (2.7% in 2001) relates to the Canadian market, 22.8% (17.9% in 2001) relates to the United Kingdom market and 39.4% (49.4% in 2001) to the United States market. No other country accounts for more than 5% of interest earning assets.

Of the total loan book which amounted to $1.70 billion as at 30 June 2002 ($1.45 billion in 2001), 77.9% (76.7% in 2001) of the lending was from Bermuda, 9.5% (10.2% in 2001) from Europe, 12.6% (13.1% in 2001) from Cayman.

## NOTE 17: Subordinated Debt Capital

On 29 June 1998, the Bank issued at par US$75 million of callable step-up subordinated Floating Rate Notes due on 1 July 2008. Interest at US$ 3-month LIBOR plus 65 basis points is payable quarterly in arrears until July 2003 when, if not redeemed, the interest steps up to US$ 3-month LIBOR plus 115 basis points. Unless previously redeemed or purchased and cancelled, the Notes are redeemable, at their principal amount on 1 July 2008. The Notes will be redeemable, in whole but not in part, at their principal amount on the Interest Payment date falling in July 2003, at the option of the Issuer, subject to the prior consent of the Bermuda Monetary Authority. The Notes may also be redeemed, in whole but not in part, at their principal amount prior to maturity at the option of the Issuer in the event of certain changes affecting tax in Bermuda. The Notes are listed on the Bermuda and Luxembourg Stock Exchanges and count as Tier 2 capital for capital adequacy purposes.

## NOTE 18: Stock Option Plan

At the Annual General Meeting of Shareholders held on 29 October 1997, the directors were granted authority to implement a Stock Option Plan for directors and employees.

Under the Bank's 1997 Stock Option Plan (the 1997 Plan), options to purchase common shares of the Bank may be granted to employees and directors of the Bank that entitle the holder to purchase one common share at a subscription price related to the market value prior to the effective date of the grant. Subscription prices are stated and payable in Bermuda dollars for the options. Generally, grants vest 25 percent at the end of each year for four years. The committee that administers the 1997 Plan has the discretion to vary the period during which the holder has the right to exercise options and, in certain circumstances, may accelerate the right of the holder to exercise options, but in no case shall the exercise period exceed ten years. The Bank has established a Stock Option Trust to meet its potential obligations under the 1997 Plan by the purchase on the open market of common shares. The Stock Option Trust is funded by a loan from the Bank. As at 30 June 2002 the Stock Option Trust held 2,062,745 shares (30 June 2001: 1,864,547 shares) that will be used to satisfy the Bank's obligations with respect to the Stock Option Plan.

The current maximum number of common shares reserved for issuance by the Board of Directors of the Company under the 1997 Plan is 2,200,000. The number of shares held by Directors and Executive at 30 June 2002 was 203,256 (30 June 2001: 240,580).

**Directors' and Executive Stock Option Plan**

| | 2002 | | 2001 | |
|---|---|---|---|---|
| | Number of Stock Options | Weighted Average Exercise Price ($) | Number of Stock Options | Weighted Average Exercise Price ($) |
| Outstanding at beginning of year | 236,846 | 16.40 | 174,719 | 16.41 |
| Granted | 91,841 | 26.51 | 76,714 | 16.31 |
| Stock dividend granted | 24,840 | 0.00 | - | - |
| Exercised | 47,137 | 14.84 | 14,587 | 16.02 |
| Forfeited/Cancelled | - | - | - | - |
| Outstanding at end of year | 306,390 | 18.40 | 236,846 | 16.40 |
| Vested and exercisable at end of year | 218,890 | 17.44 | 169,346 | 14.79 |

**Characteristics of Options Granted to Directors and Executive as at 30 June 2002**

| | Outstanding | | | Exercisable | |
|---|---|---|---|---|---|
| Issue year | Number of shares | Weighted Average Life Remaining | Weighted Average Exercise Price ($) | Number of shares | Weighted Average Exercise Price ($) |
| 1998/1999 | 54,400 | 6 | 15.59 | 46,150 | 15.47 |
| 1999/2000 | 87,365 | 7 | 14.72 | 70,865 | 14.65 |
| 2000/2001 | 85,226 | 8 | 14.86 | 60,476 | 14.86 |
| 2001/2002 | 79,399 | 9 | 28.18 | 41,399 | 28.18 |
| Total | 306,390 | 8 | 18.40 | 218,890 | 17.44 |

**Employee Stock Option Plan**

| | 2002 | | 2001 | |
|---|---|---|---|---|
| | Number of Stock Options | Weighted Average Exercise Price ($) | Number of Stock Options | Weighted Average Exercise Price ($) |
| Outstanding at beginning of year | 1,001,513 | 16.43 | 828,735 | 16.52 |
| Granted | 366,674 | 28.23 | 346,902 | 16.36 |
| Stock dividend granted | 96,774 | 0.00 | - | - |
| Exercised | 440,148 | 14.86 | 120,228 | 16.83 |
| Forfeited/Cancelled | 124,076 | 20.04 | 53,896 | 16.50 |
| Outstanding at end of year | 900,737 | 19.64 | 1,001,513 | 16.43 |
| Vested and exercisable at end of year | 300,020 | 15.96 | 666,083 | 16.82 |

**Characteristics of Options Granted to Employees as at 30 June 2002**

| | Outstanding | | | Exercisable | |
|---|---|---|---|---|---|
| Issue year | Number of shares | Weighted Average Life Remaining | Weighted Average Exercise Price ($) | Number of shares | Weighted Average Exercise Price ($) |
| 1998/1999 | 193,126 | 6 | 15.35 | 163,540 | 15.19 |
| 1999/2000 | 140,958 | 7 | 14.96 | 65,774 | 14.91 |
| 2000/2001 | 251,129 | 8 | 14.86 | 50,202 | 14.86 |
| 2001/2002 | 315,524 | 9 | 28.18 | 20,504 | 28.18 |
| Total | 900,737 | 8 | 19.64 | 300,020 | 15.96 |

## NOTE 19: Discontinued Operations

In 1997 the Bank adopted a formal plan to cease operations at its London Branch, and to exit the trade finance business in the United Kingdom. The positive earnings of this category reflects both the Bank's success in collecting old loans previously written off and the benefit of corporation tax refunds received.

## NOTE 20: Share Buy-Back Plan

In 2000 the Bank recommenced its initiative under the Share Buy-Back Plan. During the year under review, 287,521 shares (420,637 in 2001) were purchased and cancelled at a cost of $9,130 ($8,587 in 2001).

The Board of Directors of the Bank has the present intention to repurchase over the twelve month period commencing 1 July 2002 up to 2 million of its ordinary shares of par value $1 each pursuant to its share repurchase programme authorised by shareholders on 29 October 1997. As at 30 June 2002, 2 million shares represent 9.4% of total issued shares of the Bank. The Directors consider that share repurchase is an excellent means of enhancing shareholder value while increasing earnings per share. This intention is subject to appropriate market conditions and repurchases will only be made in the best interests of the Bank.

From time to time the Bank's associates, insiders, and insiders' associates as defined in The Bermuda Stock Exchange (BSX) Regulations may sell shares which may result in being repurchased pursuant to the programme, but under BSX Regulations such trades must not be pre-arranged and all repurchases must be made in the open market. Prices paid by the Bank must not, according to BSX Regulations, be higher than the last independent trade.

The Bank advises the BSX monthly of shares repurchased and cancelled.

## NOTE 21: Dividend Re-investment and Common Stock Purchase Plans

The Bank's dividend re-investment and common stock direct purchase plans permit participants to purchase, at fair market value, shares of the Bank's common stock by re-investment of dividends and/or optional cash payments, subject to terms of each plan.

## NOTE 22: Stock Dividend

In August 2001, the Bank distributed a 10% stock dividend to shareholders of record on 14 August 2001. All prior period per share amounts have been restated to reflect the stock dividend.

## NOTE 23: Comparative Figures

Certain 2001 comparative figures have been restated to conform with current year presentation.