

## **OVERVIEW**

The banking industry is heavily regulated in the PRC, with the CBRC and the PBOC acting as the principal regulatory authorities. The CBRC is responsible for the supervision and regulation of banking institutions and the PBOC, as the central bank of the PRC, is responsible for implementing monetary policies. The applicable laws and regulations governing activities in the PRC banking industry consist principally of the PRC PBOC Law, the PRC Commercial Banking Law and the PRC Banking Regulatory Law as well as rules and regulations promulgated thereunder.

### **Initial Development of the Regulatory Framework**

Established on December 1, 1948, the PBOC was, between 1983 and 2003, the only regulatory authority responsible for the supervision and regulation of the PRC financial industry. In January 1986, the State Council promulgated the Interim Provisions on the Supervision of Banks in the PRC, which clearly stipulated for the first time that the PBOC was the central bank of the PRC and the regulatory authority for the PRC financial industry.

The PRC PBOC Law was enacted in March 1995 and was later amended on December 27, 2003. It defines the scope of duties and the organizational structure of the PBOC and grants the PBOC the mandate to regulate the Renminbi, implement monetary policies and exercise regulatory power over the financial industry. The PRC Commercial Banking Law was enacted in May 1995 and was later amended on December 27, 2003. It provides the fundamental operating principles for commercial banks in the PRC. The PRC Commercial Banking Law and the PRC PBOC Law formed the regulatory framework for the PRC financial industry.

### **Establishment of the CBRC**

The CBRC was established in April 2003 to assume the regulatory authority over banking institutions from the PBOC, and was given the mandate to implement reforms, minimize overall risks, promote stability and development and enhance the competitiveness of the PRC banking industry.

In December 2003, the PRC Banking Regulatory Law was promulgated, which sets forth the regulatory functions and duties of the CBRC. The December 2003 amendments to the PRC PBOC Law and the PRC Commercial Banking Law also reflected the functional division between the CBRC and the PBOC.

Regulations and rules issued by the PBOC before the establishment of the CBRC in April 2003 remain valid and effective after the establishment of the CBRC, unless they are revoked or superseded by subsequently adopted laws, regulations and rules.

## **REGULATORY AUTHORITIES**

### **The CBRC**

Under the PRC Banking Regulatory Law, the CBRC is the regulatory authority responsible for the supervision and regulation of banking institutions established in the PRC, including deposit-taking financial institutions, such as commercial banks, urban credit cooperatives, rural credit cooperatives, and policy banks. Some non-banking financial institutions, including asset management companies, trust and investment companies, finance companies, financial leasing companies, as well as other financial institutions whose establishment is subject to the CBRC's approval, are also under the jurisdiction of the CBRC.

The CBRC has extensive supervisory power over banking institutions established in the PRC, including:

- promulgating rules and regulations applicable to banking institutions established in the PRC;

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- reviewing and approving the establishment and termination of banking institutions established in the PRC;
- reviewing and approving the merger and spin-off of banking institutions established in the PRC;
- reviewing and approving the business scope of banking institutions established in the PRC;
- granting financial institution permits to commercial banks and their branches, sub-branches and outlets;
- regulating banking products and services, including approving the launching of certain banking products and services, such as credit cards, fund custody and online banking;
- requiring banking institutions to operate in accordance with the principle of prudential operations;
- regulating the qualifications of directors and senior officers of banking institutions established in the PRC;
- examining the qualifications of 5% or more shareholders of banking institutions established in the PRC;
- regulating and supervising operations and risk exposure of banking institutions established in the PRC;
- regulating fee-based services and products, including the rates of such fees;
- establishing disclosure requirements;
- reviewing and monitoring banking institutions by means of on-site and off-site examinations; and
- imposing corrective or punitive measures for any violation of applicable laws and regulations, including suspension of business operations.

The CBRC combines on-site and off-site examinations to regulate banking institutions. In addition to examining the audited financial statements and other relevant materials required to be filed by the banking institutions, the CBRC also conducts on-site inspections as well as interviews with directors and senior officers of the banking institutions where it deems such additional measures to be necessary. In May 2004, the CBRC promulgated the Provisional Procedures of Off-site Examination of Joint Stock Commercial Banks to clarify the objectives, scope, methods, frequency and procedures of off-site examinations. To ensure compliance by banking institutions with the applicable laws and regulations, the CBRC has powers to issue corrective and/or disciplinary orders and to impose penalties and/or fines on a banking institution. Where a banking institution fails to comply with the relevant laws and regulations, the CBRC can restrict the banking institution's distribution of dividends and transfer of assets, order the controlling shareholders to dispose of their shares or restrict their rights, demand personnel changes to the board of directors and senior management or restrict their authority, or suspend the opening of new branches. In the event of a credit crisis within a banking institution, the CBRC may assume the management or arrange for the restructuring of such banking institution. In severe cases, the CBRC may order a banking institution to suspend operations and revoke its financial institution permit.

Since its establishment, the CBRC has undertaken a series of measures, including:

- adopting a risk assessment system for joint stock commercial banks;
- issuing new rules regarding the capital adequacy of commercial banks;
- strengthening regulations on risk management and transactions with insiders, related parties and/or shareholders of commercial banks;

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- setting new disclosure requirements for joint stock commercial banks;
- establishing new standards and procedures for granting financial institution permits to banking institutions and their branches;
- developing clearer application and approval processes for the provision of new banking services;
- increasing the type of products and services that banking institutions may offer; and
- broadening the business scope of foreign-invested banking institutions.

Starting from 2004, PRC banking institutions, including PRC commercial banks, are required to pay banking institution supervision fees and business supervision fees to the CBRC semi-annually. The current annual supervision fee rates for PRC domestic commercial banks are:

- for the banking institution supervision fee, 0.08% of the total paid-in capital of the relevant commercial bank; and
- for the business supervision fee, 0.02% for the portion of the total asset less than RMB3 trillion; 0.015% for the portion between RMB3 trillion and RMB4 trillion; 0.01% for the portion between RMB4 and RMB5 trillion; and zero for the portion over RMB5 trillion.

The current rates are valid for three years from 2004. A new set of rates will be established in 2006.

Under the current rates, for 2004 our Company paid to the CBRC banking institution supervision fees in the amount of approximately RMB14 million and business supervision fees in the amount of approximately RMB171 million.

### **The PBOC**

Under the PRC PBOC Law, the PBOC is the central bank of the PRC. The major functions of the PBOC include:

- formulating and implementing monetary policies in accordance with applicable laws;
- regulating the inter-bank lending, bond, foreign exchange and gold markets;
- establishing Renminbi exchange rate policies;
- issuing Renminbi and managing its circulation;
- maintaining, managing and operating the foreign exchange and gold reserves of the PRC;
- managing the state treasury;
- coordinating with relevant government authorities to formulate the settlement and clearing rules and maintaining the normal operation of the settlement and clearing systems;
- collecting data and performing macroeconomic analysis and forecasts for the financial industry;
- coordinating anti-money laundering activities in the PRC and monitoring fund flows for anti-money laundering purposes;
- supervising the credit information collecting and rating industry and promoting the establishment of a public credit system; and
- engaging in international financial activities.

### **Other Regulatory Authorities**

In addition to the CBRC and the PBOC, commercial banks in the PRC are also subject to the supervision and regulation of other regulatory authorities including, among others, the SAFE, the

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CSRC and the CIRC. For example, in conducting foreign exchange settlement business, we are subject to the regulation of the SAFE and the requirements under the Administrative Measures of Foreign Exchange Business of Banks (《銀行外匯業務管理辦法》); in conducting fund custodian business, we are subject to the regulation of the CSRC and the requirements under the Measures for the Pilot Management of Establishing Fund Management Companies by Commercial Banks (《商業銀行設立基金管理公司試點管理辦法》) (See “– Other Requirements – Establishment of Fund Management Companies by Commercial Banks”) and the Tentative Administrative Procedures for Securities Investments in China by Qualified Foreign Institutional Investors (《合格境外機構投資者境內證券投資管理暫行辦法》); and in conducting bancassurance business, we are subject to the regulation of the CIRC and the requirements under the Interim Measures on the Administration of Concurrent-Business Insurance Agency (《保險兼業代理管理暫行辦法》).

### ESTABLISHMENT AND SCOPE OF BUSINESS ACTIVITIES

#### Financial Institution Permit

Under the PRC Commercial Banking Law, a financial institution permit must be obtained from the CBRC in order to engage in banking business. To obtain such a permit, the following conditions must be satisfied:

- the articles of association shall comply with the provisions of the PRC Commercial Banking Law and the PRC Company Law;
- the registered capital shall comply with the minimum amount stipulated by the PRC Commercial Banking Law;
- the Directors and senior officers shall possess professional knowledge and relevant working experience;
- the organization structure and management system shall be properly established; and
- the business premises, safety and preventive measures and other operational facilities shall comply with relevant requirements.

We have received a financial institution permit and are authorized by the CBRC to engage in our banking business.

#### Minimum Registered Capital Requirements

According to the PRC Commercial Banking Law, the minimum registered capital for a commercial bank with a nationwide operation is RMB1 billion, while the minimum registered capital for an urban commercial bank and a rural commercial bank is RMB100 million and RMB50 million, respectively. The registered capital shall be fully paid in by shareholders. A commercial bank is required to allocate a minimum of RMB100 million for each branch and RMB50 million for each sub-branch as operating capital. The total amount of operating capital allocated by a commercial bank to all branches cannot exceed 60% of its total registered capital. As of December 31, 2004, our registered capital was RMB39,070 million, which was fully paid in by our shareholders. Moreover, we are fully in compliance with the operating capital requirements for each of our branches and sub-branches, and the total amount of operating capital allocated by our Company does not exceed 60% of our total registered capital.

#### Scope of Business Activities

Under the PRC Commercial Banking Law, commercial banks may conduct all or part of the following business activities:

- accepting deposits and granting loans;
- conducting domestic and overseas settlements;

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- handling acceptance and discounts on instruments;
- issuing finance bonds;
- acting as agents to issue, honor and underwrite government bonds;
- trading government bonds and finance bonds;
- engaging in inter-bank loan business;
- trading foreign exchange on their own behalf or as agents;
- engaging in bank card business;
- providing letter of credit and guarantee services;
- collecting and making payment as agents and acting as ancillary insurance agents;
- providing safe deposit box services; and
- other business activities approved by the CBRC.

Commercial banks in the PRC are required to stipulate their scope of business activities in their articles of association and submit their articles of association to the CBRC for its approval.

The provision of services by a commercial bank within its scope of business activities is subject to the following rules:

- a commercial bank is permitted to take deposits and grant loans without obtaining separate approvals from the CBRC;
- for certain types of intermediary services, such as letters of credit, financial derivatives and fund custody services, a commercial bank is required to obtain prior written approval from the CBRC before launching such services. The CBRC shall decide to approve or not within 30 business days after the receipt of the application;
- for certain types of intermediary services, such as entrusted loans and safe deposit boxes, a commercial bank is required to submit a report to the CBRC and will be permitted to commence such services upon receiving written acknowledgement from the CBRC within 15 business days after the submission; and
- for certain types of intermediary services for which filing of or approval from regulatory authorities is not required, in lieu of a prior approval, a commercial bank is required to file a report to the CBRC.

### **Fundamental Changes**

Approval from the CBRC must be obtained prior to any fundamental change of a commercial bank, including without limitation:

- any change in the bank's name, registered capital, business scope or the operating premises of its headquarters, branches or sub-branches;
- any amendment to its articles of association;
- establishment of any branches;
- appointment of any new directors, independent supervisors or senior officers;
- any purchase of equity interest in the bank that results in the purchaser becoming a 5% or more shareholder;
- any change to a 5% or more shareholder;
- any merger or spin-off; or
- any dissolution and liquidation of the bank.

**PRUDENT OPERATING REQUIREMENTS**

**Loan Classification**

***Five-category Classification***

In December 2001, the PBOC promulgated the Loan Classification Principles. Under the Loan Classification Principles, all commercial banks in the PRC are required to classify their loans under a five-category system. In association with these Loan Classification Principles, the PBOC issued the Loan Classification Notice. Under the Loan Classification Notice, all commercial banks in the PRC are required to report to the PBOC, within 20 working days after the end of each calendar quarter or 45 working days after the end of each calendar year, the quality of their loans under the five-category system as well as a comparison against the results set forth in the previous report.

The following table sets forth the definition of each category under the Loan Classification Principles:

<u>Category</u>	<u>Classification</u>
Pass . . . . .	Loans where the borrower has been performing its obligations and there are no signs that the borrower will default on principal and interest.
Special-mention . . .	Loans where the borrower is currently able to make principal and interest payments, but is experiencing factors that may be prejudicial to repayment.
Substandard . . . . .	Loans where the borrower is clearly experiencing factors jeopardizing its ability to meet payment obligations and it is clear that the borrower's income from its ordinary course of business does not allow it to make principal and interest payments in full. In addition, these loans may result in a loss even after the enforcement of collateral.
Doubtful . . . . .	Loans where the borrower is unable to meet its payment obligations. These loans will result in a material loss even after the enforcement of collateral.
Loss . . . . .	Loans where no, or only a minimal amount of, principal and interest are collectible after exhausting all collection efforts and all available legal proceedings.

When categorizing loans, the following factors should be considered by commercial banks:

- the borrower's capability to meet its payment obligations, including its cash flow, financial situation and non-financial factors that will impact the borrower's capability to meet its payment obligations;
- the borrower's records of prompt repayment of principal and interest;
- the borrower's intention to promptly repay principal and interest;
- the collateral of the loans;
- the legal consequences of failing to make prompt repayment of principal and interest; and
- the bank's credit management.

Under the Loan Classification Notice, the PBOC (now the CBRC) monitors the quality of loans of commercial banks through both on-site inspections and off-site monitoring activities. Generally, the PBOC (now the CBRC) conducts regular on-site inspections on a yearly basis.

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Prior to the Loan Classification Principles taking effect, many commercial banks in the PRC classified their loans based on a four-category loan classification system, as set forth in the following table:

<u>Category</u>	<u>Classification</u>
Normal . . . . .	Loans not yet due.
Overdue . . . . .	Loans that are overdue for less than 90 days (including any extension of the term of the loans).
Idle . . . . .	Loans that are overdue for more than 90 days, or that are not overdue yet or are overdue for less than 90 days but one of the following conditions exists: (1) the borrower is closed, liquidated, dissolved pursuant to law and ceases to exist as a legal person; (2) the borrower retains its legal person status but has ceased production and operation; or (3) the borrower retains its operation but its business has no prospects, it is insolvent or it has incurred significant losses.
Dead . . . . .	Loans, the repayment of which cannot be recovered or loans that should be categorized as dead loans in accordance with the relevant regulations promulgated by the MOF.

Since 2002, we have been classifying our loans based on the five-category system under the Loan Classification Principles.

### ***Provision requirements***

Subsequent to the promulgation of the Loan Classification Principles, the PBOC issued the Provision Guidelines on April 26, 2002. The Provision Guidelines took effect on January 1, 2002, and commercial banks are not required to comply with relevant provision requirements until the end of 2005. Under the Provision Guidelines, commercial banks are required to make adequate provisions in accordance with the risk associated with their loans classified in one of the categories.

According to the Provision Guidelines, provisions for loan loss include general provisions, specific provisions, and special provisions. General provisions refer to the provisions made for all unidentified but possible losses, which are made based on certain percentages of the balance of total outstanding loans; specific provisions refer to the provisions made for specific losses in connection with each loan based on its risk category under the Loan Classification Principles; and special provisions refer to the provisions made for the risks specially related to certain countries, regions, industries, or certain types of loans.

Commercial banks are required to make general provisions on a quarterly basis, and from 2005, the year-end balance of general provisions shall not be less than 1% of the total loan balance of the bank at the end of any given calendar year.

Commercial banks are required to make specific provisions for individual loans in accordance with the following chart:

<u>Category</u>	<u>Provisioning Ratio</u>
Pass . . . . .	—
Special-mention . . . . .	2%
Substandard . . . . .	25%
Doubtful . . . . .	50%
Loss . . . . .	100%

For loans classified as substandard or doubtful, the provisioning percentage may fluctuate within a range of 20% of the respective guideline percentage listed above.

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Commercial banks may make special provisions on a quarterly basis in accordance with special risk factors (including risks in association with certain industries and countries), general loss rates and historical experience.

### Capital Adequacy Ratio

According to the PRC Commercial Banking Law and the New Capital Adequacy Regulations, which were promulgated by the CBRC on February 23, 2004 and took effect on March 1, 2004, PRC commercial banks must maintain a minimum capital adequacy ratio of 8% and a minimum core capital adequacy ratio of 4%. Our capital adequacy ratio was 8.83%, 7.41% and 9.72% as of December 31, 2002, 2003 and 2004, respectively, as disclosed by the PBOC and the CBRC in their annual inspection reports on our Company and calculated in accordance with the formula promulgated by the PBOC and the CBRC and based on PRC GAAP. Our core capital adequacy ratio was 6.18%, 6.36% and 6.77% as of December 31, 2002, 2003 and 2004, respectively, as disclosed by the PBOC and the CBRC in their annual inspection reports on our Company and calculated in accordance with the formula promulgated by the PBOC and the CBRC and based on PRC GAAP.

Prior to March 1, 2004, a commercial bank's capital adequacy ratios were calculated as follows:

$$\text{Capital adequacy ratio} = \frac{\text{Net regulatory capital}}{\text{On-and off-balance sheet risk weighted assets}}$$

$$\text{Core capital adequacy ratio} = \frac{\text{Core capital}}{\text{On-and off-balance sheet risk weighted assets}}$$

In the preceding formula, core capital includes fully paid-in share capital, capital surplus, surplus reserve and retained earnings. Net regulatory capital includes both core capital and supplementary capital, less certain deductions (including equity investments in other banks and enterprises, and investments in real estate not for self-use). Supplementary capital includes loan loss reserves, bad debt provisions, provisions for investment risk, and long-term bonds with a minimum original maturity of five years. Different risk weightings are assigned for cash, obligations of the PRC central government and the PBOC, loans to enterprises and individuals, inter-bank loans and other assets, as well as for off-balance sheet items.

The New Capital Adequacy Regulations set forth a new method for calculating the capital adequacy ratios for PRC commercial banks. The New Capital Adequacy Regulations provide a transition period ending on December 31, 2006 for PRC commercial banks to meet its capital adequacy requirements progressively. During this transition period, PRC commercial banks must formulate practical phase-in plans to raise their capital adequacy ratios, which are required to be filed with the CBRC for its approval. The CBRC will closely monitor the progress made by PRC commercial banks under their approved phase-in plans and may require PRC commercial banks to take corrective measures. All PRC commercial banks are required to meet the minimum capital adequacy ratio requirements under the New Capital Adequacy Regulations by January 1, 2007.

The new regime for calculating capital adequacy can be summarized as follows:

$$\text{Capital adequacy ratio} = \frac{(\text{Regulatory capital} - \text{capital deduction})}{(\text{Risk-weighted assets} + (12.5 \times \text{market risk capital}))}$$

$$\text{Core capital adequacy ratio} = \frac{(\text{Core capital} - \text{core capital deductions})}{(\text{Risk-weighted assets} + (12.5 \times \text{market risk capital}))}$$

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In the preceding formula:

- **Regulatory capital** includes both core capital and supplementary capital. Core capital includes paid-in capital or ordinary shares, capital surplus, surplus reserve, retained earnings and minority interest. Supplementary capital includes reserve for revaluation, general provisions, preferred stock, convertible bonds and long-term subordinated debt. However, a PRC commercial bank's supplementary capital shall not be more than 100% of its core capital, and the long-term subordinated debt included in its supplementary capital shall not be more than 50% of its core capital.
  
- **Capital deductions** include goodwill, equity investments in non-consolidated financial institutions, and equity investments in enterprises and real estate not for self-use.
  
- **Core capital** includes paid-in capital or ordinary shares, capital surplus, surplus reserve, retained earnings and minority interest.
  
- **Core capital deductions** include goodwill, 50% of equity investments in non-consolidated financial institutions, and 50% of equity investments in enterprises and real estate not for self-use.
  
- **Risk-weighted assets** refer to the assets calculated by multiplying the value of on- and off-balance sheet assets by their corresponding risk weightings, after taking into account risk mitigating factors. In calculating risk-weighted assets, specific provisions must be deducted from the book value of loans and impairment reserves must be deducted from the book value of other assets. A commercial bank must also have capital reserves for the credit risk of off-balance sheet items.
  
- **Market risk capital** refers to the capital reserve that a bank is required to maintain for the market risks relating to its assets. Market risk refers to the risk of losses in on- and off-balance sheet positions arising from movements in market prices and includes risks related to interest-rate sensitive financial instruments and securities under trading accounts, and the foreign exchange risk and commodity risk of commercial banks.

Compared to the capital adequacy ratio requirements prior to March 1, 2004, the new requirements under the New Capital Adequacy Regulations take into account market risks. In addition, different risk weightings are assigned for cash, claims against central governments and central banks, claims against utilities enterprises, claims against domestic financial institutions, claims against enterprises and individuals, as well as off-balance sheet items. Moreover, commercial banks are required to hire independent rating agencies and use their ratings to determine the risk weightings related to their overseas claims. Furthermore, the original preferential risk weightings granted to loans secured by key state-owned enterprises have been abolished under the New Capital Adequacy Regulations.

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The following table sets forth the current risk weightings for different assets under the New Capital Adequacy Regulations.

<u>Items</u>	<i>Risk weighting of on-balance sheet assets</i>	<u>Risk weightings</u>
a. Cash		
i. Cash in vault		0%
ii. Gold		0%
iii. Deposits at the PBOC		0%
b. Claims on central government and central bank		
i. Claims on the PRC central government		0%
ii. Claims on the PBOC		0%
iii. Claims on the governments or central banks of other countries or jurisdictions, where the ratings for such countries or jurisdictions are AA– or higher <sup>(1)</sup>		0%
iv. Claims on the central governments or central banks of other countries or jurisdictions, where the ratings for such countries or jurisdictions are below AA– <sup>(1)</sup>		100%
c. Claims on public-sector entities (not including their affiliated commercial enterprises)		
i. Claims on public-sector entities invested in by central governments of other countries or jurisdictions, where the ratings for such countries or jurisdictions are AA– or higher <sup>(1)</sup>		50%
ii. Claims on public-sector entities invested in by central governments of other countries or jurisdictions, where the ratings for such countries or jurisdictions are below AA– <sup>(1)</sup>		100%
iii. Claims on domestic public-sector entities invested in by the PRC central government		50%
iv. Claims on other public-sector entities		100%
d. Claims on domestically incorporated financial institutions		
i. Claims on policy banks		0%
ii. Claims on asset management companies invested in by the PRC central government		
1. Claims on debts issued by the asset management companies by way of private placements to purchase the state-owned banks' non-performing loans		0%
2. Other claims on asset management companies		100%
iii. Claims on domestically incorporated commercial banks		
1. With an original maturity of four months or shorter		0%
2. With an original maturity over four months		20%
e. Claims on financial institutions incorporated in other countries or jurisdictions		
i. Claims on commercial banks or securities firms where the ratings for such countries or jurisdictions are AA– or higher <sup>(1)</sup>		20%
ii. Claims on commercial banks or securities firms where the ratings for such countries or jurisdictions are below AA– <sup>(1)</sup>		100%
iii. Claims on multilateral development banks		0%
iv. Claims on other financial institutions		100%
f. Claims on enterprises and individuals		
i. Claims secured by residential mortgages		50%
ii. Other claims on enterprises and individuals		100%
g. Other assets		100%

(1) These ratings refer to credit ratings of Standard & Poors or the equivalent thereof.

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Commercial banks in the PRC are required to report to both the CBRC and the PBOC their capital adequacy ratios quarterly on a non-consolidated basis and every six months on a consolidated basis. In addition, the CBRC conducts on-site inspections and off-site monitoring activities to monitor commercial banks' capital adequacy ratios. The CBRC classifies commercial banks into three categories based on their capital adequacy ratios:

<u>Categories</u>	<u>Capital Adequacy Ratio</u>		<u>Core Capital Adequacy Ratio</u>
Commercial banks with adequate capital . . . . .	≥8%	and	≥4%
Commercial banks with inadequate capital . . . . .	<8% but ≥4%	or	<4% but ≥2%
Commercial banks with severely inadequate capital . . . . .	<4%	or	<2%

The CBRC oversees each commercial bank individually in accordance with its capital adequacy ratio calculated in accordance with the formula promulgated by the PBOC and the CBRC and based on PRC GAAP. For commercial banks with adequate capital, the CBRC will support the steady development of their businesses. For commercial banks with inadequate capital, unless a waiver from the CBRC is obtained, the CBRC will take relevant corrective measures, including, among others, issuing regulatory opinions, requiring such bank to work out a feasible plan within two months to effectively raise its capital adequacy ratios by restricting the rate of asset growth, reducing the scale of risk-weighted assets, limiting acquisitions of fixed assets and/or restricting dividend and other income distribution, and applying a stricter standard in approving the opening of new branches or initiating new businesses. For commercial banks with severely inadequate capital, the CBRC may, in addition to the above corrective measures, require the removal of the bank's senior management, take over the bank as a receiver pursuant to relevant laws, facilitate the restructuring of the bank or, in the most severe cases, revoke the bank's financial institution permit.

Established in 1974, the Basel Committee on Banking Supervision (the "Basel Committee"), a committee of central banks and bank supervisors and regulators from major industrialized countries that was established to discuss issues related to prudential banking supervision, decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord (the "Basel I") in 1988. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8% by the end of 1992. Since 1988, the Basel I has been progressively introduced not only in member countries of the Basel Committee but also in almost all countries with active international banks. The CBRC, however, did not adopt the Basel I, although the capital adequacy standards in the PRC are based on the framework proposed by the Basel I.

Since 1999, the Basel Committee has issued certain proposals for a New Capital Adequacy Framework (the "Basel II") to replace the Basel I. Following extensive interaction with banks and industry groups, the Basel II was issued on June 26, 2004. The Basel II will be available for implementation as of the end of 2007. The Basel II retains the key elements of the Basel I, including the general requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets, and sets forth the supervisory review of an institution's internal assessment process and capital adequacy and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. The CBRC has not adopted the Basel II.

### **Subordinated Debt and Subordinated Bond**

The CBRC issued the Subordinated Debt Notice on November 26, 2003. Pursuant to the Subordinated Debt Notice, a PRC commercial bank may issue fixed-term debt for which the repayment of the principal and interest is subordinated to the bank's other liabilities but superior to the bank's equity capital. A PRC commercial bank may include such fixed-term subordinated debt in the bank's supplementary capital, which practice may be different from those adopted in other jurisdictions. To qualify for inclusion in the bank's supplementary capital, the subordinated debt must have a minimum term of five years and the proceeds must not be used for purposes of offsetting a bank's operating losses. Subordinated debt can be issued only through private placements to certain legal person

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institutions, and these legal person institutions cannot transfer the subordinated debt. Moreover, subordinated debt cannot be issued to other commercial banks. All material information related to the issuance of subordinated debt, including investment risks, must be fully disclosed. The CBRC has the authority to approve the issuance of subordinated debt by a PRC commercial bank.

The CBRC and the PBOC jointly issued the Subordinated Bond Measures on June 17, 2004. Pursuant to the Subordinated Bond Measures, a PRC commercial bank may issue bonds which are subordinated to the bank's other liabilities but superior to the bank's equity capital. A PRC commercial bank may, upon approval by the CBRC, include such subordinated bonds in the bank's supplementary capital, which practice may be different from those adopted in other jurisdictions. Subordinated bonds can be issued either under a public offering in the inter-bank bond market or under a private placement. Holders of subordinated bonds are free to transfer the subordinated bonds. A PRC commercial bank may not hold subordinated bonds issued by other banks with an aggregate amount that exceeds 20% of its core capital. All material information related to the issuance of subordinated bonds, including investment risks, must be fully disclosed. The CBRC has the authority to approve the issuance of subordinated bonds by a commercial bank, while the PBOC regulates the issuance and trading of subordinated bonds in the inter-bank bond market.

### Liquidity Ratios

The following table sets forth the required liquidity and loan-to-deposit ratios for commercial banks in the PRC under the PRC Commercial Banking Law and the Examination Measures and Supervision Indicators Relating to the Administration of Assets/Liabilities Ratio of Commercial Banks issued by the PBOC in 1996, as well as the liquidity and loan-to-deposit ratios of our domestic banking operations calculated in accordance with the formula promulgated by the PBOC and the CBRC and based on PRC GAAP as of the dates indicated:

	Requirements	As of December 31,		
		2002	2003	2004
<b>Liquidity ratios</b>				
Renminbi current assets to Renminbi current liabilities	≥25%	51.42%	53.02%	66.30%
Foreign currency current assets to foreign currency current liabilities	≥60%	181.94%	98.19%	57.05% <sup>(1)</sup>
<b>Loan to deposit ratios</b>				
Renminbi loans to Renminbi deposits	≤ 75%	67.67%	67.77%	64.00%
Foreign currency loans to foreign currency deposits	≤ 85%	43.07%	67.55%	65.17%
Renminbi medium- and long-term loans to Renminbi medium and long-term deposits	≤120%	115.77%	119.97%	129.23% <sup>(2)</sup>
Foreign currency medium- and long-term loans to foreign currency medium- and long-term deposits	≤ 60%	10.83%	22.36%	29.48%

(1) This is below the minimum requirement of 60% under the relevant regulations. This decrease compared to December 31, 2003 is primarily due to the fact that, in order to achieve better returns, in 2004 we increased our allocation of funds to investments (such as debt securities) with maturities in excess of one month.

(2) This is higher than the upper limit of 120% under the relevant regulations. This higher ratio is primarily due to the significant growth in the Company's medium- to long-term loans in 2004.

Unlike in many developed countries, such as the United States, there is no deposit insurance with respect to retail deposits in the PRC.

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### Other Operational Ratios

In addition to the capital adequacy ratios and the liquidity ratios, the following table sets forth other operational ratios for commercial banks under the relevant PRC regulations as well as such ratios for our domestic banking operations calculated in accordance with the formula promulgated by the PBOC and the CBRC and based on PRC GAAP as of the dates indicated:

	Requirements	As of December 31,		
		2002	2003	2004
<b>Loan concentration ratios</b>				
Total outstanding loans to one single customer to the bank's net regulatory capital <sup>(1)</sup> .....	≤10%	7.47%	8.83%	7.19%
Total loans granted to top ten customers to the bank's net regulatory capital <sup>(1)</sup> .....	≤50%	42.90%	48.79%	34.59%
<b>Inter-bank ratios</b>				
Total Renminbi inter-bank borrowings from other banks and financial institutions as of the end of the relevant period to the bank's total Renminbi deposits as of the end of the relevant period .....	≤ 4%	0.01%	0.04%	0.001%
Total Renminbi inter-bank loans to other banks and financial institutions as of the end of the relevant period to the bank's total Renminbi deposits as of the end of the relevant period .....	≤ 8%	1.38%	0.78%	0.51%
<b>Offshore use of funds ratio</b>				
<i>Offshore investment ratio</i>				
Total offshore investment (including overseas loans, overseas equity investment and offshore deposits) as of the end of the relevant period to the bank's total assets in foreign currency as of the end of the relevant period .....	≤30%	70.94%	43.36%	43.41% <sup>(2)</sup>
<b>Reserve ratios</b>				
Renminbi reserve deposits with the PBOC plus the bank's Renminbi cash as of the end of the relevant period to Renminbi deposits as of the end of the relevant period ...	≥ 5%	14.00%	15.10%	14.23%
Foreign currency deposits with other financial institutions plus cash in foreign currency as of the end of the relevant period to the bank's total cash in foreign currency as of the end of the relevant period .....	≥ 5%	19.98%	7.61%	7.64%

(1) Ratios presented are for the Group.

(2) This is higher than the upper limit of 30% under the relevant regulations. This is primarily due to the limited channels available for PRC commercial banks to utilize their foreign exchange assets within the PRC, as foreign currency investment opportunities in the PRC have been largely limited to loans.

As of December 31, 2004, our foreign currency liquidity ratio, Renminbi medium- and long-term loans to Renminbi medium- and long-term deposits ratio as well as offshore investment ratio were not in full compliance with the relevant regulatory requirements. Under the Consultation Paper of the Core Regulatory Ratios With Respect to Risk Management for PRC Commercial Banks issued by the CBRC in February 2005, neither the offshore investment ratio nor the Renminbi medium- and long-term loans to Renminbi medium- and long-term deposits ratio is listed as a core regulatory ratio, and the foreign currency liquidity ratio requirement has been proposed to be reduced from 60% to 25%. In addition, we have not been subject to any regulatory actions or penalties by the CBRC or other regulatory authorities due to such noncompliance. We currently believe, based on the advice of our PRC legal counsel, King & Wood, PRC Lawyers, that the likelihood of any administrative sanctions by the CBRC that could result in a material adverse effect on our business, results of operations or financial condition is remote. We have been further advised by our PRC counsel, King & Wood, PRC Lawyers, that pursuant to the Consultation Paper of the Core Regulatory Ratios With Respect to Risk

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Management for PRC Commercial Banks, such non-compliance will not affect our Company's ability to fully comply with the core regulatory requirements with respect to risk management.

We have adopted measures including, among others, (1) adjusting our deposit structure to reduce the cost of funding, (2) increasing net interest income, (3) developing new products, and (4) introducing a performance-based review system, to strengthen our compliance with regulatory requirements on operational ratios.

### **Internal Control**

The Internal Control Guidelines issued by the PBOC in September 2002 require commercial banks in the PRC to establish a sound internal control system to ensure effective risk management and compliance with laws and regulations. The Internal Control Guidelines specifically require commercial banks to establish a risk management department to monitor risks in all business aspects. In addition, commercial banks must have an independent internal auditing department to monitor and assess all its departments and business operations.

According to the Internal Control Guidelines, commercial banks shall establish a sound corporate governance structure to ensure the effectiveness of their internal controls. The Corporate Governance Guidelines and the Directors and Supervisors Guidelines provide best practice guidelines pursuant to which joint stock commercial banks may adopt appropriate measures to improve their corporate governance. For instance, joint stock commercial banks are required to establish an organizational structure under which management and supervisory powers and responsibilities are separated among the shareholders, the board of directors, the board of supervisors and the senior management. The Directors and Supervisors Guidelines also suggest that the board of directors of a joint stock commercial bank should have at least two independent directors and, under the Corporate Governance Guidelines, senior management should comprise at least one quarter but not more than one third of the board of directors. The board of directors should establish special committees to regulate auditing matters and related party transactions, risk management, remuneration and nomination. A board of supervisors should also be established to oversee and supervise the board of directors, senior management and other officers, to examine and supervise the bank's operational and financial activities, to audit and monitor the bank's business decisions, risk management and internal controls, and to provide guidance to the bank's internal auditing department. The supervisory board should consist of representatives from the shareholders and employees, as well as external supervisors. Commercial banks should also have in place comprehensive policies, procedures and systems for reporting and disclosing information regarding corporate governance. The PBOC considers the effectiveness of a commercial bank's internal controls an important factor in granting licenses for business expansion.

On December 25, 2004, the CBRC published the Trial Measures on the Evaluation of Internal Controls. The Trial Measures on the Evaluation of Internal Controls detail the procedures, measures and ranking standards for the internal control evaluation of commercial banks by the CBRC. The CBRC can, based on the performance of the internal control of commercial banks, as reflected by their rankings and evaluation reports, take different supervisory measures, such as interviewing the personnel in charge or the chairman of the board of directors of commercial banks and issuing warnings. In severe cases, the CBRC can even disqualify the relevant management, require the termination of certain business activities and reject the application for opening additional branches or starting new businesses.

In the event of the non-compliance by a PRC commercial bank with the Trial Measures on the Evaluation of Internal Controls, the CBRC may impose sanctions including, among others, change of senior management, suspension of business, and revocation of the practice license of persons involved.

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Following the adoption of Internal Control Guidelines and the Trial Measures on the Evaluation of Internal Controls, we have revised our internal control system to be in compliance with such regulatory requirements. The CBRC conducts assessments of our compliance with such regulatory requirements on a regular basis. The most recent assessment was in September 2004, at which time the CBRC evaluated our compliance with such regulatory requirements as of June 30, 2004. Since the Internal Control Guidelines were issued in 2002, the CBRC has issued several assessment reports. According to these assessment reports, the CBRC considered our internal control system to be comprehensive in nature and to cover core aspects of our businesses. However, these reports also stated that, among other things, (i) there were deficiencies in our corporate governance structure, in that the board of directors had not optimally exercised its powers and the senior management had been granted an excessive level of authority (ii) there were weaknesses in the implementation of our internal control system, such as lack of independence of our internal control departments at the branch level and a weakness in the monitoring of our business operations and (iii) there were weaknesses in the management of credit approvals and disposal of non-performing loans, such as inconsistent application or misapplication of the 5-category classification system. As part of its assessment reports, the CBRC made recommendations with respect to improving our internal control system and complying with such regulatory requirements, all of which we have taken seriously and we have accordingly made changes to our internal controls.

In response to the CBRC's assessment reports and recommendations, we implemented various measures to enhance our corporate governance, improve our internal controls, and strengthen our management of credit approvals and disposal of non-performing loans. In particular, with respect to enhancing our corporate governance, we further defined and clarified the powers and authority enjoyed by the board of directors, including our independent non-executive directors, strengthened our board committees by appointing independent directors as chairmen, adopted administrative measures on related party transactions, and improved our information disclosure system. In addition, with respect to improving internal controls, we focused on strictly implementing our internal control policies and procedures, which include, among others, establishing an independent three-tier internal auditing system, introducing a stringent accountability system to control and manage our operational risks, establishing a system to coordinate risk management across different business departments and increasing the sanctions and penalties for violations of relevant regulatory requirements or our internal rules and policies. Moreover, with respect to the strengthening of our management of credit approvals, we separated our credit review and approval system from business departments, and have established a risk monitoring department to monitor our implementation of loan classification standards in accordance with applicable PRC laws. See also the section headed "Business – Risk Management and Internal Controls".

The CBRC has not imposed any sanctions on our Company in relation to its findings and recommendations relating to our internal controls as described above, nor has the CBRC made any further comments on the effectiveness of the various measures we implemented to improve our corporate governance, internal controls, management of credit approvals, disposal of non-performing loans or other related matters.

### **Related Party Transactions**

Under the PRC Commercial Banking Law, commercial banks are not allowed to grant unsecured loans to related parties or to grant secured loans to such persons on terms more favorable than those offered to other borrowers. Under the PRC Commercial Banking Law, "related parties" of a commercial bank include its directors, supervisors, senior officers and employees with authority to approve loan applications or that are involved in the loan approval process, as well as close relatives of such persons, and enterprises or other entities in which any such person has invested or assumed a senior management position.

According to the Corporate Governance Guidelines, joint stock commercial banks are prohibited from granting loans to their shareholders on terms more favorable than those offered to other

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borrowers. In the event that joint stock commercial banks face liquidity problems, shareholders are required to repay outstanding loans due and also repay in advance outstanding loans not yet due. In addition, a shareholder cannot use its own shares of a joint stock commercial bank as collateral for loans from such bank. It may only pledge its shares in a commercial bank as collateral or guarantee for loans from other entities upon written notice to the board of directors of the bank in which it holds shares. Moreover, if the outstanding amount of the loans to a shareholder exceeds the audited net asset value of its shares in the bank for the immediately preceding year, the shareholder cannot use its shares as collateral for loans unless certificates of deposit or government bonds are provided by it to the bank as additional collateral.

In April 2004, the CBRC promulgated the Related Party Transactions Measures, providing more stringent and detailed requirements on related party transactions. It requires commercial banks to adhere to the principles of honesty and fairness in conducting related party transactions, with terms no more favorable than those to non-related parties in similar transactions. The Related Party Transactions Measures became effective on May 1, 2004.

According to the provisions of the Related Party Transactions Measures, the related parties of a commercial bank include connected natural persons and connected legal persons and other organizations. Connected natural persons include the insiders and major natural person shareholders of a commercial bank and their close relatives; the controlling natural person shareholders, directors and key management personnel of the connected legal persons or other organizations of a commercial bank; and other natural persons who have significant influence over the commercial bank. Connected legal persons or organizations of a commercial bank include its major corporate shareholders; other legal persons or organizations directly or indirectly under common control of a third party with the commercial bank; legal persons or organizations through which insiders and major natural person shareholders of a commercial bank or their close relatives directly, indirectly or jointly control or may exercise significant influence over the commercial bank; and other legal persons or organizations that can, directly or indirectly, jointly control the commercial bank or have significant influence over the commercial bank. The related party transaction control committee of the board of the commercial bank must be responsible for supervising the related party transactions of commercial banks.

Pursuant to the Related Party Transactions Measures, related party transactions of commercial banks means the transfer of resources or obligations between the bank and its related parties, including the provisions of credits, the transfer of assets, the provision of services and other related party transactions identified by the CBRC. When the amount of any single related party transaction represents more than 1% of the bank's net equity, or any single related party transaction will make the total outstanding value of transactions with such related party represent more than 5% of the bank's net equity, such transaction must be examined by the related party transaction control committee of the commercial bank and submitted to the board of directors for approval. It must also be reported to the supervisory board of the bank and the CBRC within 10 working days after such board approval. Any related party transaction that does not exceed the threshold level has to be examined and approved according to the internal authorization procedure of the commercial bank and submitted to the related party transactions control committee for filing or approval.

Pursuant to the Related Party Transactions Measures, a commercial bank is prohibited from granting to related parties unsecured loans or accepting its own shares as collateral for loans. It cannot provide guarantees for facilities granted to related parties unless the related parties provide certificates of deposit or government bonds with a sufficient amount as a counter-collateral. If a commercial bank suffers a loss from loans granted to a related party, it may not provide loans to that related party in the next two years except as otherwise approved by the board of directors. Moreover, a related party transaction may not be resubmitted for consideration within six months after it has been rejected. The credit facilities granted to a single related party may not exceed 10% of the commercial bank's net equity. The credit facilities granted to all affiliates of a connected legal person or organization may not exceed 15% of the bank's net equity. The overall credit facilities granted to all related parties may not exceed 50% of the bank's net equity.

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Pursuant to the Related Party Transactions Measures, commercial banks must submit to the CBRC, on a quarterly basis, status reports regarding their related party transactions, and disclose matters relating to related parties and related party transactions in their financial statements. Furthermore, the board of directors is required to report annually at the shareholders' meetings related party transactions and the implementation of mechanisms for monitoring and approving related party transactions. The CBRC has the power to request the rectification of transactions that violate the Related Party Transactions Measures and impose sanctions on the bank and/or the relevant parties.

We adopted the Administrative Measures Regarding Related Party Transactions in April 2005. These administrative measures set forth, among other things, detailed definitions for related parties and related party transactions. In addition, these administrative measures provide for the day-to-day management and reporting procedures regarding related party transactions. In particular, these administrative measures prohibit us from extending unsecured loans to any related parties or granting credit facilities to any single related party for more than 10% of our shareholder's equity or to any group customer for more than 15% of our shareholder's equity.

### **Risk Management with Respect to Group Customers, Real Estate Loans and Automobile Loans**

#### ***Group Loans***

In order to control the concentration of credit risks for commercial banks, the CBRC promulgated Group Loans Guidelines in October 2003. The Group Loans Guidelines require commercial banks to pay special attention to loan applications by affiliated companies of the same group. Under the Group Loans Guidelines, commercial banks are required to treat affiliated companies of the same group as a single group customer and conduct centralized information management and risk assessment of overall credit exposure, including loans, inter-bank loans and bill acceptances, of these companies. If the total outstanding credit exposure to a group customer exceeds 15% of the net regulatory capital of a commercial bank, the CBRC will consider such level to be imprudent, and will require the bank to take measures to reduce such percentage. In order to collect information for credit assessment of their group customers, commercial banks are allowed to require their group customers to report their respective related party transactions during the credit review process. Commercial banks should also establish a sound information system in order to assist the management of credit exposure to group customers. Commercial banks are allowed to unilaterally terminate the loans to group customers and require early repayment of principal of and interest on such loans if group customers make any false statements or utilize an affiliate relationship to evade payment obligations. Commercial banks must also set internal credit limits for loans that can be granted to different individual companies of a related group and a single consolidated credit limit for such group in order to avoid concentration of credit risks.

#### ***Real Estate Loans***

On September 2, 2004, the CBRC issued the Real Estate Loan Guidelines to regulate risk management with respect to real estate loans, including land reserve loans, real estate development loans, personal housing loans and commercial property loans. For each of these types of loans, the Real Estate Loan Guidelines provide for a respective standard for granting credit, operational procedures, risk control measures and supervisory and management measures after a loan is made. In response to the significant increase in personal housing loans in the PRC in recent years, the Real Estate Loan Guidelines specifically provide that commercial banks shall focus on the examination of the repaying ability of the borrower to make sure that the monthly housing expense of the borrower is no more than 50% of his/her monthly income and the total monthly debt service is no more than 55% of his/her monthly income.

#### ***Automobile loans***

On August 16, 2004, the CBRC issued the Automobile Loan Measures to replace the 1998 Administrative Measures on Automobile Loans. Compared to the 1998 version, the Automobile Loan

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Measures emphasize risk management. For example, under the Automobile Loan Measures, borrowers are classified into individual borrowers, car dealership borrowers and institutional borrowers, and each category has its own risk management measures. Furthermore, the Automobile Loan Measures require lenders, including commercial banks, to establish a credit rating system, a risk warning system and an inter-bank information sharing system. Moreover, under the Automobile Loan Measures, the amount of loans for self-use automobiles cannot exceed 80% of the purchase price of such automobiles, while for commercial automobiles and second-hand automobiles, the amount of loans cannot exceed 70% and 50%, respectively, of the purchase price of such automobiles.

### **Risk Management with Respect to the Derivatives Business**

On February 4, 2004, the CBRC issued the Derivative Business Measures, which set forth, among other matters, detailed regulations on market access and risk management with respect to derivatives business conducted by financial institutions.

Under the Derivative Business Measures, financial institutions seeking to conduct derivatives business must apply to the CBRC for prior approval and satisfy the relevant qualification requirements, which include, among others, having established a sound risk management system that monitors risks on a real-time basis; having established a sound internal control system; having established a competent derivative transactions processing system; and having a competent professional team to conduct derivatives business.

On March 22, 2005, the CBRC issued the Derivative Business Circular to further strengthen the risk management of the derivatives businesses conducted by PRC domestic banks.

Under the Derivative Business Circular, PRC domestic banks conducting derivatives business are required to strictly implement the trading and exposure authorization limits and stop loss limits. All material derivatives trading activities and all trading activities involving new derivative products are required to be approved by the board of directors or senior management personnel duly authorized by the board of directors.

Moreover, the Derivative Business Circular sets forth detailed requirements with respect to corporate governance and internal controls for PRC domestic banks conducting derivatives business, which include, among others, reviewing the risk management policies and procedures on a regular basis, segregating senior management in charge of risk management and internal controls from those in charge of marketing and trading of derivative products, establishing procedures whereby officers in charge of risk management can report risk exposures directly to the senior management, and establishing a rotation system for traders and officers in charge of trading activities.

Furthermore, the Derivative Business Circular requires PRC domestic banks to enhance their risk supervision and assessment in conducting derivatives business. PRC domestic banks are required to link their derivatives trading system with the risk management system, and branches must not be permitted to conduct any derivatives business transaction that exceeds the authorization limits granted by the head office. PRC domestic banks are also required to establish internal risk reporting systems under the Derivative Business Circular.

### **Risk Rating System Applicable to Joint Stock Commercial Banks**

In February 2004, the CBRC announced a provisional risk rating system for joint stock commercial banks. Under this provisional risk rating system, capital adequacy, asset quality, management quality, profitability, liquidity and market risks of a joint stock commercial bank are evaluated by the CBRC on a continuous basis and a rating score is granted by the CBRC to each joint stock commercial bank. Each joint stock commercial bank is classified into one of the five risk rating categories according to the rating score it obtains from the CBRC. The CBRC determines the frequency and scope of its on-site inspections of each individual joint stock commercial bank based on the category to which such bank belongs. However, these rating scores are not publicly available.

### **Due Diligence in Granting Credit**

In July 2004, the CBRC issued the Due Diligence Guidelines in order to improve the prudent management of the credit operations of commercial banks in the PRC. The Due Diligence Guidelines require commercial banks to establish a strict vertical management system to manage all credit risks associated with their credit operations. Commercial banks must also establish standard operating procedures, setting out due diligence requirements throughout all stages of its credit operations, including borrower credit rating investigation, credit approval, fund disbursement and ongoing loan monitoring. In addition, commercial banks must ensure that competent personnel are staffed at each stage of the credit operations. Furthermore, an internal review and supervision system must be put into place by each commercial bank to monitor the implementation of its due diligence procedures and to penalize the relevant personnel for any violation of these procedures.

Our Company is currently in compliance with the Due Diligence Guidelines in all material respects.

### **Operational Risks Management**

On March 22, 2005, the CBRC issued the Operational Risk Control Circular to further strengthen PRC commercial banks' ability to identify operational risks and the risk management and control thereof. Under the Operational Risk Control Circular, PRC commercial banks are required to establish internal rules and policies specifically for management and control of operational risks. Internal audit departments and the business operation departments are required to conduct independent and ad hoc reviews and examinations of the business operations from time to time. For business areas involving higher operational risks, ongoing reviews and examinations are required to be conducted. Moreover, a PRC commercial bank's head office is required to assess the implementation and compliance of its internal policies and rules on operational risks from time to time.

In addition, the Operational Risk Control Circular sets forth detailed requirements for PRC commercial banks to follow, which include, among others, establishing a system under which branch officers in charge of business operations are required to rotate and take compulsory leave on a regular basis, establishing a system to encourage the full compliance with applicable regulations and internal rules and policies by all employees, improving reconciliation in a timely manner of the account statements between commercial banks and their customers and those between operational departments and accounting departments within one commercial bank, segregating persons in charge of account keeping and persons in charge of account reconciliation, and establishing a system for the control and management of specimen signatures and banking transaction documents.

### **Other Requirements**

#### ***Use of Funds***

Under the PRC Commercial Banking Law, commercial banks are not allowed to engage in trust investment or securities investment business, or invest in real property other than for their own use, or invest in non-banking financial institutions and enterprises, unless otherwise approved by the relevant government authorities. The use of funds by commercial banks is limited to the following:

- short-term, medium-term and long-term loans;
- discounts on negotiable instruments;
- inter-bank loans;
- trading of government bonds;
- trading of finance bonds;
- investment in banking institutions; and
- other uses as may be approved by the relevant government authorities.

### ***Establishment of Fund Management Companies by Commercial Banks***

On February 20, 2005, the PBOC, the CBRC and the CSRC jointly promulgated the Fund Management Companies Administrative Measures, which permit state-owned commercial banks and joint stock commercial banks to establish fund management companies. Under the Fund Management Companies Administrative Measures, the establishment of fund management companies is subject to two levels of review and approval by the PRC regulatory authorities. First, a PRC commercial bank that intends to establish a fund management company must obtain an approval from the CBRC with respect to its qualifications to invest in fund management companies (the "Qualification Approval"). After receiving such qualification approval from the CBRC, the commercial bank may then apply for approval from the CSRC with respect to the establishment of the fund management company (the "Establishment Approval"). In addition, commercial banks are required to file their applications for both the Qualification Approval and the Establishment Approval with the PBOC for its records.

The Fund Management Companies Administrative Measures set forth certain detailed measures to segregate the risks associated with the securities market and the banking sector, which include, among others, separating client information between commercial banks and their fund management companies, preventing commercial banks' employees from holding concurrent positions in the fund management companies established by such commercial banks and prohibiting commercial banks from acting as custodians for the funds managed by their fund management companies.

Under the Fund Management Administrative Measures, the CBRC is responsible for establishing the relevant risk monitoring criteria for commercial banks that have established fund management companies. The CSRC is responsible for examining and approving the funds raised and managed by fund management companies. The PBOC is responsible for supervising the national inter-bank bond market transactions conducted by fund management companies.

### ***Information Disclosure***

PRC commercial banks are generally required to submit regular returns to the PBOC or CBRC, as applicable, which are similar to those submitted by other banks in other jurisdictions, such as capital adequacy ratios, liquidity ratios and loss provisions.

In May 2002, the PBOC issued the Information Disclosure Measures, which provide the minimum requirements for the information disclosure of commercial banks that have total assets of no less than RMB1 billion and deposit balances of no less than RMB500 million. Under the Information Disclosure Measures, commercial banks are required to publish an annual report within four months after the end of each financial year, in which the bank's financial situation and results of operations as of the end of the preceding financial year must be provided. Furthermore, the annual report shall also disclose, among other things, audited financial statements prepared under PRC GAAP, material related party transactions and capital adequacy ratios, risk management performance, corporate governance and other significant events such as any increase or decrease in registered capital during the year. PRC GAAP may be materially different from the generally accepted accounting principles used by banks in other jurisdictions. The financial statements of commercial banks are required to disclose certain regulatory compliance information, the scope of which may be different from or even less than that which is required in other jurisdictions. In addition, PRC commercial banks are not required to reconcile such regulatory compliance information to the financial statements, which practice may be different from that in other jurisdictions or under different accounting standards, including IFRS, which we have adopted for our financial reporting. The board of directors and the president of commercial banks are liable for the truth, accuracy and completeness of the information disclosed in the annual report.

### ***Deposit Reserves with the PBOC***

PRC regulations require all commercial banks to maintain with the PBOC a deposit reserve, which shall amount to a certain percentage of the bank's total outstanding customer deposits. A PRC commercial bank's current deposit reserve ratio for customer deposits denominated in Renminbi varies

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in accordance with its capital adequacy ratio calculated in accordance with the formula promulgated by the PBOC and the CBRC and based on PRC GAAP. If its capital adequacy ratio is 4% or above, its current deposit reserve ratio for customer deposits denominated in Renminbi is required to be 7.5%; otherwise, its current deposit reserve ratio is required to be 8%. For customer deposits denominated in foreign currencies, the current deposit reserve ratio is 3% of the bank's total outstanding customer deposits denominated in foreign currencies. There is no deposit insurance system in the PRC.

Our Company is currently in compliance with these deposits reserve ratios requirements.

### ***Ownership Restrictions***

Under the current ownership restrictions imposed on investment in commercial banks in the PRC, a prior approval from the CBRC is required for any person or entity to hold 5% or more of the registered capital or the total issued shares of a commercial bank. If any existing shareholders of a commercial bank increase their shareholding in excess of the 5% threshold without obtaining the CBRC's prior approval, such shareholders will be subject to CBRC sanctions, which include, among others, correction of such misconduct and confiscation of illegal earnings, if any. Furthermore, such bank and its shareholders may be subject to fines imposed by the CBRC for not obtaining the prior approval from the CBRC.

In addition, the Corporate Governance Guidelines, which we have adopted in our Articles, impose certain additional requirements on shareholders of PRC joint stock commercial banks. For example, in the event that a commercial bank encounters liquidity problems, its shareholders are required to immediately repay outstanding loans due and repay in advance outstanding loans not yet due from the bank. Furthermore, if a commercial bank fails to meet the required capital adequacy ratios calculated in accordance with the formula promulgated by the PBOC and the CBRC and based on PRC GAAP, its shareholders are obligated to endorse measures determined by the bank's board of directors that are aimed at increasing the capital adequacy level, regardless of whether or not such measures are in the best interests of shareholders. Moreover, if shareholders of a commercial bank fail to repay outstanding loans when due, their voting rights will be suspended for the period during which the relevant loan is overdue.

Under the PRC Company Law and CBRC rules and regulations, shareholders of a joint stock commercial bank may not use their shares in such bank as collateral for receiving loans from such bank. Moreover, there are legal limitations on the ability of shareholders in a joint stock commercial bank to pledge to any lender their shares in such bank. Those restrictions include the following:

- if a shareholder of a joint stock commercial bank pledges its shares in the bank as collateral for itself or any other third party, it must give prior notice to the board of directors of the bank in which it holds shares; and
- if the outstanding amount of the bank's loans to a shareholder exceeds the audited value of such shareholder's equity in the bank for the immediately preceding year, and if such shareholder does not pledge any government bonds or bank deposit certificates as collateral, the shareholder may not pledge its shares.

### ***Anti-Money Laundering***

Commercial banks in the PRC are required to comply with the Anti-Money Laundering Regulations issued by the PBOC in 2003. Under the Anti-Money Laundering Regulations, commercial banks must establish an internal anti-money laundering procedure and file such procedure with the PBOC. In addition, commercial banks are also required to either establish an independent anti-money laundering department, or to designate a relevant department to implement its anti-money laundering procedure. Also, commercial banks are required to establish a system to record the identities of all customers and their respective deposits, settlement and other transactions with the bank, and, where necessary and pursuant to appropriate judicial proceedings, to cooperate with government authorities in preventing money laundering activities and freezing of assets.

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The PBOC conducts on-site inspections of PRC commercial banks' compliance with the Anti-Money Laundering Regulations, and may impose penalties for any violations thereof. The PBOC issued a notice on March 25, 2005, imposing a fine on our Shanghai branch in the amount of RMB50,000 for failure to report certain large and irregular Renminbi and foreign exchange transactions.

In addition, the SAFE, as the PRC government authority in charge of foreign exchange transactions, conducts periodic examinations of foreign exchange transactions conducted by PRC commercial banks. In particular, under the relevant SAFE regulations, PRC financial institutions are required to timely report to the SAFE any large or irregular foreign exchange transactions they encounter. Under the relevant SAFE regulations, large foreign exchange transactions refer to, among others:

- any single cash transaction with an amount equal to or more than US\$10,000;
- a series of cash transactions in one day with an aggregate amount equal to or more than US\$10,000;
- any single non-cash transaction with an amount equal to or more than US\$100,000 by natural persons;
- a series of non-cash transactions in one day with an aggregate amount equal to or more than US\$100,000 by natural persons;
- any single non-cash transaction with an amount equal to or more than US\$500,000 by entities other than natural persons; or
- a series of non-cash transactions in one day with an aggregate amount equal to or more than US\$500,000 by entities other than natural persons.

Under the relevant SAFE regulations, irregular foreign exchange transactions refer to, among others:

- frequent foreign exchange deposits and withdrawals by natural persons; or
- frequent foreign exchange cash transactions by entities other than natural persons.

In SAFE's recent examinations, our Zhongshan branch, Nanning branch, Chongqing branch and Zhengzhou branch were found to have failed to report certain large and irregular foreign exchange transactions, and the SAFE imposed fines on three of these four branches in the total amount of RMB62,000.

The fines by the PBOC and the SAFE are immaterial in terms of our overall financial situation and results of operations. In responding to these findings, we are in the process of establishing appropriate systems including, among others, an anti-money laundering data reporting system to detect large amount or suspicious transactions and further promote our full compliance with the Anti-Money Laundering Regulations and other relevant regulations.

### ***Limitation on Enforcement of Security Interest***

Pursuant to a recent judicial interpretation issued by the Supreme Court of the PRC on the enforcement of seized assets in civil proceedings, effective January 2005, the courts in the PRC are not permitted to foreclose and sell mortgaged residential properties for repayment of indebtedness if these properties are the necessary residential properties of the relevant individuals and their families.

### **Regulation of Interest Rates**

Interest rates on deposits and loans denominated in Renminbi are set by commercial banks in accordance with the official benchmark rates published and modified by the PBOC from time to time.

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There are currently different PBOC benchmark rates set for different types of business. Commercial banks are allowed to set their own interest rates within the ranges as described below:

<u>Product</u>	<u>As of October 29, 2004</u>	<u>Prior to October 29, 2004</u>
<b>Loans</b>		
<b>Renminbi Loans</b>		
Term of less than one year . . . . .	No upper limit but cannot be lower than 90% of the PBOC benchmark rate	10% lower to 70% higher than the PBOC benchmark rate
Term of one to five years . . . . .	No upper limit but cannot be lower than 90% of the PBOC benchmark rate	10% lower to 70% higher than the PBOC benchmark rate
Term of over five years . . . . .	No upper limit but cannot be lower than 90% of the PBOC benchmark rate	10% lower to 70% higher than the PBOC benchmark rate
Discounted bills . . . . .	Must be set no lower than the PBOC's rediscount rate but cannot be set above the lending rate band applicable to loans with a comparable term	Must be set no lower than the PBOC's rediscount rate but cannot be set above the lending rate band applicable to loans with a comparable term
Mortgages <sup>(1)</sup> . . . . .	Fixed by the PBOC	Fixed by the PBOC
Automobile and other loans to individuals . . . . .	No upper limit but cannot be lower than 90% of the PBOC benchmark rate	10% lower to 70% higher than the PBOC benchmark rate
<b>Foreign Currency Loans</b> . . . . .	Not subject to restrictions	Not subject to restrictions
<b>Deposits</b>		
Renminbi deposits other than negotiated deposits <sup>(2)</sup> . . . . .	No lower limit but cannot be higher than the PBOC benchmark rate	Fixed by the PBOC
Negotiated deposits . . . . .	Not subject to restrictions	Not subject to restrictions
Foreign currency deposits denominated in US dollars, Euros, Japanese Yen and HK dollars with an amount less than US\$3 million, other than inter-bank deposits or deposits by non-PRC residents . . . . .	No lower limit but cannot be higher than the ceiling set by the PBOC	No lower limit but cannot be higher than the ceiling set by the PBOC
All other foreign currency deposits . . . . .	Not subject to restrictions	Not subject to restrictions

(1) Effective March 17, 2005, there is no upper limit for the interest rates for mortgage loans but they cannot be lower than 90% of the PBOC benchmark rates for Renminbi loans with the same term.

(2) Negotiated deposits are deposits by insurance companies of RMB30 million or more, or deposits by the National Social Security Fund of RMB500 million or more, both with a term greater than five years, or deposits by China Post of RMB30 million or more with a term longer than three years.

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The following table sets forth the PBOC benchmark rates as of the dates indicated:

	As of December 31,							
	1997	1998	1999	2000	2001	2002	2003	2004
	(percentages)							
<b>Interest Rates on Loans</b>								
<b>Short-term Loans</b>								
six months .....	7.65	6.12	5.58	5.58	5.58	5.04	5.04	5.22
one year .....	8.64	6.39	5.85	5.85	5.85	5.31	5.31	5.58
<b>Medium- and Long-term Loans</b>								
three years or less .....	9.36	6.66	5.94	5.94	5.94	5.49	5.49	5.76
five years or less .....	9.90	7.20	6.03	6.03	6.03	5.58	5.58	5.85
Over five years .....	10.53	7.56	6.21	6.21	6.21	5.76	5.76	6.12
Rediscount Rate .....	(1)	3.96	2.16	2.16	2.97	2.97	2.97	3.24
<b>Mortgage Rates<sup>(3)</sup></b>								
five years or less .....	(2)	(2)	(2)	(2)	(2)	4.77	4.77	4.95
Over five years and up to 30 years .....	(2)	(2)	(2)	(2)	(2)	5.04	5.04	5.31
<b>Interest Rates on Deposits</b>								
Demand .....	1.71	1.44	0.99	0.99	0.99	0.72	0.72	0.72
<b>Time</b>								
three months .....	2.88	2.79	1.98	1.98	1.98	1.71	1.71	1.71
six months .....	4.14	3.33	2.16	2.16	2.16	1.89	1.89	2.07
one year .....	5.67	3.78	2.25	2.25	2.25	1.98	1.98	2.25
two years .....	5.94	3.96	2.43	2.43	2.43	2.25	2.25	2.70
three years .....	6.21	4.14	2.70	2.70	2.70	2.52	2.52	3.24
five years .....	6.66	4.50	2.88	2.88	2.88	2.79	2.79	3.60

Source: PBOC Quarterly Statistical Bulletin.

(1) A floating rate 5-10% lower than the central bank lending rates of corresponding maturity.

(2) Mortgage rates for 1997 to 2001 were set by the PBOC using different maturity periods and ranged from 5.58% for mortgage loans with a term of one year to 6.32% for mortgage loans with terms of over ten years and up to 20 years.

(3) Effective March 17, 2005, the PBOC benchmark mortgage rates began to peg to the regular PBOC benchmark rates for loans with the same term.

### **Interest Rates on Loans**

Starting from October 29, 2004, PRC commercial banks may set their interest rates on Renminbi-denominated loans at their own discretion so long as such interest rates are not less than 90% of the PBOC benchmark rate.

In case there is any adjustment of the PBOC benchmark rates during the term of a Renminbi-denominated loan, prior to January 1, 2004, commercial banks may re-price the interest rates for their Renminbi-denominated medium- and long-term loans (all loans with an original maturity longer than one year) except mortgage loans in accordance with the changes in the PBOC benchmark rates only on the next anniversary date of the loan. Since January 1, 2004, however, in the event of a change in the PBOC benchmark rates, commercial banks may re-price the interest rates for their Renminbi-denominated medium-and long-term loans except mortgage loans on a monthly, quarterly or annual basis. Under the current regime, commercial banks are not allowed to adjust the interest rates for their short-term loans (all loans with an original maturity of one year or less) even when the PBOC benchmark rates are adjusted during the term of these loans.

Interest rates on mortgage loans are currently fixed by the PBOC. In the event of any changes in the PBOC benchmark rates during the term of a mortgage loan, commercial banks are required to apply the adjusted PBOC benchmark rates to their existing mortgage loans on January 1 of the subsequent calendar year.

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Interest rates on foreign currency loans have been relaxed already and can be determined by commercial banks at their own discretion based on the market conditions and other factors.

### ***Interest Rates on Deposits***

Starting from October 29, 2004, PRC commercial banks may set their own interest rates on Renminbi deposits so long as such interest rates are not higher than the relevant PBOC benchmark rates. However, interest rates on negotiated deposits, which are deposits by insurance companies in amounts of RMB30 million or more or deposits by the National Social Security Fund in amounts of RMB500 million or more, both with a term greater than five years, or deposits by China Post in amounts of RMB30 million or more with a term longer than three years, are currently not subject to these restrictions.

In addition, interest rates on foreign currency deposits with an amount of US\$3 million or more or its equivalent, interest rates on foreign currency inter-bank deposits and interest rates on foreign currency deposits made by non-PRC residents have been relaxed. Interest rates on foreign currency deposits denominated in US dollars, Euros, Japanese Yen and HK dollars with an amount of less than US\$3 million or its equivalent cannot be higher than the ceiling set by the PBOC.

### ***PBOC's Monetary Policies***

The PBOC is responsible for formulating and implementing monetary policies and making adjustments thereto from time to time in accordance with the macroeconomic environment. By using financial instruments such as the deposit reserve ratio and re-discount rate, and by adjusting the cash supply on the market, the PBOC's monetary policies affect the interest rates, and hence affect operating results of commercial banks in the PRC.

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## **FOREIGN INVESTMENT IN THE PRC BANKING INDUSTRY**

### **WTO Commitments**

Since the PRC's accession to the WTO in December 2001, the banking industry in the PRC has been increasingly opening up to participation by foreign-invested financial institutions. The following table summarizes the PRC's WTO commitments with respect to the banking industry:

<u>Subject matter</u>	<u>The PRC's Commitments</u>	
<b>Geographic Restrictions on the Provision of Banking Services</b>	Foreign Currency-denominated Products and Services	No restriction upon the PRC's accession to the WTO
	Renminbi-denominated Products and Services	Geographic restrictions have been, or will be, phased out under the following schedule: Upon accession, Shanghai, Shenzhen, Tianjin and Dalian; Prior to December 11, 2002, Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan; Prior to December 11, 2003, Jinan, Fuzhou, Chengdu and Chongqing; Prior to December 11, 2004, Kunming, Beijing and Xiamen; Prior to December 11, 2005, Shantou, Ningbo, Shenyang and Xi'an <sup>(1)</sup> ; Prior to December 11, 2006, all geographic restrictions will be removed.
<b>Restrictions on Customers</b>	Foreign Currency-denominated Products and Services	No restriction upon the PRC's accession to the WTO
	Renminbi-denominated Products and Services	Client restrictions will be phased out under the following schedule: Prior to December 11, 2003, foreign-invested financial institutions will be permitted to provide services to the PRC enterprises. Prior to December 11, 2006, foreign-invested financial institutions will be permitted to provide services to all PRC clients.

(1) While under the WTO Protocol the PRC government committed to allow foreign-invested financial institutions to engage in Renminbi business in Shenyang and Xi'an starting December 11, 2005, the PRC government in fact has granted such permission since December 11, 2004.

Pursuant to the above WTO commitments, foreign-invested financial institutions currently can provide foreign currency services in the PRC without geographic and client restrictions. With respect to the Renminbi currency business, foreign-invested financial institutions currently are permitted to provide services to PRC enterprises in 18 cities. All geographic and customer restrictions, however, will be phased out by December 11, 2006.

### **Foreign-Invested Banks**

Under the Foreign-Invested Institutions Regulations, the establishment of foreign-invested banks in the PRC, including in the forms of wholly foreign-owned banks, joint venture banks and branch offices of foreign banks, are subject to the approval from the CBRC.

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According to the Foreign-Invested Institutions Regulations, the following conditions shall be satisfied to establish a wholly foreign-owned bank or a joint venture bank in the PRC:

- the applicant shall be a financial institution;
- the applicant must have established a representative office in the PRC for at least two years;
- the year-end assets of the applicant prior to the application shall be no less than US\$10 billion;
- the applicant shall be subject to effective and comprehensive financial regulation in its home country or region;
- the applicant has received approvals from the regulatory authorities in its home country or region; and
- the applicant shall meet other requirements set forth by the PBOC or the CBRC.

According to the Foreign-Invested Institutions Regulations, the following conditions shall be satisfied to establish a branch office of a foreign bank in the PRC:

- the applicant has set up a representative office in the PRC for at least two years;
- the year-end assets of the applicant prior to the application shall be no less than US\$20 billion and the capital adequacy ratio of the applicant shall be no less than 8% at the time of application;
- the applicant shall be subject to effective and comprehensive financial regulation in its home country or region;
- the applicant has received approvals from the regulatory authorities in its home country or region; and
- the applicant shall meet other requirements set forth by the PBOC or the CBRC.

Wholly foreign-owned banks and joint venture banks shall have a registered capital as well as paid-in capital of the exchangeable foreign currency equivalent to at least RMB300 million. For branch offices, foreign banks shall allocate to each of their branch offices in the PRC operating capital of no less than the exchangeable foreign currency equivalent to RMB100 million.

### **Equity Investment by Foreign Financial Institutions in PRC Banks**

Under the Measures on Equity Investment by Overseas Financial Institutions issued on December 8, 2003, foreign equity investment in a PRC commercial bank is currently subject to the CBRC's approval. According to the Measures on Equity Investment by Overseas Financial Institutions, the equity investment by a single foreign financial institution in a PRC bank shall not exceed 20%. A non-listed PRC commercial bank with equity investment from foreign financial institutions of 25% or more shall be regulated as a foreign-invested bank, while a listed PRC commercial bank with equity investment from foreign financial institutions of 25% or more shall be regulated as a PRC bank.

## **RECENT DEVELOPMENT OF PRC BANKING REGULATIONS**

### **Guidelines on Market Risk Management of Commercial Banks**

On December 29, 2004, the CBRC promulgated the Guidelines on Market Risk Management of Commercial Banks, which became effective on March 1, 2005. These Guidelines were promulgated to strengthen the market risk management of PRC commercial banks.

The Guidelines on Market Risk Management of Commercial Banks set forth (1) responsibilities of the board of directors and senior management in the supervision of market risk management, (2)

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policies and procedures of market risk management, (3) detection, quantification, monitoring and control of market risk, and (4) responsibilities for internal controls and conducting external audits.

According to the Guidelines on Market Risk Management of Commercial Banks, commercial banks are required to establish formal written policies and procedures to manage market risk. These policies and procedures shall cover, among others:

- permitted business activities, such as the trading of, and investment in, certain financial instruments;
- the level of market risk that can be deemed acceptable to the commercial bank;
- the organizational structure for market risk management;
- a set of procedures for the detection, quantification, monitoring and control of market risk; and
- an information system for market risk management.

### **HONG KONG SUPERVISION AND REGULATION**

Banking activities in Hong Kong are primarily subject to the provisions of the Banking Ordinance, and to the powers, functions and duties granted by the Banking Ordinance to the Hong Kong Monetary Authority. The principal function of the Hong Kong Monetary Authority is to promote the general stability and effectiveness of the banking system in Hong Kong. The Hong Kong Monetary Authority is responsible for supervising compliance with the provisions of the Banking Ordinance and also supervises compliance with the Hong Kong Monetary Authority's guidelines, and legislation promulgated by the Securities and Futures Commission.

The Hong Kong Monetary Authority has responsibility for regulating banking institutions and granting banking licenses, and has discretion to attach conditions to a bank's operating license. The Hong Kong Monetary Authority requires every authorized institution to implement a comprehensive risk management system to identify, measure, monitor and control the various types of risks relating to its activities and, where appropriate, to hold capital against those risks.

The supervisory approach of the Hong Kong Monetary Authority is based on a policy of "continuous supervision" through on-site examinations, off-site reviews, prudential meetings, cooperation with external auditors and sharing information with other supervisors. The Hong Kong Monetary Authority obtains regular returns from and sends examination teams to all authorized institutions. In addition, all fully licensed banks in Hong Kong, whether incorporated overseas or locally, are required to be members of the Hong Kong Association of Banks, which represents the banking industry in banking-related matters and promotes best practices for banks in Hong Kong.

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The Hong Kong Monetary Authority introduced its loan classification guidelines in 1994, which were further updated in 1999. The Hong Kong Monetary Authority loan classification guidelines also employ a five-category classification system, namely, pass, special-mention, substandard, doubtful and loss. The Hong Kong Monetary Authority five-category classification system is substantially similar to the five-category system under the PBOC's Loan Classification Principles. However, differences do exist between the Hong Kong Monetary Authority five-category system and that of the PBOC's Loan Classification Principles. For example, the period of time for which the loan is overdue is a determining factor under the Hong Kong Monetary Authority loan classification guidelines, but not under the PBOC's Loan Classification Principles. In addition, there are differences between the provisioning policies under the Hong Kong Monetary Authority loan classification guidelines and those under the PBOC's Loan Classification Principles. For example, the Hong Kong Monetary Authority suggests to make provisions for individual loans in accordance with the following chart:

<u>Category</u>	<u>Provisioning Ratio</u>
Pass .....	1%
Special-mention .....	2%
Substandard .....	20% - 25% against unsecured portion
Doubtful .....	50% - 75% against unsecured portion
Loss .....	100%

This is different from the provision requirements under the PBOC's Loan Classification Principles as disclosed under the section headed “– Prudent Operating Requirements – Provision Requirements”.

The Banking Ordinance requires banks to report to the Hong Kong Monetary Authority certain periodic returns and other information and establishes certain minimum standards and ratios relating to capital adequacy, liquidity, capitalization, limitations on shareholdings, exposure to any one customer, unsecured advances to persons affiliated with the bank and holdings of interests in land, with which all banks must comply.

The Hong Kong Monetary Authority has also issued various guidelines on business practices of authorized institutions. Some of the guidelines (for example, Supervisory Policy Manual CG-1 “Corporate Governance of Locally Incorporated Authorized Institutions” and Supervisory Policy Manual FD-1 “Financial Disclosure by Locally Incorporated Authorized Institutions”) apply only to authorized institutions incorporated in Hong Kong and others (for example, Supervisory Policy Manual FD-3 “Financial Disclosure by Overseas Incorporated Authorized Institutions”) only apply to authorized institutions incorporated overseas.

In addition, pursuant to Rule 4.10 of the Hong Kong Listing Rules, the financial information to be disclosed in our Accountants' Report must be in accordance with the best practice, which is at least that required to be disclosed in respect of specific matters in the accounts of a company under the Companies Ordinance, IFRS and the Financial Disclosure by Locally Incorporated Authorised Institutions (the “Guidelines”), issued by the Hong Kong Monetary Authority.

We are currently unable to provide certain disclosures as required by the Guidelines as relevant information is currently not available. Such disclosures are described in the following four paragraphs. We believe that the financial disclosures which we are currently unable to provide are immaterial to potential investors under the Global Offering. However, we will endeavor to collect the relevant information so that we will be in a position to provide such required disclosures under the Guidelines within a reasonable timeframe in the future, as outlined below. We have obtained a waiver from the Hong Kong Stock Exchange from strict compliance with the requirement under Rule 4.10 of the Hong Kong Listing Rules to make disclosure in this prospectus of information required under the Guidelines, on the condition that we are required to comply with Rule 4.10, including the Guidelines, to the extent that such information is available to us.

The Guidelines require the disclosure of the amount of provisions released back to the profit and loss in the relevant period. We did not segregate the amount of provisions released from the amount of

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new provisions charged to profit and loss account during the relevant period, and in lieu of that, we disclosed the amount of new provisions net of releases as a single amount in Note 18(b) (see also Note 8) to Appendix I – “Accountants’ Report”. We expect to be able to make such disclosure by June 30, 2006.

The Guidelines require the disclosure of rescheduled advances to customers net of amounts included in overdue advances and the percentage of such advances to total advances to customers. Similar information on rescheduled advances to banks and other financial institutions are also required to be disclosed. We did not keep track of rescheduled advances in our system during the relevant period, and in lieu of that, we disclosed the amount of impaired loans as of December 31, 2002, 2003 and 2004 in Note 18 (c) “Impaired loans” to Appendix I – “Accountants’ Report”. We expect to be able to make such disclosure by June 30, 2005.

The Guidelines require the disclosure of the amount of other assets, divided into major categories of assets such as trade bills and debt securities, which have been overdue for over three months. We did not segregate the overdue trade bills from the overdue loans and advances during the relevant period, and in lieu of that, we disclosed the amount of overdue loans including trade bills as a single amount in note (5)(a) to Appendix II – “Unaudited Supplementary Financial Information”. We expect to be able to make such disclosure by June 30, 2006.

The Guidelines require the disclosure of the breakdown of one or more of the following profit or loss information by business segments: (i) total operating income (net of interest expense); (ii) profit or loss before charge for bad and doubtful debts; (iii) profit or loss after charge for bad and doubtful debts; and (iv) profit or loss before taxation. We are currently unable to disclose such information, and in lieu of that, we disclosed the total revenue amount by business segment as of December 31, 2002, 2003 and 2004 in note 38(b) to Appendix I – “Accountants’ Report”. We are currently in the process of establishing a management accounting system as part of our organizational restructuring, which would enable us to report net profits for each of our business segments by the end of 2005.

### **SUPERVISION AND REGULATION OF OTHER JURISDICTIONS**

Our operations in New York, Tokyo and Singapore are subject to the regulation of the Board of Governors of the Federal Reserve System of the United States, the Financial Services Agency of Japan and the Monetary Authority of Singapore, respectively. They are also subject to the respective local banking regulatory requirements, including requirements with respect to internal controls, capital adequacy ratios, and others.

The Monetary Authority of Singapore in 2002 identified that our Singapore branch did not have adequate internal controls over certain credit and operational aspects of its business. In response to this, we have taken steps to resolve the issues identified by the Monetary Authority of Singapore. Such steps include, among others, restructuring our Singapore branch such that the respective business units shall be responsible for compliance with the applicable laws, regulatory requirements and our internal rules and policies, and the branch internal audit department, which is responsible for performing compliance tests and internal audit reviews to ensure the full compliance with external and internal requirements, shall report directly to the internal audit department at our head office. We have appointed KPMG to review and assess, in March 2003, February 2004 and March 2005, the status and effectiveness of the steps that have been taken by our Singapore branch to address the findings of the Monetary Authority of Singapore. All the findings of the Monetary Authority of Singapore, with the exception of the automation of procedures to detect certain types of banking transactions that is currently in progress, have now been fully addressed.

The Secretary of the Financial Service Agency of Japan has been granted a general power under applicable Japanese Law to request the Tokyo branch of a foreign bank to submit reports regarding the status of the business and assets, including capital adequacy, of such foreign bank for the purposes of

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*inter alia*, enabling the Secretary of the Financial Service Agency of Japan to conduct meaningful supervision over such foreign bank's Tokyo branch. In exercising its general supervisory power, the Secretary of the Financial Service Agency of Japan requested on July 22, 2004 our Tokyo branch to submit a report on the financial conditions of our Tokyo branch on the ground that our Company's capital adequacy ratio did not reach 8%. In response to this, our Tokyo branch has responded to the Financial Service Agency by providing a report on our Company's financial conditions. As of December 31, 2004, our Company's capital adequacy ratio was 9.72%.