
RISK MANAGEMENT

OVERVIEW

As a commercial bank, we are subject to a number of risks, primarily including credit risk, market risk, operational risk, liquidity risk and compliance risk. In order to manage these risks, we are committed to establishing a comprehensive risk management system that covers the identification, assessment, measurement, monitoring, reporting and control of risks. We have been dedicated to strengthening our risk management, with the NPL ratio of our total loans and advances to customers being 0.75%, 0.64%, 0.74% and 0.80% as of December 31, 2010, 2011 and 2012 and June 30, 2013, respectively.

Our principles for risk management are to steer the optimization of business portfolios by using our economic capital management framework and risk pricing mechanism to facilitate the match between the returns and the risks assumed, and to maintain our risk exposure within acceptable risk levels, in coordination with the implementation of our overall business strategies and comprehensive risk management system. On this basis, we ultimately aim to maximize returns to our Shareholders by maintaining capital adequacy levels that balance our risk exposure with our strategic objectives while striving to comply with the relevant regulatory requirements.

Our risk management principles are as follows:

- (i) Comprehensive risk management: to establish and refine our comprehensive risk management covering various major risks;
- (ii) Independent risk management: our risk management system is kept independent from our business operational system; and
- (iii) “Creating value through effective risk management”: we create business value by achieving a balance between risk and return and a balance between control and efficiency.

Our risk management goals are as follows:

- (1) To cultivate a proactive risk management culture of “creating value through effective risk management” by:
 - improving our policies and procedures, strengthening our training and implementing a position certification system to improve the quality of our business and risk management personnel;
 - senior management setting an example for the rest of our staff and increasing accountability in order to increase our staff’s awareness of risk; and
 - including risk management performance as an evaluation criterion for appraisals of our staff, branches, sub-branches and various departments.
- (2) To formulate and adhere to proactive and prudent risk management policies by:
 - applying differentiated policies at different levels, standardizing the policy and management procedure through expert participation, regular reviews and other methods, and implementing our principles of fully identifying risks, accurately assessing risks, and taking reasonable risks;
 - establishing regular review mechanisms and continuous optimization of the relevant mechanisms in order to better balance the relationship between principles and flexibility, the relationship between differentiation and consistency and the relationship between economic interests and social responsibility; and
 - enhancing our policy execution system.

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- (3) To build up a risk management organizational matrix by:
- building up our risk management organizational structure and system in accordance with the principles of vertical management for credit risk, centralized management for market risk and hierarchical management for operational and compliance risks in order to reflect the risk management needs of our business development;
 - improving our risk management organizational matrix and extending such structure to tier-two branches, cross-city and county-level sub-branches;
 - defining a clear allocation of functions and responsibilities among our various committees, departments, units and personnel to prevent any gap in or overlap of duties and authorities and to increase our risk management efficiency; and
 - ensuring the independence and professionalism of our Risk Management Department and aligning its functions closer to market conditions and our business objectives.
- (4) To ensure prudent and effective risk management processes by:
- focusing on the different characteristics of credit risk, market risk, operational risk, liquidity risk and compliance risk and building corresponding risk management processes;
 - implementing a system of comprehensive early warning, prompt risk reporting and swift response to risks; and
 - ensuring that the Board of Directors, its Risk Management Committee and senior management promptly monitor various risks and adopt effective measures to prevent and resolve such risks.
- (5) To set up an appropriate and active advanced technology support system for proactive risk management by:
- following the core principles of the New Basel Capital Accord and adopting the best practices of banks both within and outside the PRC;
 - setting up a technology support system that covers effective measurement, analysis and management of credit risk, market risk, operational risk, liquidity risk and compliance risk; and
 - utilizing advanced technology to support more specialized and targeted risk management processes.

KEY RECENT IMPROVEMENTS IN RISK MANAGEMENT

The key risk management improvements we have made in recent years are as follows:

- In January 2007, we implemented a risk and control self-assessment program across various business lines as well as in our branches and sub-branches, conducted risk investigations using process analysis methodologies and by taking into consideration internal and external data relating to operational risk incidents together with findings from audit and compliance inspections and evaluated and improved the effectiveness of risk control measures.
- In November 2007, we established the Operation Management Department, which is responsible for managing clearing and settlement activities throughout our Bank, approving the disbursement of corporate and retail credit and conducting centralized management of letters of credit, letters of guarantee and other settlement products. By standardizing our operations, the Operation Management Department helped improve the standards of our centralized management and our operations, enhance risk management and improve operational efficiency.

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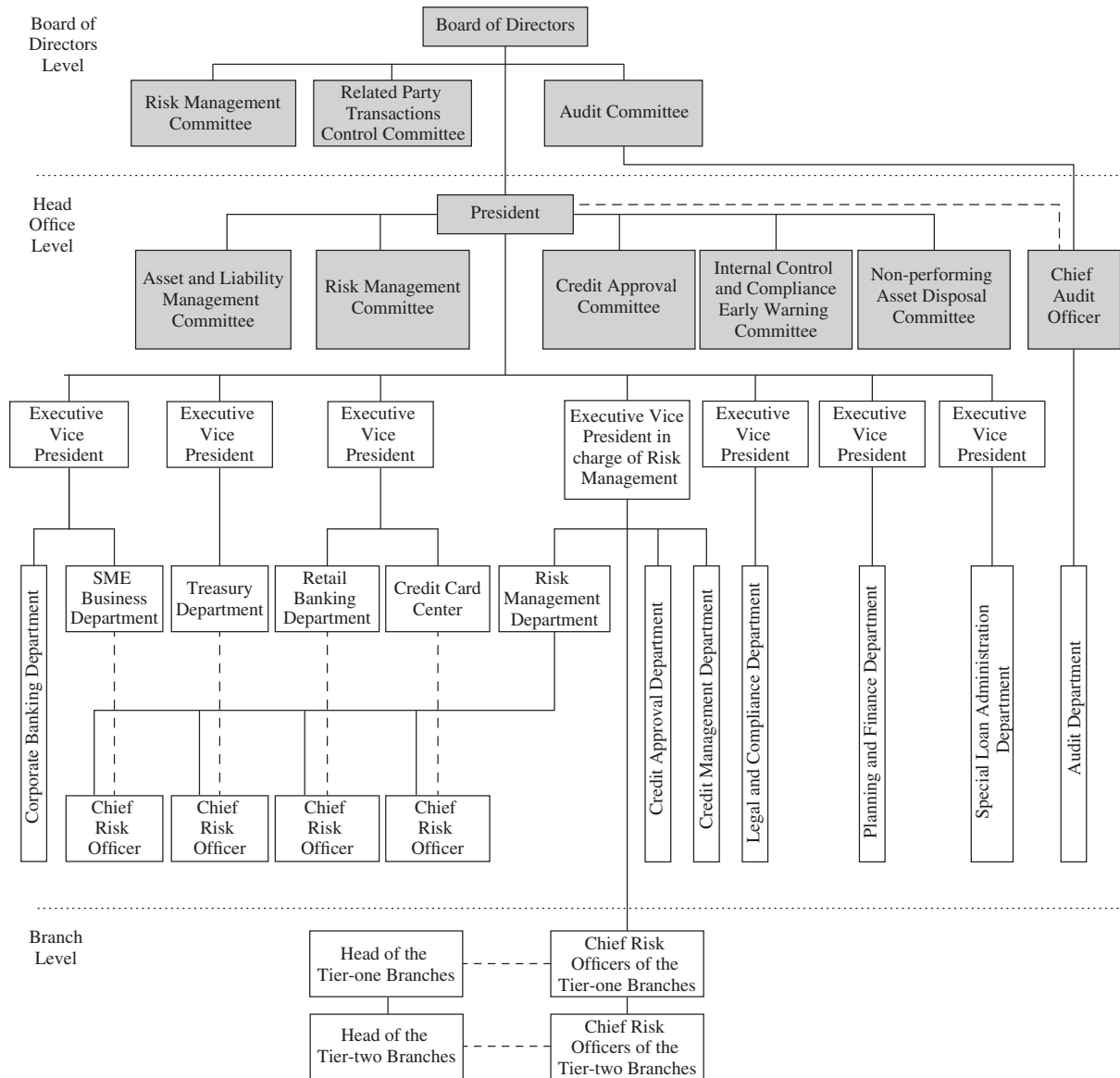
- In February 2008, we integrated the functions and personnel of the three regional credit approval centers into the Credit Approval Department of our Head Office, which is responsible for approving loans falling outside the limit of authority of the branch-level chief risk officers. Additional integration of resources was carried out to further standardize and regulate credit approval process.
- In December 2008, we started to assign chief risk officers to various business departments of our Head Office, including the Treasury Department, the Credit Card Center, the Retail Banking Department and the SME Business Department. Through the assignment process, we have created a mechanism for the effective operation of, and cooperation between, the departments in charge of risk management and the frontline departments. This in turn allowed us to fully capitalize on the risk prevention function of the frontline departments and the risk control function of the middle offices, thus further strengthening the risk management of our business lines.
- In December 2009, we completed and submitted a Compliance Self-assessment Report and 13 sub-reports concerning compliance guidelines to the CBRC.
- In March 2010, we initiated a compliance platform project to fulfill the requirements of the New Basel Capital Accord, which mainly includes compliance self-assessment, project management and the establishment of a risk-weighted assets system.
- In June 2010, we implemented our operational risk management system.
- In December 2010, we implemented our market risk management system.
- In November 2011, we submitted an assessment application for the implementation of the New Basel Capital Accord to the CBRC.
- In January 2012, we began implementing plans to consolidate our risk management functions by shifting the main reporting line of each business line's chief risk officer and risk management team to the Risk Management Department in order to strengthen the independence of our risk management functions. We completed such adjustments in December 2012.
- During 2012, we adopted multiple measures to strengthen our risk management, including: (i) enhancing capital management by improving policies and management processes, bolstering capital deployment plans and promoting organic integration between capital management, risk management, assets and liabilities management and financial and business planning; (ii) launching a series of plans and proposals to improve risk management procedures, including an early warning platform for corporate customers, obtaining market information on risks, assessments on the impact of our debts and promoting accuracy and precision in our comprehensive risk management system; and (iii) formally commencing our risk-weighted assets system, which calculates risk-weighted assets based on four methods: initial capital method, weighted method, basic internal rating, and advanced internal rating (with the second, third and fourth methods falling under the principle of the new capital method).
- In early 2013, we completed upgrades of our credit rating system for corporate customers and further improved both the stability of our credit rating model and the practical business applicability of our non-retail internal rating adjustments system.
- In May 2013, we established the Credit Management Department at the Head Office in order to implement a risk management system that better suits the development of the SME and micro-enterprise financial services. The Credit Management Department also aims to enhance our risk management capability, strengthen our post-credit management and ensure the quality and stability of our credit assets.

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- During the second half of 2013, in response to concerns about the tightening of liquidity in the PRC banking industry which resulted in significant, temporary fluctuations in the inter-bank lending rate during certain periods, we have emphasized amongst our departments the overriding importance of sound liquidity, increased our reserve level, and arranged for stronger short-term liquidity commitments, as well as implemented further upgrades to our internal controls to mitigate potential operational risk, including: (i) centralizing liquidity gap solutions through inter-bank financing under our Head Office; (ii) enhancing the daily critical point calibration mechanism; (iii) reevaluating the operational and liquidity risk management system and the reporting mechanism; (iv) strengthening our procedures in emergency management; and (v) controlling the scale of our inter-bank business and executing improved matching of inter-bank assets and liabilities.

RISK MANAGEMENT STRUCTURE

The chart below illustrates our risk management structure:



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Board of Directors and Board Committees

The Board of Directors is the highest decision-making authority within our Bank in terms of risk management and is responsible for determining the overall risk management strategies and making important decisions for our Bank. It is also responsible for: determining our risk tolerance; examining the risk precaution measures formulated by our senior management; deciding on the fundamental management system and the establishment of our internal management organization; appointing senior management; examining the internal control assessment reports provided by the management, audit and regulatory authorities; reviewing and commenting on the effectiveness of our internal control system; and supervising the senior management's continuous improvement of our internal control system. The Board of Directors performs its risk management functions through the Risk Management Committee, the Audit Committee and the Related Party Transactions Control Committee.

The Risk Management Committee is responsible for formulating our risk management strategies and overall risk tolerance, and implementing such strategies and risk tolerance upon approval of the Board of Directors. It is also responsible for: supervising senior management in their management of credit, market and operational risks; assessing our risk management system and making recommendations to the Board of Directors; preparing periodical risk management reports for submission to the Board of Directors; developing management targets with respect to our capital adequacy ratio; and advising on related information disclosure.

The Audit Committee is responsible for monitoring and supervising our internal control function as well as overseeing our accounting policies and financial reporting procedures.

The Related Party Transactions Control Committee is responsible for the implementation of policies and guidelines relating to the review, approval, management and supervision of our related party transactions, as well as the assessment of the potential risks they may give rise to.

For further details of the respective responsibilities of our Board of Directors, as well as the Risk Management Committee, the Audit Committee and the Related Party Transactions Control Committee, see "Appendix VI – Summary of Articles of Association" and "Directors, Supervisors and Senior Management – Board of Directors Committees."

Senior Management and Special Committees

Based on the risk management strategies reviewed and approved by the Board of Directors, the senior management formulates, implements and manages various policies, systems, rules and limits covering a wide range of risks during the course of their day-to-day operations and management functions in order to ensure that all types of risks are effectively managed and controlled. Our senior management has established the following special committees: the Asset and Liability Management Committee, the Risk Management Committee, the Credit Approval Committee, the Non-performing Asset Disposal Committee and the Internal Control and Compliance Early Warning Committee, which coordinate, organize and supervise their respective risk management functions.

President

Our President is responsible for the operation and management of our Bank, including overall risk management and implementation of decisions made by the Board of Directors. Our President submits business plans to and implements such plans upon approval by, the Board of Directors. Our President also formulates our internal management organizational structure, core management policies and specific rules and procedures. The President may undertake other functions and exercise other powers as conferred upon him under the Articles of Association or by the Board of Directors.

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Executive Vice President in Charge of Risk Management

Our Executive Vice President in charge of risk management reports to the Board of Directors' Risk Management Committee and the President on bank-wide risk exposure, material matters relating to risk and corresponding solutions, as well as the organization and operation of our risk management system. Our Executive Vice President in charge of risk management is also responsible for formulating and, upon obtaining the relevant approval, implementing our risk management framework, principles and strategies based on our overall development strategies. Furthermore, based on his authority, our Executive Vice President in charge of risk management: approves and supervises the implementation of risk management indicators for various business activities, bank-wide risk management policies and reporting processes; carries out assessments of the risk management system; examines and approves the detailed rules on risk management; and is responsible for tailoring our risk management system to achieve its risk management objectives. The chief risk officers of tier-one branches report to our Executive Vice President in charge of risk management.

Special Committees under Senior Management

- Risk Management Committee. By taking into consideration the external economic environment and our business development and risk management, the Risk Management Committee reviews our risk management strategies and provides suggestions on amendments to such strategies to our President at our President's executive meetings. It is also responsible for: the review of our risk management policies, procedures and rules and regulations, as well as their implementation upon submission and approval in accordance with the management procedure; the review of reports on the bank-wide risk profile, material matters relating to risk and risk management, and the organization and operation of our risk management functions; and the review of risk management issues raised by relevant departments of our Head Office and by our branches.
- Asset and Liability Management Committee. The Asset and Liability Management Committee is responsible for reviewing and providing guidance for our business development plans. It is also responsible for reviewing and determining annual targets and plans for the allocation of assets, liabilities and off-balance sheet items and making adjustments to such targets and plans in accordance with specific circumstances. Further, it regularly reviews reports on the bank-wide asset and liability status. It is also responsible for the management of bank-wide liquidity risk and the interest rate risk of banking books.
- Credit Approval Committee. The Credit Approval Committee is responsible for the examination and approval of credit applications that fall beyond the limits of authority of the Credit Approval Department of our Head Office and for providing guidance on matters relating to credit examination and approval throughout our Bank.
- Non-performing Asset Disposal Committee. The Non-performing Asset Disposal Committee reviews and approves the procedures, incentive measures and relevant policies for the disposal of and recovery of non-performing assets as well as examines and approves asset disposal proposals, the repayment of debts by assets, loan foreclosure on repossessed assets, the loan write offs and litigation relating to non-performing assets and risk agency matters.
- Internal Control and Compliance Early Warning Committee. The Internal Control and Compliance Early Warning Committee reviews early warning signal reports, approves proposals for handling early warning signals, instructs relevant departments to conduct special investigations, implements action plans in relation to early warning signals and performs other compliance functions with respect to the management of early warning signals.

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Head Office Risk Management Departments

Risk Management Department

The Risk Management Department coordinates and puts in place comprehensive risk management for credit, market and operational risk. It is responsible for: formulating policies and procedures for risk management; regular review and modification according to actual circumstances, and setting out relevant implementation rules; formulating, tracking and improving our credit policies, risk management system and methods and the rules and processes of making credit-related decisions; compiling and collating various types of risk management reports and reporting to the senior management, the Asset and Liability Management Committee and the Risk Management Committee of our Bank and the Risk Management Committee of the Board of Directors in a timely manner; formulating strategic plans for our credit portfolios composition; analyzing the performance of our credit portfolios; and organizing, developing and maintaining risk management systems and models. The Risk Management Department assigns a chief risk officer and/or a risk management team to each of the Retail Banking Department, Credit Card Center, Treasury Department and SME Business Department to establish customized risk management systems targeted to address specific risk profiles of each business line.

Credit Approval Department

In accordance with our credit policies and procedures, the Credit Approval Department is responsible for: examining, considering and approving various types of credit business applications within their limit of authority; administering the specific delegation of credit approval authority in our credit business; formulating plans for credit approval authority delegation in our credit business; organizing, monitoring, administering and appraising the bank-wide implementation of credit approval authority delegation; and periodically reviewing the credit examination and approval activities of lower-level credit approval functions.

Credit Management Department

The Credit Management Department performs three core functions: (i) data analysis and model building at the portfolio level, (ii) post-credit-granting review and management and risk warning at the business level, and (iii) key operating procedure control at the process level. The Credit Management Department is responsible for coordinating credit risk monitoring and portfolio management for large, medium, small and micro-sized credit granting operations at our bank. Additionally, the Credit Management Department conducts industry and credit asset portfolio data analysis, formulates and maintains our post-credit-granting management system, reviews and examines credit and loans granted to corporate and retail customers, monitors and administers key credit business procedures, and monitors and guards against events associated with material risks.

Legal and Compliance Department

The Legal and Compliance Department is responsible for: coordinating and organizing the management of internal control, compliance risk and legal risk throughout our Bank; developing the relevant compliance risk management policies and systems; providing guidance for implementing bank-wide compliance tasks; organizing legal and compliance inspections for our businesses and communicating with external regulatory authorities in connection with compliance matters.

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Special Loan Administration Department

The Special Loan Administration Department is responsible for: formulating implementation rules on the management of non-performing assets; managing non-performing loans; filing claims against borrowers who become bankrupt or insolvent, or handling follow-up work against borrowers who are liquidated or dissolved; handling debt restructuring in relation to non-performing assets; assessing the rating, interest suspension, waivers of interest and other issues relating to non-performing assets and reporting to the Non-performing Asset Disposal Committee for approval; and preparing application materials relating to debt write-offs for submission to the Non-performing Asset Disposal Committee for examination and approval.

Other Departments

In addition to those set forth above, certain other departments also implement risk management policies and procedures and perform certain management functions within their scope of operation.

Risk Management Structure at the Branch and Sub-branch Levels

Tier-one Branches

We have implemented a program to assign chief risk officers to tier-one branches. While chief risk officers at the branch level are directly under the leadership of our Head Office, they also report to the local branch heads and are subject to the guidance of the Risk Management Department, Credit Approval Department, Credit Management Department, Special Loan Administration Department and Legal and Compliance Department in our Head Office in relation to business matters so as to maintain the independence of the risk management of tier-one branches. Chief risk officers at the branch level supervise the risk management department, special loan administration department and legal and compliance department of their respective branches and are responsible for managing the credit risk of such branches and examining and approving loans within their limit of authority. They also assist the branch heads in managing operational and compliance risks.

Tier-one branch heads are ultimately responsible for tier-one branch-level operational and management matters. They are in charge of the overall risk management tasks of their local branches and are responsible for creating a favorable atmosphere for risk management and for establishing an effective risk management system. Based on the principle of the hierarchical management of operational and compliance risks, branch heads are responsible for establishing branch-level operational risk and compliance risk management systems at the request of our Head Office and have primary responsibility for the management of such risks at the branch level. In accordance with the principle of vertical management of credit risk, branch heads support their respective branch's chief risk officers in managing credit risk by examining the branch/regional marketing guidelines and by exercising the "veto right" in the dual approval process for corporate credit applications.

Tier-two Branches, Cross-city and County-level Sub-branches

In order to standardize the risk management of tier-two branches, cross-city sub-branches and county-level sub-branches and to promote the healthy and orderly development of our businesses, we have begun to apply the risk management system of tier-one branches to our tier-two branches, cross-city sub-branches and county-level sub-branches.

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CREDIT RISK MANAGEMENT

Credit risk is the risk of loss that we may suffer from default by an obligor or counterparty of his/her obligations or commitments under a contract. We are exposed to credit risk mainly in the form of loan portfolios, investment portfolios, guarantees and balance sheet and off-balance sheet credit risk exposure. To address our off-balance sheet credit risk, we implemented a comprehensive risk management program for all of our off-balance sheet businesses to prevent them from over-expanding by utilizing measures such as risk quotas and economic capital evaluations. We incorporated our off-balance sheet businesses into our uniform credit management system and centralized our credit risk management.

We manage credit risk by adopting normalized and unified processes and standards for our credit business. The Risk Management Department of our Head Office, in conjunction with other relevant departments, regularly reviews and modifies the workflows and standards adopted for our credit business. Credit risk management includes corporate credit, retail credit and financial institution credit management and may be broadly divided into three segments, namely: (i) acceptance of credit applications and credit investigations; (ii) credit examination and approval; and (iii) opening of credit lines and post-disbursement management.

Management of Credit Risk Associated with Corporate Credit Business

Acceptance of Credit Applications and Credit Investigation

All applications made to us for corporate credit are handled by our customer relationship managers. We adhere to the principle of “two-person investigation” in carrying out our credit investigations. The primary customer relationship managers and supporting customer relationship managers conduct comprehensive investigations of applicants or target customers, collect relevant information and data and thoroughly assess the credit applicant’s eligibility for credit, the customer’s solvency, compliance of the business by which the credit will be utilized and the reasonableness of credit plans. The credit investigation consists mainly of on-site investigation, which is supplemented by indirect investigations. Visits are made to the applicant’s financial department, production and operation premises, key managers, clients and creditors with a view to obtaining first-hand data and gaining a comprehensive understanding of the production and operation, management, financial affairs, and credit status of, and industry information relating to, the applicant. If necessary, we may verify the authenticity of the information provided by customers through third party credit investigation agencies, relevant governmental departments, social intermediaries and other commercial banks and file the information for our records. If a customer relationship manager determines that an applicant meets the requirements of our credit policies and the basic criteria for credit, the customer relationship manager will request that the applicant submits the credit application and the relevant documents required in connection with the credit application.

The risk managers work in parallel with the customer relationship managers during the credit investigation process to uncover and assess credit risk and provide their opinions on the appropriateness of credit extension. The analysis and assessment of credit business usually include: (i) risk rating; (ii) assessment of credit business; and (iii) assessment of collateral.

(i) Risk rating

Our rating of risks associated with the corporate loan business generally consists of borrower rating and facility rating. In general, we carry out both borrower rating and facility rating for our normal risk corporate loan business and, if the loan is guaranteed, we carry out guarantor rating. Borrower rating is an assessment of a borrower’s willingness and ability to repay its debts in the future, based on a comprehensive analysis of the quantitative and qualitative risk factors of a borrower (or a guarantor), and

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the rating results are shown by credit ratings. Our borrower rating system is composed of 24 different grades, with each individual grade corresponding to a probability of default (PD) in a one-year horizon. Facility rating is an assessment of the expected loss rate (ER) of specific transactions. A comprehensive consideration of borrower rating and default loss rate is shown as the product of the PD and loss given default (LGD). The assessment results are classified into 12 grades.

We use an internal rating system to rate the risks associated with our corporate credit business. Our internal rating system, which was developed under the guidance of the New Basel Capital Accord, was introduced on a bank-wide basis in 2004. On the basis of business performance indicators and data on the financial status of customers and through customer assessment models, the system measures the probability of default of customers, and, on that basis, computes the preliminary results of customer rating. The customer relationship managers are responsible for the preliminary assessment of borrower rating and risk managers are responsible for review and approval of the borrower rating. We treat credit risk rating results as an important basis for decision-making for our credit business, and have established clear guidelines on thresholds based on risk ratings.

(ii) Assessment of credit business

The investigation and assessment of the first source of repayment is the primary part of the credit investigation. Customer relationship managers are responsible for credit analysis and assessment.

The analysis and assessment of credit risk mainly include investigation of: (i) the integrity of a borrower; (ii) authority for a borrower to borrow funds; (iii) use of loans; (iv) profitability of the borrower and the professional management capability for the operation of such borrower; (v) professional knowledge of the borrower; (vi) prospects of the industry in which the borrower operates; (vii) repayment terms; (viii) sources of repayment funds; (ix) forecast of cash flow in various business cycles; (x) current credit and financial information of the borrower and relevant members of its group company; and (xi) valuation of collateral (or pledge) and its validity as well as the ability of guarantors to repay for borrowers and the validity of the guarantee.

(iii) Assessment of collateral

For loans with collateral, the value of collateral is usually required to be evaluated by independent appraisers. While different loan-to-value ratios will apply to loans secured by collateral based on the type and the specific condition of such collateral, the ratio should not generally exceed the maximum loan-to-value ratio for such type of collateral. Set out below are the loan-to-value ratios for major types of collateral:

Major types of collateral	Maximum loan-to-value ratio
Land use right mortgage (assignment)	70%
Real estate	40% – 60%
Machinery and equipment	30% – 40%
Certificates of deposits, treasury bonds, financial bonds.....	80% – 90%
Warehouse receipts, bill of lading	70%
Other rights ⁽¹⁾	40% – 80%
Other movable assets	50%

Note:

(1) Mainly include other property rights that may be pledged pursuant to the laws and administrative regulations of the PRC, such as receivables, transferable fund shares and shareholder rights.

Where loans are to be guaranteed by a third party with joint and several liability, we conduct an assessment of the guarantor's financial status, credit records and ability to repay for borrowers.

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Credit Examination and Approval

Approval Authority

Our credit approval departments are independent from our business operation units. The examination and approval of credit follow the principles of objectivity and impartiality and opinions as to decision-making are given independently without any interference from internal or external factors. All credit projects are handled in conformity with the stipulations set by us with respect to the investigation and granting of credit and the processes for examination and approval.

Our normal-risk corporate loans are examined and approved by our authorized approval authorities and personnel, including our Head Office's Credit Approval Committee and Credit Approval Department, the chief risk officer of the SME Business Department of our Head Office, the chief risk officers of the branches, the general manager of the Risk Management Department of the branches as well as the heads of branch-level SME credit management centers and other authorized personnel, in each case according to the particular authorities granted to them. Our low-risk corporate loans are examined and approved by authorized examination and approval officers in various business lines.

Examination and Approval Process

(i) Normal-risk corporate credit business

Generally, the credit approval process includes the following stages of review and approval:

- (1) the customer relationship manager completes a credit investigation report and, upon approval from the persons in charge of the relevant operational units, submits the report to the branch risk manager for review and issuance of a review report;
- (2) upon review by the branch-level risk manager, any matter within the authority of the general manager of the branch-level risk management department will be sent to him/her for review and approval. The general manager of the branch-level risk management department directly issues rejections of credit applications and sends accepted applications to the head of the branch-level corporate banking business, who holds veto power, for review and as part of the dual approval process. The head of the branch-level corporate banking business then signs his or her opinion and issues the decision;
- (3) upon review by the branch-level risk manager, any matter that exceeds the authority of the general manager of the branch-level risk management department must be submitted as a separate review report to the branch-level credit review committee for comments (certain applications are not subject to this review process and can be directly submitted to branch-level risk officer). Credit applications not approved by the credit review committee are submitted to the chief risk officer, who then issues the rejections. Credit applications that have been reviewed and approved by the credit review committee are submitted to the branch's chief risk officer for approval within the limits of his authority as part of the dual approval process, and then submitted to the branch head, who holds veto power, for review and approval; and
- (4) credit applications accepted by the chief risk officer but that exceed the chief risk officer's approval authority may only be submitted to our Head Office if the branch head signs a written consent. All credit applications submitted to the Head Office by the branches and relevant departments of the Head Office are initially examined for preliminary approval by a junior examination officer of the Credit Approval Department, and then submitted to the competent higher-level review officer or institution for final approval. In accordance with the different features of credit applications, such applications may be approved by meetings or by authorized officers of the Credit Approval Department of our Head Office.

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(ii) Examination and approval of credit applications from SMEs

For our SME customers, the approval process generally follows the above process for credit applications. However, an SME applicant of a tier-one branch shall also undergo credit investigation by the SME credit management center of the risk management department of that branch, followed by a report issued on the investigation. Any applications approved at this stage will then be examined for approval by the head of the branch-level SME credit management center, unless such approval would exceed his authority, in which case the application will be referred to the general manager of the branch-level risk management department or the branch-level chief risk officer for examination and approval within the limits of his authority. An application which has been approved by the head of the branch-level SME credit management center within the limits of his authority will then require the issuance of a signed opinion from the general manager of the SME business department, who holds a veto right.

For tier-two branches, cross-city sub-branches and county-level sub-branches that have a chief risk officer, an application by an SME customer must be investigated by the risk manager of the branch or sub-branch and then submitted to the chief risk officer of the branch or sub-branch for examination and approval within the limits of his authority. Where the approval of an application requires higher authority, the application will be referred to the tier-one branch chief risk officer for examination and approval within the limits of his authority.

Since 2012, we have implemented various measures in order to proactively address potential risks in connection with the downturn in macroeconomic conditions, as well as strengthen our risk management and improve asset quality. First, we implemented improved business modeling and improved risk mitigation functions. Second, we strengthened our risk monitoring system and conducted real-time surveillance and on-site examinations. Third, we maintained monitoring of risks associated with SMEs, enhanced monitoring of customers with non-performing loans and increased our clearing and recovery efforts.

(iii) LGFV credit business

For our LGFV credit business, we have implemented a risk management system that governs the whole process of the extension of such credit by following commercial principles and by standardizing our operations. In conducting risk assessments to ensure that the borrowers (particularly with respect to new loans) meet our credit standards, we take into account the overall solvency of the LGFVs and their debt servicing ability so as to prudently evaluate the risks associated with granting loans to such entities, including collateral risk and maturity risk. In the post-disbursement stage, we continuously monitor factors that may affect repayment and we use a comprehensive early warning system to identify, categorize, report and address maturity risk. We have developed rating tools that classify the underlying risks of loans to such entities in a more accurate and objective manner and analytical tools to strengthen maturity risk analysis and monitoring.

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The CBRC requires PRC banks to classify LGFV loans in accordance with the level of cash flow coverage, which refers to a borrower's cash flow divided by the total loan principal and the interest incurred. The following table sets forth the level of cash flow coverage for our LGFV loans as of June 30, 2013:

	Proportion of borrowers as of June 30, 2013⁽⁵⁾
Full coverage ⁽¹⁾	95.56%
Basic coverage ⁽²⁾	3.87%
Semi-coverage ⁽³⁾	0.24%
Non-coverage ⁽⁴⁾	0.33%

Notes:

- (1) Full coverage means a borrower has sufficient cash flow to cover 100% or more of its total loan principal and the interest incurred.
- (2) Basic coverage means a borrower has sufficient cash flow to cover between 70% and 100% of its total loan principal and the interest incurred.
- (3) Semi-coverage means a borrower has sufficient cash flow to cover between 30% and 70% of its total loan principal and the interest incurred.
- (4) Non-coverage means a borrower has sufficient cash flow to cover less than 30% of its total loan principal and the interest incurred.
- (5) The percentages below are subject to rounding.

As of June 30, 2013, the cash flow of the majority of our LGFV borrowers was sufficient to cover 100% (or above) of the principal and the interest incurred. The remaining loans were secured by valid guarantees or collaterals or those originated from economically developed regions equivalent to or above the prefectural level.

As of June 30, 2013, 36% of our total LGFV loans were extended to entities at the provincial level, 53% were at the prefectural level and 11% were at lower levels of administrative division. As of June 30, 2013, our loans to LGFVs located in the Yangtze River Delta, Bohai Rim, Pearl River Delta and the other regions represented approximately 23%, 21%, 8% and 48%, respectively, of our total LGFV loans. As of June 30, 2013, our loans to LGFVs in the industries of (i) transportation infrastructure, (ii) municipal infrastructure, (iii) land reserves and (iv) others represented 32%, 17%, 42% and 9%, respectively, of our total LGFV loans.

(iv) Corporate real estate loan business

We require the implementation of credit life cycle process management for our corporate real estate loan business, which means that we focus on mid- to high-end customers and have put in place a specialized and centralized management system for our entire corporate real estate loan business. We have established the Real Estate Finance Center under the Corporate Banking Department of our Head Office, which is responsible for coordinating our corporate real estate loan operations and reviewing relevant project proposals. The Credit Approval Committee of our Head Office, the real estate credit approval center of the Credit Approval Department and the chief risk officers at the branch level are authorized to carry out the examination and approval of loan applications. After credit extension, we require that the utilization of credit match the construction progress of a real estate development project. During the post-disbursement stage, we require that management, control and risk investigation for loans be strengthened by strictly monitoring the source of funds for repayment and conducting regular reappraisals of the value of collateral and pledged assets. Since 2008, we have been conducting special stress tests on real estate loans and loans granted to industries related to real estate and developing risk measurement tools for loans granted to industries related to real estate. As of June 30, 2013, our residential and commercial property development loans, primary land development loans and mortgage loans for properties used for business operation of our corporate real estate loans accounted for 42.05%, 40.11% and 11.46% of our total corporate real estate loans, respectively.

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(v) Low-risk corporate credit business

Our low-risk corporate credit business is conducted through a special credit approval process, and applications are examined and approved by authorized approval officers from the corporate banking business line within the limits of their authority. Low-risk corporate credit applicants are required to fulfill the following conditions: (1) the collateral and pledged assets are cash-equivalent assets or guarantees provided by financial institutions recognized by us; (2) the security provided can discharge in full the obligations relating to our creditor's rights (including principal, interest and service fees); and (3) the security is not legally defective and there is no associated policy risk.

Opening of Credit Lines and Post-disbursement Management

Opening of Credit Lines

The opening of credit lines involves fulfilling prerequisites for the granting of credit, entering into relevant contracts, loan reviews and making necessary accounting entries. After a credit application is approved, a credit line can be opened only after a Disbursement Approval Center at the branch level has determined upon examination that the prerequisites for the granting of credit have been fulfilled, the credit contract has been signed by an authorized person, the relevant legal procedures have been completed and the validity of any security has been confirmed. Substantially all of our credit contracts are in the standard form prescribed by our Legal and Compliance Department, and those that are not are subject to approval by our Legal and Compliance Department.

Post-disbursement Management

We have established a post-disbursement management system with defined responsibilities and standardized methods to continuously monitor factors that may affect repayment. We conduct off-site and on-site inspections and apply risk modelling techniques on the basis of our experience in order to detect the potential risks associated with a specific borrower, issue early warnings and adopt remedial measures. Customer relationship managers are responsible for the day-to-day credit check on the operating conditions and use of credit by their respective borrowers, so as to detect any signs of potential credit default and to adopt risk mitigation measures as soon as possible. Risk monitoring centers of the risk management/credit management departments at the branch level are responsible for post-disbursement organization, supervision, guidance, inspection and reporting. We emphasize monitoring factors that may have a negative impact on the ability of borrowers to make repayment, mainly including (i) the operating and overall credit risk status of a borrower, including its receivables and inventory, changes in operating cash flow and unusual cash outflows; (ii) the status of projects into which loans are injected; and (iii) the condition of assets collateralized or pledged as security for credit, as well as the condition of guarantors.

Early Warning

Following the principles of prompt reporting and quick response, we have established a comprehensive early warning system that sets out early warning processes, including identification, categorization, verification, reporting, handling and cancellation. We have three types of early warnings based on their degree of urgency and have designed action plans to deal with different types of early warnings so that business units are able to take the necessary measures to deal with risks promptly. Our Head Office maintains a Risk Management Committee, and each branch has early warning committees, which coordinate the early warning work of our Head Office and the branches, respectively. Our Head Office's Risk Management Committee and the branch-level early warning committees are responsible for early warning management at their respective levels and hold regular meetings to review the status of systematic risk and individual risk in order to deal with early warning signals promptly and to assess the results of response measures.

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Loan Classification and Provision of Reserve

In 1999, in accordance with the requirements of regulatory authorities, we started to apply a five-category loan classification system. We carry out loan classification and make provisions for losses in accordance with the relevant requirements of PRC regulations as well as the requirements of PRC and international accounting standards.

The classification of loan risks and estimation of expected losses are carried out at different levels. Customer relationship managers are responsible for the preliminary classification of risks as well as for estimating the losses of non-performing loans, the results of both of which are then subject to review by risk managers. At the credit application stage, reports are submitted to the upper level following credit granting procedure to obtain determination from the relevant examination and approval institutions, and the scope of authority for determination is the same as the scope of authority for examination and approval. For the day-to-day management of existing credit, our Head Office Credit Management Departments, chief risk officers at the branch level and branch risk managers make the final determination within the limits of their authority.

At the beginning of 2007, on the basis of our existing five-category classification system and internal rating-based approach, we adopted a 12-category loan classification system that refined our loan classification in accordance with the default risks of a corporate borrower and facility risk arising from the loan. Based on the varying degrees of credit asset risk, our 12-category loan classification further expands the “normal” grade under the original five-category loan classification system into seven grades, which are expressed from P1 to P7. The original “special mention” class is further broken down into two grades, which are expressed by SM1 and SM2. Loans under “sub-standard,” “doubtful,” and “loss” classes remain unchanged and are collectively referred to as non-performing credit assets.

The following table illustrates our five-category and 12-category loan classification systems:

12-Category Loan Classification	Names under the Five-Category Classification	Names under the 12-Category Loan Classification
1	} Normal	Grade 1 Pass (P1)
2		Grade 2 Pass (P2)
3		Grade 3 Pass (P3)
4		Grade 4 Pass (P4)
5		Grade 5 Pass (P5)
6		Grade 6 Pass (P6)
7		Grade 7 Pass (P7)
8	} Special Mention	Grade 1 Special Mention (SM1)
9		Grade 2 Special Mention (SM2)
10	Sub-standard	Sub-standard (SS)
11	Doubtful	Doubtful (DF)
12	Loss	Loss (LS)

Through this loan classification system, we classify corporate loans on the basis of both quantitative and qualitative factors by analyzing the default risk of a corporate borrower and facility risk arising from the loan and considering the estimated impairment losses.

Our loan classification system is designed to help us to better monitor changes in our asset quality, detect potential credit risks and more effectively conduct post-disbursement management of our loan portfolio. We believe that this system has helped us strengthen our loan monitoring capabilities.

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We make provision for losses arising from different types of our corporate credit assets in two ways: individually assessed provisions and collectively assessed provisions. Loss estimation is carried out on an individual basis for non-performing credit assets, whereas collective loss provisions are applied to credit assets classified as “normal” and “special mention.”

Termination of loans to potential high-risk customers

We have established an exit management mechanism for potential high-risk customers in order to optimize our portfolio of borrowers and prevent potential risks from materializing. Potential high-risk customers are those who are expected to suffer an adverse impact on their repayment ability or to experience adverse changes in their financial condition. For such customers, we normally reduce credit limits, terminate credit lines, cease renewing credit facilities and request the provision of additional risk mitigation and other measures in accordance with the relevant provisions of their respective loan contracts.

Non-performing Loan Management

We proactively manage non-performing loans to reduce the associated risks to our loan portfolio, promptly write off doubtful debts and improve our recovery on disposals.

The non-performing asset disposal committees at our Head Office and branch level are responsible for managing and recovering our non-performing loans. They are also responsible for approving disposal and recovery plans for non-performing assets, including asset restructuring, settlement of loans by taking collaterals, write-off of loans and other related issues. Steps taken for the recovery of non-performing loans mainly include collection, foreclosure on collateral, legal proceedings, reduction or waiver of interest, loan restructuring, write-offs and collection by third parties.

Credit Risk Management for Retail Credit Business (Excluding Credit Cards)

Acceptance of Credit Applications and Credit Investigation

When handling a new business, a customer relationship manager of our retail credit business is required to have a face-to-face interview with the credit applicant, and all documents must be signed by the applicant in the presence of the manager. The applicant will be requested to sign an application form and provide his or her identity card, proof of income, transaction contracts, certification of ownership of assets collateralized or pledged as security, a written undertaking from the guarantor, if any, and materials proving the guarantor’s creditworthiness. We mainly rely on income, credit history and loan repayment ability to assess the applicant.

Our retail credit business customer relationship managers are responsible for assessing retail credit applicants and completing the reporting materials required for approval. The assessment mainly focuses on the credit risk of the applicant and the valuation of the loan collateral. We conduct our credit investigations through on-site investigations, telephone interview and information inquiries as well as through other channels and methods to verify the authenticity of loan-related information. For mortgage loans that are doubtful or that are particularly large, customer relationship managers may take additional verification steps by making “home visits”. The appraisal of the collateral for retail loans is similar to the appraisal of the collateral for corporate loans. In the case of secured loans, we usually request an independent appraiser approved by our Bank to appraise the security provided.

On the basis of the results of inquiries made with the personal credit database of the PBOC, and in light of the results of the assessment of the applicant’s risk profile and the risk mitigation factors, retail customer relationship managers will prepare reporting materials for approval.

Credit Approval

Our retail credit approval is carried out by branch chief risk officers or persons authorized by them within the limits of their authority, except for high-risk retail credit business applicants, which must go through panel examination and approval. Our retail credit business is mainly approved by authorized individuals.

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Loan Disbursement and Post-disbursement Management

After the loan applications of individual customers are approved, the authorized signatory of our business units, the borrower and the guarantor (if any), jointly enter into retail loan contracts and a disbursement will be made after the loan prerequisites are satisfied. In our retail loan monitoring, we focus on the repayment ability of the borrower and the status of assets collateralized or pledged as security and any change in their value. We adopt a five-category classification for retail loans by reference to the risks associated with the loans.

Once a loan becomes overdue, the customer relationship manager or specific collectors will, in the context of the individual circumstances leading to the overdue balance and the accompanying risks, demand repayment through various actions, including the use of telephone, e-mail, letters and home visits.

Based on the actual conditions of non-performing retail loans, repayment will be demanded from the borrowers and guarantors by one or several of the following ways: collection, litigation, appointment of factoring agents or repayment of loans by assets.

Credit Card Risk Management

Identification of Credit Risk

The Credit Card Center imposes different criteria for credit cards granted to different types of customers, making full use of risk measurement methods such as application grading models, behavior assessment models, initial credit line models and dynamic management of credit lines so as to manage credit card risk in a quantitative manner, which enables us to carry out differential management of customers with differing risk profiles and income statuses. On this basis, we decide whether a card should be issued and, if so, what type of card should be issued and what credit limit should be granted. Our Credit Card Center has completed building the Internal Assessment System, and is now using the measurement methods under the New Basel Capital Accord to monitor changes in asset quality.

Our Credit Card Center has set up a specialized risk data analysis team, which pays close attention to the macroeconomic development of China as well as the development of the credit card business in the banking industry. Furthermore, based on the requirements of our business, we collect information relating to the credit risk control measures of other banks through a number of channels and provide such information to risk policy-makers for their reference. Based on our business planning and risk management targets, we adjust our credit card policy in line with the current forecast of the credit card business in a timely manner.

We investigate and identify potential customer credit risks through a number of channels, including making full use of internal and external credit investigation means such as our credit card blacklist system, the personal credit information database of the PBOC, the identity verification system of the Ministry of Public Security, China UnionPay's risk information sharing system and the industry-wide risk information sharing system.

Credit Risk Control System

The Credit Card Center has established the Risk Management Department, Credit Approval Department, Collection Management Department, Strategy Research Department and other departments so as to strengthen the exchange and coordination of risk prevention information. We update guidelines for the examination and approval of credit card applications every year. The guidelines set out our risk management guiding principles, classify the clients into different types, namely supported, restricted and prohibited, and clarify the approval process for special cases. We have developed our own examination and approval management system, online credit limit adjustment system, electronic debt collection system and

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operational risk reporting system. In addition, we have carried out operational risk and control self-assessment (RCSA) for the purpose of identifying risks and refining our internal controls. The Credit Card Center has introduced the TRIAD customer management system which aims to improve our customer satisfaction through effective allocation of resources under our customer credit line management and behavior management, while controlling risk.

Since 2012, we have made persistent efforts to improve our risk management methods. We deploy differentiated risk management strategies that account for client attributes and transaction behavior, which allows us to focus on our large number of customers while also refining our credit card risk management. Meanwhile, we optimized our internal ratings system based on the New Basel Capital Accord through our re-examination algorithms, which adjust for the probability of default and changes in economic conditions.

Credit Risk Management for Financial Institution Credit Business

Our financial institution credit business primarily includes (i) investments in domestic financial bonds and other quoted securities, financial institution placements and borrowing, and trading of derivatives and (ii) investments in overseas negotiable instruments and overseas financial institution placements. We set up credit limits with respect to countries, regions and domestic and overseas counterparties. Such limits are subject to the approval by the Credit Approval Department and the Credit Approval Committee of our Head Office within their respective limits of authority.

Credit Risk Management System

Our credit risk management systems include our corporate credit risk management system, retail credit risk management system and financial institution credit risk management system.

Our corporate credit risk management system allows for electronic handling and streamlining of the credit granting process, from credit application, review and approval to disbursement approval and post-disbursement management. We pursue the continued development of our corporate loan risk management system to enhance its functions. In particular, by targeting credit extensions to micro-enterprises, we have developed an electronic procedure and risk model catering to the characteristics of micro-enterprises in our risk management system, which provide systemic support for the whole procedure, including risk identification, measurement, monitoring, mitigation and control.

Our retail credit risk management system is a comprehensive retail loan risk management system, comprising analysis modelling software, decision-making engines, process management and numerous relevant data sets, which are key to our establishment of a comprehensive risk management system for our Bank. The entire retail credit management process can be managed through this electronic system, which includes loan application, on-line approval, loan disbursement and post-disbursement management.

Our financial institution credit risk management system facilitates the process of the information collection and credit application, customer rating, credit approval, disbursement and post-disbursement monitoring in relation to financial institutions.

LIQUIDITY RISK MANAGEMENT

Liquidity risk refers to the risk of that, although a bank is solvent, it may be unable to obtain sufficient funds in a timely manner, or at a reasonable cost, to cope with asset growth or settle due and payable debts. Most of the funds held by us come from the deposits of our customers. In recent years, our customers' deposits have grown in quantity and diversified in types and term length. Based on estimation of our future cash flow, we take action to maintain an appropriate percentage of liquid assets.

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Our Asset and Liability Management Committee is responsible for managing our overall liquidity. The Asset and Liability Management Committee, with our President as its chairman, is responsible for formulating policies relating to liquidity based on relevant regulatory requirements and the principle of prudence. The objectives of our liquidity policies are as follows:

- to maintain our liquidity at a stable and sufficient level and to ensure that we are in a position to fulfill payment obligations in a timely manner and meet our liquidity demands relating to our assets, liabilities and off-balance sheet operations, both in the case of normal business operations and in stressed circumstances, by setting up a methodical and comprehensive liquidity risk management system; and
- to make reasonable and timely adjustments to the scale and structure of our assets and liabilities based on market changes and business development and to pursue the maximization of profits and the minimisation of costs in order to maintain an appropriate level of liquidity with an aim to ensure the “safety, liquidity and efficiency” of our capital.

Our Planning and Finance Department is responsible for the daily management of our liquidity risk and for formulating and timely revising our liquidity risk management strategies. It is also responsible for the identification, measurement, monitoring and reduction of bank-wide liquidity risk. Our Treasury Department is responsible for day-to-day position management and forecasts and for maintaining our highly liquid asset portfolio at an appropriate level based on our liquidity risk management strategies. In the event of a material incident relating to payment obligations or any structural change, timely reports as well as recommendations must be given to the Asset and Liability Management Committee.

We mainly adopt liquidity gap analysis to measure liquidity risk and adopt different scenario analysis and stress tests to assess the impact created by the relevant liquidity risk. While we reduce our liquidity risk by term matching, diversification of liabilities and other on-balance sheet business adjustments in light of internal transfer pricing and external pricing, we also attempt to adjust for any liquidity shortfall by making use of monetary swaps and other financial derivatives.

MARKET RISK MANAGEMENT

Market risk means the risk of losses to our businesses resulting from an adverse movement of market prices, including interest rates, exchange rates, commodity prices and stock prices.

The Board of Directors bears ultimate responsibility for monitoring and managing our exposure to market risk to ensure that we can effectively identify, measure, monitor and control the different types of market risk to which our businesses are exposed. The Risk Management Committee of the Board of Directors is responsible for monitoring market risk management within its limit of authority delegated by the Board of Directors and reviewing our strategies, policies and procedures relating to market risk management together with relevant proposals on the acceptable market risk level put forward by the senior management. Most of the market risks to which we are exposed in our business operations and development are concentrated in our treasury management, including (i) money market activities, (ii) investment portfolio management and (iii) treasury transactions on behalf of customers. The Planning and Finance Department is responsible for the day-to-day monitoring and management of the underlying interest rate risk and foreign exchange risk of banking books. The Risk Management Department is responsible for establishing and improving our market risk management system, formulating market risk management policies and identifying, monitoring and reporting our market risk exposure.

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In accordance with the requirements of regulatory authorities and the general practices of the banking industry, we divide our on- and off-balance sheet assets into two categories: trading book and banking book. Based on the nature and characteristics of the relevant accounts, we adopt methods to identify, measure, monitor and control market risk. Trading books refer to the financial instruments and commodities positions that could be traded freely. Banking books represent business other than trading books. We primarily measure and monitor the market risk associated with trading books through sensitivity indicators, scenario analysis and foreign exchange exposure analysis. We measure and monitor the market risk associated with banking books through sensitivity gap analysis, stress tests and effective duration analysis.

We aim to effectively identify, measure and monitor factors relating to market risk. In order to ensure that the market risk we assume is within our risk tolerance, we have established a tiered cap system for market risk management. The first tier sets a cap on the level of overall market risk exposure deemed acceptable to us. The second tier sets exposure caps on both interest rate and exchange rate risk. Third- and fourth-tier caps are business- and product-type specific. To ensure the implementation of our tiered cap system, we have implemented a suite of cap management procedures, covering application, approval, monitoring, early warning, reporting and action plans with respect to such caps.

In order to further enhance our trading and market risk management ability, we have established a comprehensive market risk management system. The main functions of this system include front-, middle- and back-office monitoring and processing of treasury transactions. The system also provides a specialized platform for trading and market risk management. At the same time, we have also introduced a Value-at-Risk (VaR) measurement model in order to enhance our ability to measure and manage market risk to prepare for our implementation of the New Basel Capital Accord.

Interest Rate Risk Management

Our interest rate risk mainly relates to the repricing risk in our commercial banking business and the risk of our treasury position. The objectives of our interest rate risk management are to develop measures to monitor and control interest rate risk, to establish proper mechanisms to measure, analyze and follow up on changes of such risk and to take appropriate steps before escalation of interest rate risk to reduce our potential loss so that we operate our business within an acceptable range of interest rate risk and to safeguard the safety, liquidity and profitability of our business operations.

We have adopted an interest rate risk management policy that serves as the foundation for our bank account interest rate risk management mechanisms and strategies. We actively explore and improve our interest rate risk management mechanisms, and endeavor to establish an appropriate asset-liability pricing mechanism by using a fund transfer pricing system, with a focus on profit. We have also improved and upgraded our assets and liabilities management system and improved the relevance of system applications towards interest rate risk management.

In our interest rate risk management, we have taken steps in conducting active management of assets and liabilities, and applying the results of gap analysis of asset-liability management to the adjustment of portfolios and the control of liability costs so as to increase our bank-wide net interest margin.

We assess the interest rate risk relating to banking book mainly through repricing gap analysis and net profit and interest income simulation analysis. We regularly monitor the position of the gap and conduct stress tests by using gap data. On this basis, we adjust repricing term structures of interest-earning assets and interest-bearing liabilities and use derivatives to hedge against interest rate risk. At the same time, we closely monitor the movement of interest rates of local and foreign currencies, and, in line with changes in market interest rates, adjust our interest rates for deposits and loans denominated in both local and foreign currencies so as to mitigate interest rate risk.

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With respect to our treasury operations, we adopt such techniques as duration and present value per basis point to measure interest rate risk, and apply stress tests and scenario analysis to monitor and control risks.

Exchange Rate Risk Management

Our exchange rate risk primarily arises from the proprietary foreign currency portfolio within the Treasury Department's proprietary investments, and other foreign currency transactions. The objectives of our exchange rate risk management are to develop measures to monitor and control exchange rate risk, to establish proper mechanisms to measure, analyze and follow up on changes in such risk and to take appropriate steps before escalation of exchange rate risk to reduce our potential loss so that we operate our business within an acceptable range of exchange rate risk and to safeguard the safety, liquidity and profitability of our business operations. Our exchange rate risk is reflected in the mismatch of the currencies in which our assets and liabilities are denominated and the possible adverse impact of exchange rate fluctuation on our profit and capital in foreign currencies.

We have adopted exchange rate risk management measures across our Bank to centralize the management of exchange risks related to our account. We endeavor to match relevant foreign currency assets with liabilities and control the exchange risks by making available and utilizing various currency sources. We strictly control risk exposure in foreign exchange settlement and sales and take measures to improve the position-closing method for foreign exchange settlement and sales. We also implement a "multiple price quotations per day" mechanism to reduce exchange risk. We actively research, design and develop various derivative financial instruments and innovative financial products, aiming at managing exchange rate risk by utilizing appropriate financial instruments.

OPERATIONAL RISK MANAGEMENT

Operational risk represents the risk of loss associated with deficiencies and failures of internal processes, personnel and information systems, or external events. The operational risk that we face primarily includes, among others, internal and external fraud, damage to tangible property, disruptions to our operations or information technology system and problems associated with transaction settlement as well as business processes management. Operational risk also includes legal risk but does not include strategic or reputational risk.

Our operational risk management aims to control operational risk within an acceptable range, to increase service efficiency and optimize work flows, to lower management cost and increase profitability, to reduce the impact of contingencies and to ensure normal and continuous operation of our business.

We have established a hierarchical operational risk management structure, operating under the guidance of the operational risk management policies formulated by the Board and implemented by our senior management, with three lines of defense. The Board of Directors is ultimately responsible for operational risk management. Our senior management actively leads the relevant initiatives; branch-level management teams are responsible for operational risk management at their respective branches, with branch heads having ultimate responsibility at branch level.

Business units and functional departments constitute the first line of defense to safeguard against operational risk, directly bearing and managing the operational risk of their own departments or lines and assuming primary responsibility for operational risk management. The Risk Management Department and Legal and Compliance Department constitute the second line of defense to safeguard against operational risk, and are responsible for establishing an operational risk management framework and guarding, supporting and monitoring the implementation of our operational risk management at all levels. The internal audit departments and discipline and inspection departments constitute the third line of defense

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against operational risk. The internal audit departments are responsible for auditing the implementation of our operational risk management system across our Bank and reporting related issues to the senior management and the Audit Committee of the Board of Directors, and the discipline and inspection departments carry out investigations and culpability verifications and ensure that the relevant individuals are held accountable for any operational issues identified.

We have preliminarily established an operational risk identification and assessment system, which is based on operational risk and control self-assessment (RCSA), supplemented by an operational risk event reporting system and key operational risk indicators and supported by internal audit and compliance assessments. Under the hierarchical management of operational risk, different business lines or business departments are responsible for applying the relevant tools to identify, assess and control operational risk and adopt appropriate risk management measures.

We have implemented the operational risk and control self-assessment (RCSA) process and have incorporated this into the daily work of our business lines, branches and sub-branches. The RCSA is implemented by the institute or department that assumes direct responsibility for operational risk for the purpose of internally assessing operational risks and effectiveness of control in accordance with the principles of operational risk management.

We have established an operational risk reporting system whereby various business lines and various branches and sub-branches are required to report on operational risk events in accordance with the predetermined reporting scope, route and format. The operational risk reporting system helps to pinpoint weak links in operational risk control through identifying spread of losses, and can be used to verify the results of operational risk control self-assessment so as to evaluate the quality of the RCSA.

We have set up a key risk indicator (KRI) system for operational risk, which covers our main risk categories and key product groups. By continuously monitoring key risk indicators, we aim to keep abreast of changes in our operational risk exposure and to enhance our adaptable supervision capabilities so as to actively manage operational risk and be able to issue early warnings prior to the occurrence of potential operational risk incidents.

COMPLIANCE RISK MANAGEMENT

Compliance risk refers to the risk of legal sanctions, regulatory penalties, material financial loss, or reputational damage to a commercial bank resulting from failure to comply with applicable laws and regulations as well as relevant industry standards. Compliance risk management is an important part of our overall risk management and we have accordingly placed strong emphasis on compliance risk management throughout our internal control structure and procedures. The Board of Directors is ultimately responsible for matters relating to compliance risk and the legal and compliance departments at both our Head Office and at the branch level take comprehensive responsibility for coordinating bank-wide compliance risk management, including the implementation of an integrated and coordinated compliance risk management system and the adoption of tracking and monitoring measures. We continuously provide effective guidance, monitoring, alerts, identification and assessment with respect to compliance risk, and actively promote systematic compliance management.

CAPITAL MANAGEMENT UNDER COMPREHENSIVE RISK MANAGEMENT

We believe we have an established capital management system and promote organic integration between our capital management, comprehensive risk management and assets and liabilities management. We also strengthened our valued-based portfolio management system to enhance our systematic risk management capability.

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Our capital management organizational structure encompasses the Board, supervisory committee and senior management. We emphasize efficiency in our capital management by using RAROC/EVA indicators as guidance. We also utilized a number of tools in our capital management, such as (i) advanced audit mechanisms, (ii) a multi-tiered capital management and internal capital adequacy assessment program (ICAAP) and (iii) a risk-weighted assets system at the accounting level (including standard and advanced methods for capital measurement).

Anti-Money Laundering

In accordance with relevant legal and regulatory requirements on anti-money laundering, we have formulated rules, regulations and policies for the monitoring, reporting and managing of anti-money laundering risk, which are reviewed on an annual basis and revised as necessary to satisfy our own risk management requirements and those of relevant regulators.

We carry out anti-money laundering training by internal or third party consultants to increase the awareness among our staff of anti-money laundering risks. We have established an Anti-Money Laundering Leading Team and an Anti-Money Laundering Work Office. The Anti-Money Laundering Leading Team is responsible for spearheading our bank-wide anti-money laundering initiatives, formulating and overseeing the implementation of relevant laws and regulatory rules on the identification and handling of large transactions and suspicious transactions. It is comprised of the respective heads of the Legal and Compliance Department, Operation Management Department, Trade Finance Department, Retail Banking Department and other related departments. Each such department bears management responsibility for anti-money laundering activities in accordance with its authority. The Anti-Money Laundering Work Office is within the Legal and Compliance Department, and is responsible for the day-to-day bank-wide management of anti-money laundering risk and coordinating the reporting of anti-money laundering work of relevant departments, and the consolidation and reporting of the data of large transactions and suspicious transactions.

INTERNAL CONTROL

We continue to enhance our internal control functions and our corporate governance and strive to achieve the best practice standards of our industry.

We maintain a three-tiered internal control management system, which consists of the decision-making level, the implementation level and the supervision and evaluation level.

Decision-making Level

The Board of Directors has ultimate decision-making authority and is mainly responsible for deciding our internal control strategy and making the most significant business decisions. The Board of Directors is also responsible for reviewing the internal control reports submitted by our senior management, auditors and regulators, conducting overall assessment of the integrity and effectiveness of our bank-wide internal control system, and advising on improvements and supervising the senior management to carry out continuous improvement and refinement of our internal control system.

Implementation Level

Our senior management is supervised by the Board of Supervisors and is responsible for: (i) implementing the various strategies, policies, systems and procedures approved by the Board of Directors; (ii) establishing an organizational structure with specific authorization and duties as well as clear reporting lines; (iii) setting up a procedure for identifying, measuring and managing risks; developing and implementing sound and effective internal control measures; and (iv) adopting measures to rectify any existing internal control deficiencies.

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The special committees under the senior management, including, among others, the Risk Management Committee, the Asset and Liability Management Committee and the Internal Control and Compliance Early Warning Committee, are responsible for internal control and risk management within their respective limits of authority.

Business departments in our Head Office are responsible for departmental internal control matters, including the implementation of internal control policies and procedures, identification and management of internal control deficiencies and timely reporting on their internal control efforts to the senior management.

Management at the branch level is responsible for branch-level internal control matters, including, at the request of the senior management or the business departments of our Head Office, the formulation of specific detailed implementation rules and business procedures and the establishment and enhancement of internal control mechanisms.

Supervision and Evaluation Level

The Board of Supervisors is responsible for supervising our Bank in its compliance with the relevant laws and regulations, as well as supervising the Board of Directors and senior management in their performance of their respective duties and inspecting and supervising our Bank in connection with the matters relating to internal control. The Audit Department is responsible for carrying out audits, supervision and assessment of our business operations, internal control and risk profile across our Bank.

INTERNAL AUDIT

Pursuant to the Guidelines on Internal Audit for Banking Financial Institutions (銀行業金融機構內部審計指引) issued by the CBRC, we began to reform our internal audit system starting at the end of 2006. We have put in place an independent vertical audit management system under which our audit functions are accountable to the Board of Directors and report to the Board of Directors, the Audit Committee of the Board of Directors and our senior management. We have also implemented an internal audit organizational structure comprising the Audit Department of our Head Office and five audit centers. The Audit Department and the audit centers are independent of other business departments and branches. They conduct their audit, supervision and assessment of matters relating to the business and operational management, internal control and risk profile across our Bank and supervise the audited authorities and departments to perform their duties by carrying out routine audits, special audits and audits into economic liabilities arising from existing and departing officers. The Audit Department is responsible for: (i) carrying out audits of our business operations, internal controls and risk profile across our Bank; (ii) making consistent efforts to improve review and supervision of our internal controls; and (iii) continuously strengthening the normalization and standardization of our internal control process, which has resulted in the quality and results of our audits improving continuously and promoted stable and healthy business operations across our Bank.

The Audit Department is responsible for auditing and assessing bank-wide operational activities, risk profile, internal control and corporate governance effectiveness; formulating the parameters for audit work and audit business systems across our Bank; formulating and organizing the implementation of annual work plans; managing and giving guidance to the audit centers; and conducting audits of the line departments, key businesses of our Head Office and key branches.

Each regional audit center is responsible for the implementation of annual work plans at a regional level and examining and assessing business operations, risk profile, internal control and corporate governance of branches within its region.