

President's Report

In the first half of 2006, the strong economic growth in China provided a favourable environment for the banking industry; and meanwhile the government implemented various macroeconomic control measures in order to maintain a sustainable growth of the economy. Faced with both opportunities and challenges, the Bank strengthened its risk management and internal controls, enhanced its service quality and accelerated product innovation, thus achieving stable business growth and further improvement in asset quality.

FINANCIAL HIGHLIGHTS

In the first half of 2006, profit before tax reached RMB 32,814 million, up 3.4% over the same period last year. Steady growth was achieved in the financial performance, but the growth in profit before tax was dampened by the following factors: the Bank increased the basic salary and basic welfare of its staff since the second half of 2005; marketing activities were conducted earlier in 2006 compared with prior years, resulting in these expenses higher than the same period last year. In addition, the reform of the RMB exchange rate regime also led to an increase in net foreign exchange loss compared with the same period last year.

As the income tax exemption in relation to the restructuring expired on 30 June 2005, the net profit decreased by RMB 5,126 million to RMB 23,223 million compared with the same period last year. Excluding the income tax exemption effect in relation to the restructuring, the net profit for the first half of the year increased by RMB 2,722 million, or 13.3%, compared with the same period last year.

As a result of the rapid growth of infrastructure loans and residential mortgage loans, gross loans and advances to customers reached RMB 2,815,368 million as at 30 June 2006, representing an increase of RMB 356,970 million, or 14.5%, compared with that as at 31 December 2005. Accordingly, net interest income increased by 15.1% to RMB 65,285 million compared with the same period last year.

Our fee and commission-based services also achieved impressive results, with net fee and commission income for the first half of the year increasing by 60.6% to RMB 6,274 million compared with the same period last year. Net fee and commission income represented 8.9% of the operating income compared with 6.2% for the same period last year, reflecting the increased efforts and resources invested to develop these services.

As we continued to improve risk management practices and make timely adjustments to our lending criteria, steady improvement was achieved in the credit asset quality, with the non-performing loan ratio decreased to 3.51% compared with 3.84% at the end of last year, and the ratio of allowances to non-performing loans increased to 71.37% compared with 66.78% at the end of last year. Such ratio increased to 80% from 76% at the end of last year after taking into account the appropriated general reserve.

BUSINESS REVIEW

● Major businesses

In the first half of this year, operating income was RMB 70,864 million, up 12.6% compared with the same period last year. Operating income from corporate banking, personal banking, treasury business and others including overseas operations accounted for 57.3%, 29.0%, 12.7% and 1.0% respectively of the total.

The Bank's traditional edge in infrastructure loans was further strengthened. As at 30 June 2006 our corporate loan balance reached RMB 1,989,027 million, representing an increase of 12.0% compared with the end of 2005, with infrastructure loans contributing to 44.4% of the increase in total corporate loans. The loan growth was attributable to the fact that, with the commencement of the Eleventh Five Year Plan this year, the market demand for medium and long-term loans was strong and our expertise in this area met the demand well, which led to increased lending to key customers from core industries such as transportation and energy. Meanwhile, the Bank exercised cautious control over the direction and pace of credit extension, strengthened our monitoring of the industries that were subject to the government's macroeconomic control measures and leveraged on the credit risk early warning system and economic capital approach in governing loan extension.

The growth of our residential mortgage loans in the first half of 2006 ranked first among the PRC banks. The balance of residential mortgage loans amounted to RMB 391,875 million as at 30 June 2006, up 12.5% compared with the end of last year. The Bank improved existing residential mortgage loan products, and introduced innovative products and combined financial services to meet the differentiated and individualised demands of its customers.

Bank card business expansion reached a historic high. In the first half of the year, fee income of RMB 1,733 million was generated from bank card business, a significant increase of 30.0% compared with the same period last year. The Bank continued to enhance the features of its cards, target marketing forces at attracting and retaining high net-worth customers, and actively develop its merchants. As a result, there was a significant increase in the number of cards issued and the total spending. The number of credit cards in issue increased by 1.35 million to 4.47 million during the period. The total spending amount increased by 150% over the same period last year, while over 7,000 merchants were newly developed by the Bank.

There was phenomenal growth in customer-driven treasury products. We acted as lead underwriter of short-term financial notes totalling RMB 43,500 million, maintaining our leading position in the PRC market. In January 2006, the Bank became one of the first Renminbi market makers in the inter-bank foreign exchange market. The transaction volume of trade-related foreign exchange and settlement business totalled US\$48,933 million, up 30.4% from the same period last year. The volume of foreign currency derivatives transactions conducted on behalf of customers reached US\$6 billion, an increase of 102.4% over the same period last year.

- **Risk management**

We have actively proceeded with the reform of our risk management system with the focus on establishing a vertical risk management and parallel operation structure, which was implemented across the Bank from March 2006. With the appointment of our Chief Risk Officer and risk supervisors in all tier-one branches in place, a vertical risk management framework has taken shape.

We further enhanced our risk management technology. Our self-developed internal rating system has been applied in the credit grading of our customers. We also commenced the upgrading of the credit management information system ("CMIS") to provide a more solid foundation for the identification and measurement of risks. The development of the asset and liability management system, which focuses on the management of market risk and liquidity risk, has progressed smoothly, and market risk measuring techniques and reporting systems were further improved.

- **Our products**

We have strived to expand our product portfolio and introduce value-added new products in a timely manner to best satisfy the needs of our customers.

During the first half of 2006, we introduced new residential mortgage loan products, such as maximum amount mortgages and fixed rate mortgage loans, and increased flexibility of lending and repayment. We launched a series of new products targeted at corporate customers, such as co-advisory services in IPO and commercial property mortgage loans. In order to meet the market demand for trade finance, the Bank also introduced services such as overseas financing guarantees and export credit refinancing. In June 2006, the Bank obtained approval from CBRC to invest abroad for its customers, and became one of the first commercial banks to be recognised as Qualified Domestic Institutional Investor (QDII). The Bank also launched Renminbi quanto product linked with foreign exchange rates to meet customers' investment needs.

- **Our services**

We are committed to instilling the customer-focused philosophy into every staff member.

In the first half of the year, we enhanced the efficiency of the front office and centralised processing ability of the back office by improving the transaction processing procedures. We provide quality service to high net-worth customers through the use of the customer relationship management system and expanding our wealth management card's function in overseas transactions. We are the only commercial bank in the PRC that offers all mobile phone banking services including WAP, BREW and short message services. The Bank also achieved efficient coordination of its call centre system, internet banking system and mobile phone banking system by integrating various electronic service channels, and the success rate of transactions was improved. The practice of E-channel service of the Bank won the Retail Banking Project Award for Cross Channel Experience Project by *The Banker*; while our credit card system won *The Banker's* Retail Banking Innovation Award for Payment Innovation with its dual-currency structure and design of a limit beyond which a PIN is necessary to authorise transactions.

- **Our people**

We continued to revamp our human resources management, and actively explored ways to establish a market-oriented and practical human resources management system. Our human resources structure was further improved by accelerated replacement of staff through various channels, gradually reducing back office staff in administrative and logistic departments and increasing front office customer managers. We also intensified the reform of our compensation system by tying an employee's compensation to his or her job responsibilities and performance. We also established an appraisal system where middle and senior management were evaluated by key performance indicators. At present, the Bank is actively exploring the feasibility of establishing incentive schemes including a senior management stock appreciation rights plan and an employee stock ownership plan.

The Bank attaches great importance to staff education and career development. In order to enhance the quality of our staff, training programmes were extended to all staff members. In the first half of 2006, the Bank organised various domestic and overseas training programmes for its management staff and professional staff including customer managers and personal financial planners, reaching as many as 167,100 person times.

- **Technical support**

The Bank continued to invest in information technology to meet the increasing needs of its business expansion and management enhancement.

In the first half of 2006, the operational customer relationship management and integrated product service system ("OCRM-IPSS") was successfully launched, facilitating face-to-face sales activities and allowing product customisation and flexible pricing for our personal banking business. With the technical support of our automated dealing system, which allows straight-through processing for foreign exchange transactions with both retail and institutional customers, the Bank became the first PRC commercial bank to provide our customers with on-line quotations, and enabled them to execute transactions 24 hours a day.

With the successful implementation of the commercial lending process management system in pilot branches, a major process system covering the entire workflow of our credit business and integrating various lending functions came into shape. An accounting documentation management and checking system was launched in certain branches, realising automatic and electronic management of accounting documents and associated checking function. The Bank is currently implementing an ERP financial software package, upon the completion of which the general ledger and financial information for disclosure will be managed in a centralised manner. The first phase of data warehouse and management information system will be completed shortly, and help to improve the information sharing across the bank and enhance our operational management.

- **Strategic alliance**

In the first half of the year, in accordance with our business development strategies we strengthened our collaboration with Bank of America Corporation (“BAC”) in retail banking. Collaborative programmes, including transformation of retail branches and improvement of personal loan centres, were launched with the goal to accelerating the establishment of an efficient retail business model and improving service quality. At present all the projects are progressing smoothly, and waiver of fees has been realised for holders of the wealth management card of the Bank and those of BAC’s debit card and ATM card when withdrawing cash from each other’s ATMs. The assistance and cooperation programmes with Asia Financial Holdings Pte. Ltd. (“AFH”), a wholly-owned subsidiary of Temasek Holdings (Private) Limited (“Temasek”), and other associated institutions are also progressing smoothly. In addition, certain domestic and overseas training programmes were arranged under which our strategic partners would provide extensive training to our staff and share with us their business philosophies and management experiences.

LOOKING AHEAD

In the second half of the year, in light of the steady growth of China’s economy and further strengthening of the macroeconomic control measures by the government, the Bank will make reasonable adjustments to its lending scale and structure by closely tracking the macroeconomic policies and monitoring the risk associated with real estate industry. To address the financial demands of the market and customers, we will continue to enhance our capability to innovate products and services and we hope to increase the contribution of fee and commission income to operating income. In addition, we would try to apply the Six Sigma management method in the improvement of our service by learning from BAC, and expedite the implementation of the strategic assistance programmes in areas such as risk management and information technology. We will continue to promote human resources management reform so as to establish a more performance-driven system that maintains a proper balance between incentives and control.

I succeeded Mr. Chang Zhenming as President of the Bank in July 2006 and would like to extend my deep gratitude to Mr. Chang for his contribution to the reform and development of the Bank during the past two years. With the concerted efforts of the management and our staff in pursuit of excellence, we will endeavour to maintain steady growth in business and profit following the development strategies and operational targets set by the Board, and bring satisfactory returns to our shareholders and position the Bank for a brighter future.



President

24 August 2006