*You should read the selected consolidated financial and operating information set forth below in conjunction with Appendix I – "Accountants' Report", which has been prepared in accordance with IFRS, except for (1) the discussion on capital adequacy ratios, which is calculated in accordance with applicable PBOC or CBRC guidelines and based on PRC GAAP, and (2) the discussion of profit forecast, which is prepared in accordance with Hong Kong market practices. The capital adequacy ratio and the profit forecast information are not part of the Accountants' Report and have not been audited. The selected profit and loss account information for the years ended December 31, 2002, 2003 and 2004, and the selected balance sheet information as at December 31, 2002, 2003 and 2004 set forth below have been derived from Appendix I – "Accountants' Report".*

*The following discussion and analysis contains forward-looking statements that involve risks and uncertainties. Our actual results may differ from those anticipated in these forward-looking statements as a result of any number of factors, including those set forth in the sections headed "Forward-Looking Statements" and "Risk Factors".*

| | For the year ended December 31, | | |
|---|---|---|---|
| | **2002** | **2003** | **2004** |
| | **(in millions of RMB, except per share data)** | | |
| **Selected Consolidated Profit and Loss Account Data** | | | |
| Interest income | 25,878 | 29,979 | 38,352 |
| Interest expense | (9,270) | (10,305) | (13,160) |
| **Net interest income** | 16,608 | 19,674 | 25,192 |
| Fee and commission income | 1,067 | 1,418 | 1,996 |
| Fee and commission expense | (254) | (261) | (321) |
| **Net fee and commission income** | 813 | 1,157 | 1,675 |
| Dividend income | 93 | 82 | 55 |
| Gains less losses arising from trading activities | 364 | 502 | 325 |
| Gains less losses arising from investment securities | 8 | (2) | 77 |
| Other operating income (1) | 286 | 527 | 633 |
| Impairment losses on loans and advances | (947) | (5,115) | (3,215) |
| Other operating expenses (2) | (10,735) | (12,690) | (16,992) |
| **Operating profit before tax** | 6,490 | 4,135 | 7,750 |
| Income tax | (2,061) | 241 | (6,146) |
| **Net profit for the year** | 4,429 | 4,376 | 1,604 |
| **Basic and diluted earnings per share (in RMB)** | 0.26 | 0.26 | 0.06 |

(1) Consisting of profit on sales of land use rights and building, penalty income, sales of foreclosed assets and other assets, dormant accounts reversal, revaluation surplus of investment property, and other income arising from miscellaneous banking services provided to our customers.

(2) Consisting of staff costs, depreciation, operating lease rentals, general and administrative expenses, write-down of foreclosed assets, impairment of other receivables, revaluation deficit of property and equipment, revaluation deficit of investment property, business tax and surcharges, regulator's supervision fees, provision for outstanding litigation, professional fees and others.

| | As of December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| **Selected Consolidated Balance Sheet Data** | | | |
| **Assets** | | | |
| Cash and balances with central banks | 83,310 | 113,072 | 128,501 |
| Due from other banks and financial institutions | 97,293 | 99,935 | 88,923 |
| Trading assets | 141 | 3,106 | 1,533 |
| Loans and advances to customers | 395,153 | 516,675 | 631,612 |
| Investment securities – originated loans | 94,057 | 104,670 | 159,826 |
| Investment securities – available-for-sale | 14,639 | 36,687 | 90,028 |
| Investment securities – held-to-maturity | 7,942 | 6,721 | — |
| Property and equipment | 14,672 | 19,981 | 23,863 |
| Deferred tax assets | 11,304 | 11,712 | 5,025 |
| Other assets (1) | 13,492 | 13,361 | 16,144 |
| **Total assets** | 732,003 | 925,920 | 1,145,455 |
| **Liabilities** | | | |
| Due to other banks and financial institutions | 24,682 | 21,150 | 31,711 |
| Trading liabilities | 180 | 3,463 | 5,086 |
| Due to customers | 689,153 | 874,159 | 1,029,941 |
| Other liabilities (2) | 8,144 | 8,584 | 12,457 |
| Current taxes | 410 | 421 | 39 |
| Deferred tax liabilities | — | 62 | 393 |
| Subordinated term debt | — | — | 12,275 |
| **Total liabilities** | 722,569 | 907,839 | 1,091,902 |
| **Shareholders' equity** | 9,434 | 18,081 | 53,553 |
| **Total equity and liabilities** | 732,003 | 925,920 | 1,145,455 |

(1) Consisting of settlement accounts, other receivables less impairment, foreclosed assets less impairment, prepaid staff housing subsidies, prepaid rental expenses, land use rights, computer software, investment property and others.

(2) Consisting of settlement accounts, dividends payable, tax payable, staff benefits, provision for outstanding litigation, and others.

| | As of or for the year ended December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| **Selected Financial Ratios** | | | |
| **Profitability ratios:** | | | |
| Return on total assets (1) | 0.61% | 0.47% | 0.14% |
| Return on average total assets (2) | 0.65% | 0.53% | 0.15% |
| Return on shareholders' equity (3) | 46.95% | 24.20% | 3.00% |
| Return on average shareholders' equity (4) | 59.19% | 31.81% | 4.48% |
| Operating expenses to operating income (5) | 59.07% | 57.84% | 60.78% |
| Operating expenses to operating income (5) (excluding business tax) | 53.30% | 52.10% | 54.92% |
| **Asset and credit quality ratios:** | | | |
| Individually identified loans with impairment to gross loans(6) | 16.66% | 11.86% | 3.00% |
| Allowance for impaired loans to impaired loans | 44.45% | 51.03% | 44.01% |
| Allowance for impaired loans to total loans | 7.41% | 6.05% | 1.32% |
| **Other Ratios** | | | |
| Core capital adequacy ratio (7) | 6.18% | 6.36% | 6.77% |
| Capital adequacy ratio (7) | 8.83% | 7.41% | 9.72% |
| Shareholders' equity to total assets ratio (8) | 1.29% | 1.95% | 4.68% |
| Dividend payout ratio (9) | 67.98% | 14.53% | — |

(1) Represents the profit attributable to shareholders as a percentage of the year end balance of total assets.
(2) Represents the profit attributable to shareholders as a percentage of the average balance of total assets for the year.
(3) Represents the profit attributable to shareholders as a percentage of the year end balance of total shareholders' equity.
(4) Represents the profit attributable to shareholders as a percentage of average balance of total shareholders' equity for the year.
(5) Operating income consists of net interest income, net fee and commission income, dividend income, gains less losses arising from trading activities, gains less losses arising from investment securities and other operating income.
(6) Gross loans represent the total amount of loans and advances to customers before allowance for impairment.
(7) Represents the consolidated ratios as at year/period ends calculated in accordance with the PBOC or CBRC guidelines, as applicable, and based on PRC GAAP.
(8) Represents the year-end balance of shareholders' equity as a percentage of the year-end balance of total assets for the year.
(9) Represents the dividends declared per share as a percentage of net profit per share for the year.

## OVERVIEW

### *General*

We were the fifth largest commercial bank in the PRC based on total assets as of December 31, 2004. Through a network of 92 branches, 2,413 sub-branches, 87 outlets and other distribution channels, we provide a wide range of financial products and services to our corporate and retail customers. For the year ended December 31, 2004, we had operating income of RMB27,957 million. Operating income consists of net interest income, net fee and commission income, dividend income, gains less losses arising from trading activities, gains less losses arising from investment securities and other operating income. As of December 31, 2004, we had total assets of RMB1,145,455 million and shareholders' equity of RMB53,553 million.

Our business is divided into four business segments: corporate banking, retail banking, treasury operations and others. Our corporate banking business offers a broad range of products and services to our corporate customers, such as loans, deposits, bill discounting, settlement, trade finance, fund custody and guarantees. Our retail banking business offers a broad range of retail banking products and services to our retail customers, such as deposits, mortgage loans, car loans, debit cards, credit cards, wealth management and foreign exchange trading services. Our treasury operations include, among others, inter-bank money market transactions, foreign exchange trading and government and finance bonds trading and investment. Our other businesses mainly consist of management of property and equipment, other receivables and other assets that cannot be categorized as any of corporate banking, retail banking or treasury operations.

### *The Impact of Our Financial Restructuring*

Since June 2004, we have taken a number of financial restructuring measures to improve our asset quality and capital adequacy, including transfer of impaired loans to Cinda and share issuances.

We transferred impaired loans (with an aggregate original principal balance of RMB53,020 million) to Cinda in exchange for RMB20,700 million in bills issued by the PBOC, which bear a fixed annual coupon rate of 1.89% and will mature on June 29, 2009 with an early redemption right attached to the issuer. This disposal significantly decreased our provisions for impaired loans and advances to customers. See the section headed "– Results of Operations – Impairment Losses on Loans and Advances". In addition, our capital surplus was reduced as a result of the loss we recognized on the disposal of impaired loans. See the section headed "– Results of Operations – Shareholders' Equity". Our income tax expense was also significantly impacted by our disposal of impaired loans to Cinda. For a detailed description of the tax impact, see the section headed " – Results of Operations – Income Tax".

In addition, we issued a total of 5,000,000,000 Shares to the MOF for cash consideration of RMB5 billion; 3,000,000,000 Shares to China SAFE Investments Ltd. for cash consideration of RMB3 billion; 5,555,555,556 Shares to the National Council for Social Security Fund for cash consideration of approximately RMB10 billion; 631,410,570 Shares to certain of our existing shareholders for cash consideration of approximately RMB1.1 billion; and 7,774,942,580 Shares to HSBC for cash consideration of approximately US$1.75 billion.

Our ratio of impaired loans to total loans and advances to customers decreased from 11.86% as of December 31, 2003 to 3.00% as of December 31, 2004 and our capital adequacy ratio calculated in accordance with the formula promulgated by the PBOC and the CBRC and based on PRC GAAP increased from 7.41% as of December 31, 2003 to 9.72% as of December 31, 2004 primarily as a result of our financial restructuring. See also the section headed "Our Reorganization and Restructuring – Financial Restructuring" and notes 29 and 39 to Appendix I – "Accountants' Report".

## BUSINESS ENVIRONMENT

Our financial condition and results of operations, as well as the period-to-period comparability of our financial results, are significantly affected by a number of external factors, all of which are beyond our control, including:

- economic and demographic conditions in the PRC;
- macroeconomic policies of the PRC government;
- the regulatory environment in the PRC banking sector;
- competition in the PRC banking sector; and
- PRC tax policies.

### *Economic and Demographic Conditions in the PRC*

Since 1978, when the PRC government adopted the "reform and opening" policies to transform the centrally planned economy of the PRC to a market-oriented economy, the PRC has experienced rapid increases in GDP and per capita GDP. From 1980 to 2003, per capita GDP increased at a compound annual growth rate of 13.9% from RMB460 to RMB9,101. Rapid economic growth, coupled with strong foreign investment, has resulted in substantial wealth creation and accumulation in the PRC. The growing wealth, combined with the traditionally high savings rate and the large population, have made the PRC banking market one of the fastest growing banking markets in the world. We believe that the economic growth in the PRC will continue to create more opportunities in the PRC banking market.

While economic growth in general is expected to continue to support the expansion of the PRC banking industry, such impact could be cyclical in nature. For example, in 1999, when GDP growth in the PRC slowed to 7.1%, total loans of the PRC banking industry only increased by 12.5%, compared to the 19.6% compound annual growth in total loans recorded over the period from 1993 to 2003.

***Macroeconomic Policies of the PRC Government***

The PRC government in the past has implemented various macroeconomic policies to manage the growth of the PRC economy, and these macroeconomic policies often have a significant impact on the PRC banking industry and PRC banks, including us. For example, from 1993 to 1997, the PRC government took various measures designed to cool down the overheated economy, such as restricting construction and investment in real estate and property development, tightening the control of banking credit, and raising interest rates. As a result of these policies, PRC banks were compelled to restrict their loans to certain industries and raise their interest rates on deposits and loans.

In addition, the PRC government has recently taken various macroeconomic measures, such as credit controls and restricted lending to the securities and property industries, to moderate the rate of growth of the PRC economy. For example, the PBOC raised the one-year benchmark interest rates on Renminbi-denominated loans and deposits by 27 basis points and eliminated the ceiling on interest rates for Renminbi-denominated loans in October 2004. As it is expected that the PRC government will continue to use macroeconomic policies, including monetary and fiscal policies, to manage the growth of the PRC economy, our financial condition and results of operations are likely to continue to be significantly affected.

***Regulatory Environment in the PRC Banking Sector***

The banking industry is extensively regulated in the PRC, with the CBRC and the PBOC acting as the principal regulatory authorities. The PBOC, as the central bank of the PRC, is responsible for implementing monetary policies, while the CBRC is responsible for supervising and regulating banking institutions. 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.

Various regulatory measures have been taken to improve the regulatory framework and reduce the financial risk of the banking system, including, among other things, enhancing disclosure requirements, strengthening the power of supervisory authorities, developing clearer application and approval processes for banking products and services, increasing the scope of banking products and services, and implementing new asset quality and risk management requirements.

In addition, in light of the legacy non-performing loan issue faced by the PRC banking sector, the PRC government has taken various measures to improve the financial condition of PRC banks, including establishing asset management companies to facilitate non-performing loan disposals, injecting additional capital, and encouraging PRC banks to attract international investors and to access international capital markets.

We expect these regulatory reforms and governmental actions will continue to affect the PRC banking industry and us.

***Competition in the PRC Banking Sector***

The PRC banking industry is increasingly competitive. We face competition from other PRC commercial banks, including the Big Four and other joint stock commercial banks, and foreign financial institutions. Many other PRC commercial banks, including the Big Four, compete with us in substantially the same markets for loan, deposit and fee customers. In addition, the Big Four may have greater financial, management and other resources than we do, and other PRC joint stock commercial banks may have a lower impaired loan ratio due to their shorter operating history or better credit management.

In addition, as a result of the PRC's entry into the WTO, many foreign banks have opened branches in the PRC or invested in PRC commercial banks and their reach in China is expected to continue to expand. Moreover, the Closer Economic Partnership Agreement between Mainland China and Hong Kong has enabled smaller Hong Kong banks to establish their presence in the PRC.

While the presence of foreign banks, including Hong Kong banks, in the PRC is still limited, the continuing expansion of foreign banks in China will result in increasing competition in the PRC banking market. See the section headed "Business – Competition".

### *PRC Tax Policies*

Income from our domestic operations are subject to both enterprise income tax at a current rate of 33% and business tax at a current rate of 5% under applicable PRC regulations. For further details of PRC taxation policies applicable to us, see the section headed "Taxation of our Company by the PRC" in Appendix VI – "Taxation and Foreign Exchange".

Pursuant to a notice jointly issued by the PRC Ministry of Finance and the PRC State Administration of Taxation, business tax of financial and insurance institutions, including us, was reduced from 7% in 2001 to 5% in 2003. As disclosed in further detail below, business tax expenses constitute a significant portion of our other operating expenses. Following the PRC's entry into the WTO, the PRC State Administration of Taxation accelerated its reforms in an effort to gradually revise or abolish tax policies so as to comply with the WTO requirements. In addition, it is reported that the State Administration of Taxation is considering gradually abolishing preferential tax treatment for foreign investors in accordance with WTO rules, and adopting a uniform enterprise income tax system for domestic and foreign companies.

Changes in relevant tax policies are likely to affect our financial position and results of operations.

## CRITICAL ACCOUNTING POLICIES

Note 2 to Appendix I – "Accountants' Report" includes a summary of principal accounting policies used in the preparation of our consolidated financial statements. Certain of these policies are critical to the portrayal of our financial condition and results of operations, since they require management to make complex judgments based on information and data that may change in future periods. We have identified the following policies as being particularly sensitive in terms of judgments and the extent to which estimates are used.

These critical accounting policies are set forth below.

### *Allowance for Losses on Loans and Advances*

We evaluate our loans and advances to customers for impairment on an ongoing basis. An allowance for loan impairment is established if there is objective evidence that we will not be able to collect all amounts due according to the original contractual terms of loans. Such objective evidence includes, among others:

- significant financial difficulty incurred by the borrower;
- a breach of contract, such as a default or delinquency in interest or principal payment;
- for economic or legal reasons related to the borrower's financial difficulty, our granting to the borrower a concession that we would not otherwise consider (e.g., all the restructured loans);

– it becoming probable that the borrower will become bankrupt or will undergo other financial reorganization; and

– other observable data indicating that there is a measurable decrease in the estimated future cash flows from such loans.

In identifying the impairment status of loans, we also utilize the regulatory loan classification system that has been established under regulatory guidelines and is supervised by regulators. The regulatory guidelines include certain minimum quantitative standards for non-performing loan identification. In addition, we employ even more detailed quantitative standards in our loan classification system. For example, when a corporate loan is overdue for over one month, such loan will be classified as "special-mention" or below; if it is overdue for over three months, it will be classified as "substandard" or below.

For individually identified provisions for loan losses, the amount of the provision is the difference between the carrying amount and the recoverable amount. The recoverable amount is the estimated present value of expected cash flows, taking into account the repayment condition of the borrower or the guarantor and amounts recoverable from guarantees and collateral, discounted at the original effective interest rate of the loans. The following factors, among others, are considered when the Company assesses provisioning for such loan losses:

– borrower's future operational cash flows;

– net realization amount of collaterals;

– potential/possible cash flows from guarantors; and

– estimated time of cash flows.

The loan loss provision also covers losses where there is objective evidence that losses are present in components of the loan portfolio at the balance sheet date even though these losses have not been individually identified. The following factors, among others, are considered when the Company assesses provisioning for such loan losses:

– historical loss patterns of each component of the loan portfolio based on the nature of the product, credit risk by borrowers' ownership structures, industry analysis as well as geographical comparison;

– loss or migration patterns/ratios of the credit ratings allocated to the borrowers;

– macroeconomic environment, the PRC government's plan for business investment as well as balance of import and export trades; and

– cash recovered from impaired loans.

When a loan is uncollectible, it is written off against the related allowance for losses on loans and advances; subsequent recoveries are credited to the impairment losses on loans and advances in the profit and loss account. If the amount of the impairment subsequently decreases due to an event occurring after the write-down, the release of the allowance is credited as a reduction of the impairment losses on loans and advances.

We provide short-term off-balance credit facilities to high quality clients. In the unlikely event that we are asked to honor an obligation under these off-balance sheet facilities, the amount paid by us will be recorded as loans and advances classified as "substandard" or below. An allowance for impairment will be made us based on an assessment of the collectibility of the amount. In addition, we have assessed whether there is any objective evidence that these off-balance sheet items are impaired (e.g., the obligor experiencing financial difficulty), and whether it is probable that we will be asked to honor such obligation under these-off balance sheet facilities. For those off-balance sheet items that are impaired and for which impairment losses have been incurred, we assessed the adequacy of allowance for impairment for them at each of the balance sheet dates in the last three years, and considered that no material additional allowance was needed.

We believe that the accounting estimate related to our allowance for losses on loans and advances is a "critical accounting policy" because: (1) it is highly susceptible to change from period to period because it requires us to make assumptions about estimated losses relating to our loans; and (2) any significant difference between our estimated loan losses (as reflected in our allowance for losses on loans and advances) and actual loan losses could require us to take additional provisions which, if significant, could have a material impact on our net income. Our assumptions about estimated losses require significant judgment because actual losses have fluctuated in the past and are expected to continue to do so, based on a variety of factors.

Our consolidated financial statements as of and for the year ended December 31, 2004 included a total allowance for losses on loans and advances of RMB8,446 million.

***Deferred Income Taxes***

Deferred income tax is provided, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. The principal temporary differences arise from depreciation of property and equipment, impairment of loans and advances, receivables and other assets, and revaluation of certain financial assets and liabilities. The rates enacted or substantively enacted at the balance sheet date are used to determine deferred income tax.

Deferred tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences, unused tax losses and unused tax credits can be utilized. Deferred tax liabilities are the amounts of income tax payable in respect of taxable temporary differences, which are measured at the amount expected to be paid to the tax authorities in the future.

Income tax payable on profits, calculated based on the applicable tax law in each jurisdiction, is recognized as an expense in the period in which profits arise. The tax effects of income tax losses available for carry forward are recognized as an asset when it is probable that future taxable profits will be available against which these losses can be utilized.

Deferred tax related to fair value re-measurement of available-for-sale investments, which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognized in the profit and loss account together with the deferred gain or loss.

We believe the accounting estimate relating to deferred tax assets is a "critical accounting policy" because any significant difference between our assumptions and judgments made by our management in relation to the future tax benefits against which temporary differences, unused tax losses or unused tax credits can be utilized and the actual income tax could have a material impact on our financial results and net assets.

As of December 31, 2004, our deferred tax assets were RMB5,025 million. See also notes 12 and 26 to Appendix I – "Accountants' Report".

***Investment Securities***

We classify our investment securities into the following three categories: originated loans, held-to-maturity securities, and available-for-sale securities. Investment securities are initially recognized at cost (which includes transaction costs), and subsequently they are measured as follows:

- Originated loans are debt securities that are purchased at original issuance without the intent to sell immediately or in the short term. After initial recognition, the originated loans are carried at amortized cost using the effective interest method, less any provision for impairment.

- Held-to-maturity securities are investment securities with fixed maturity where management has both the intent and the ability to hold them to maturity. After initial recognition, the held-to-maturity securities are carried at amortized cost using the effective interest method, less any provision for impairment. When an entity sells held-to-maturity investment securities other than an insignificant amount or as a non-recurring, isolated event beyond its reasonable control that cannot be reasonable anticipated, IAS 39 requires the entity to reclassify all of its other held-to-maturity investment securities as available-for-sale investment securities or financial assets at fair value through profit or loss, and the Company may not recognize any held-to-maturity securities in the following two financial years.

- Available-for-sale securities are investment securities intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. After initial recognition, the available-for-sale securities are subsequently re-measured at fair value. The fair value is determined by reference to the methods below (listed in order of preference):

  — the published quoted price when the financial instrument is quoted in an active market.

  — the price used in recent transactions of similar financial instruments with adjustment when the market conditions have changed.

  — valuation techniques, including cash flow models.

  — if fair value cannot be measured reliably, equity and security investments are recognized at cost less impairment.

Gains and losses arising from changes in the fair value of available-for-sale securities are recognized as they arise in equity as revaluation reserves. When the securities are disposed of or impaired, the related accumulated fair value adjustments are included in the profit and loss account as gains and losses arising from investment securities.

An investment security is impaired if its carrying amount is greater than its estimated recoverable amount. The amount of the impairment loss for assets carried at amortized cost is calculated as the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate. By comparison, the recoverable amount of an instrument measured at fair value is the present value of expected future cash flows discounted at the current market rate of interest for a similar financial asset.

Interest earned while holding investment securities is reported as interest income. Dividends receivable are included separately in dividend income when a dividend is declared.

All ordinary purchases and sales of investment securities are recognized at the settlement date, which is the date that an asset is delivered to or by our Company. Any change in the fair value of the asset during the period between the trade date and the settlement date is accounted for in the same way as our Company accounts for the acquired asset. In other words, the change in value is not recognized for assets carried at cost or amortized cost; it is recognized in equity for assets classified as available for sale.

We believe the accounting estimates relating to the impairment of our investment securities is a "critical accounting policy" because it could have a material impact on our net profit and net assets.

***Property and Equipment***

Prior to December 31, 2003, property and equipment were measured at cost, less accumulated depreciation and impairment losses. On December 31, 2003, our Company adopted an alternative measure as permitted by IAS 16 (2003) whereby all classes of property and equipment except for leasehold improvements are carried at their fair value as revaluated at the date of the revaluation, less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Leasehold improvements continue to be stated at cost less accumulated impairment losses and depreciation. Our Company believes that this accounting policy change enables our Company to reflect its financial position more accurately in its financial statements. The effect of this accounting policy change is discussed in note 20 to the Appendix I – "Accountants' Report".

Increases in the carrying amount of the property and equipment as a result of revaluation are credited to revaluation reserves in shareholders' equity. Decreases that offset previous increases of the same asset are charged against revaluation reserves, and all other decreases are charged to the profit and loss account.

At each balance sheet date, both internal and external sources of information are considered to assess whether there is any indication that our Company's property and equipment are impaired. If any such indication exists, the recoverable amount of the asset is estimated and where relevant, an impairment loss is recognized to reduce the asset to its recoverable amount. Such impairment losses are recognized in the profit and loss account except where the impairment loss does not exceed the revaluation surplus for that same asset, in which case it is treated as a revaluation decrease.

The gain or loss on disposal of a property or equipment is the difference between the net sales proceeds and the carrying amount of the relevant asset, and is recognized in the profit and loss account. Any revaluation reserve balance remaining attributable to the relevant asset is transferred to retained earnings and is shown as a movement in reserves.

Depreciation is calculated based on the straight-line method to write off the cost or revalued amount of each asset to its residual value over its estimated useful life as follows:

| | |
|---|---|
| Buildings | 25-50 years |
| Leasehold improvements | 3-10 years |
| Equipment and motor vehicles | 3-8 years |

No depreciation is provided against construction in progress.

Repairs and maintenance are charged to the profit and loss account during the financial period in which they are incurred.

We believe the accounting estimate relating to our revaluation of property and equipment, other than leasehold property improvements, is a "critical accounting policy" because any significant change in the value of our property and equipment could have a material impact on our net profit and shareholders' equity.

***Acceptances***

Acceptances comprise undertakings by the Company to pay bills of exchange drawn on customers. Acceptances are accounted for as off-balance-sheet transactions and are disclosed as contingent liabilities and commitments.

***Financial guarantee contracts***

The Company has the following types of financial guarantee contracts: letters of credit and letters of guarantees issued. These contracts provide for specified payments to be made to reimburse the holder for a loss it incurs when a guaranteed party defaults under the original or modified terms of a debt instrument.

The Company initially recognizes all financial guarantee contracts as proceeds received in the balance sheet, which are amortized into profit and loss accounts ratably over the guarantee period. Subsequently, they are carried at the higher of amortised carrying value and any provision related to the Company's guarantee obligations. The changes in carrying value are recorded in the profit and loss account as fee and commission income.

The contractual amounts of financial guarantee contracts are disclosed as off-balance sheet items in note 32 to Appendix I – "Accountants' Report".

***Contingent liabilities and contingencies***

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Company. It can also be a present obligation arising from past events that is not recognized because it is not probable that an outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognized but is disclosed in the notes to the financial statements. When a change in the probability of an outflow occurs so that outflow is probable, it will then be recognized as a provision.

***Fiduciary activities***

Assets and income arising thereon together with related undertakings to return such assets to customers are excluded from the financial statements where the Company acts in a fiduciary capacity such as nominee, trustee or agent.

The Company grants entrusted loans on behalf of third-party lenders. The Company grants loans to borrowers, as agent, at the direction of the third-party lenders, who fund these loans. The Company has been contracted by these third-party lenders to manage the administration and collection of these loans on their behalf. The third-party lenders determine both the underwriting criteria and terms of the entrusted loans, including their purposes, amounts, interest rates and repayment schedule. The Company charges a commission related to its activities in connection with the entrusted loans which is recognized ratably over the period the service is provided. The risk of loss is borne by the third-party lenders.

***Derivative financial instruments***

Derivative financial instruments including foreign exchange contracts, currency and interest rate swaps, and other derivative financial instruments are initially recognized in the balance sheet at cost and subsequently re-measured at their fair value. Fair value is obtained from quoted market prices, discounted cash flow models or options pricing models, as appropriate. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

Certain derivatives embedded in other financial instruments receive separate accounting treatment when their risks and economic characteristics are not closely related to those of the host contract and the host contract is not carried at fair value with unrealized gains and losses reported in income.

IAS 39 imposes stringent conditions on the application of hedge accounting. Such conditions include, among others, a formal designation and documentation of the hedging relationship and an identified exact matching of the hedging instruments to the hedged items in terms of interest rates and maturity.

The derivative transactions of the Company, while considered as hedge transactions under the Company's risk management policies, do not meet the above criteria for hedge accounting under the specific rules in IAS 39 and are therefore treated as derivatives held for trading with fair value gains and losses reported as gains less losses arising from trading activities.

### *Interest income and expense*

Interest income and expense are recognized in the profit and loss account for interest-bearing instruments on an accruals basis using the effective interest method. Interest income includes coupons earned on fixed income investment and trading securities and accrued discount and premium on treasury bills and other discounted instruments. When loans become doubtful of collection, they are written down to their recoverable amounts and interest income is thereafter recognised based on the rate of interest that we used to discount the future cash flows for the purpose of measuring the recoverable amounts.

According to the PBOC's regulation on interest rates and interest accrual, interest income and interest expense are accrued only once per quarter. During each quarter, any interest income or expense are recorded when they are received or paid by us.

### *Adoption of New or Revised IASs*

It is our policy not to early adopt any new or revised IASs until we are in a position to have thoroughly assessed the impact of the new or revised IASs and to be able to fully comply with them. With respect to the new or revised IASs which became or will become effective on or after January 1, 2005, we early adopted IAS 8 (revised 2003) (Accounting Policies, Changes in Accounting Estimates and Errors), IAS 16 (revised 2003) (Property, Plant and Equipment), IAS 17 (revised 2003) (Leases) and IAS 40 (revised 2003) (Investment Property) on December 31, 2003. We early adopted these IASs because they provide more explicit guidance on the accounting of land use rights and buildings for own use and investment purposes and enable us to reflect our financial position more accurately in our financial statements.

Among the new or revised IASs that we did not early adopt, IAS 39 (revised 2003) (Financial Instruments: Recognition and Measurement) requires us to reclassify "originated loans" into other categories of investment securities. We currently expect this reclassification will have a significant impact on our financial condition beginning at January 1, 2005. For a detailed description of such financial impact, see note 2 to Appendix I – "Accountants' Report".

## RESULTS OF OPERATIONS

### Net Interest Income

The table below sets forth the principal components of our interest income and interest expense, and the associated net interest margin and net interest spread, for the periods indicated:

| | For the year ended December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB, except percentages) | | |
| **Interest income** | | | |
| Balances with central banks | 1,697 | 1,502 | 1,855 |
| Due from other banks and financial institutions | 1,783 | 2,015 | 2,231 |
| Trading securities | 4 | 9 | 6 |
| Loans and advances to customers | 18,532 | 22,174 | 28,287 |
| Investment securities | 3,843 | 4,242 | 5,885 |
| Others | 19 | 37 | 88 |
| Total interest income | 25,878 | 29,979 | 38,352 |
| **Interest expense** | | | |
| Due to other banks and financial institutions | (609) | (588) | (1,129) |
| Due to customers | (8,661) | (9,717) | (12,031) |
| Total interest expense | (9,270) | (10,305) | (13,160) |
| **Net interest income** | 16,608 | 19,674 | 25,192 |
| **Net interest rate spread** (1) | 2.57% | 2.57% | 2.61% |
| **Net interest margin** (2) | 2.55% | 2.55% | 2.59% |

(1) Represents the difference between the average yield on our total average interest-earning assets and the average cost of total average interest-bearing liabilities.
(2) Represents the ratio of net interest income to the average interest-earning assets.

Our net interest income is affected by the difference between the yields on our interest-earning assets and the cost of our interest-bearing liabilities, as well as the average volumes of these assets and liabilities. The average yields on our interest-earning assets and the average cost of our interest-bearing liabilities are significantly affected by the PBOC benchmark interest rates and PBOC's policies and regulations on interest rates. The PBOC establishes and modifies from time to time the benchmark interest rates for loans to our customers and the deposits from our customers. In addition, the average yields on our interest-earning assets and the average cost of our interest-bearing liabilities are primarily affected by PRC monetary policy, market competition and general economic, financial and liquidity conditions.

The table below sets forth the average daily balances and interest rates of our interest-earning assets and interest-bearing liabilities for the periods indicated:

| | For the year ended December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2002 | | | 2003 | | | 2004 | | |
| | Average balance[1] | Interest income/ expense | Average yield/ cost | Average balance | Interest income/ expense | Average yield/ cost | Average balance | Interest income/ expense | Average yield/ cost |
| | (in millions of RMB, except percentages) | | | | | | | | |
| **Assets** | | | | | | | | | |
| Cash and balances with central banks | 92,959 | 1,697 | 1.83% | 86,088 | 1,502 | 1.74% | 111,863 | 1,855 | 1.66% |
| Due from other banks and financial institutions | 90,550 | 1,783 | 1.97% | 94,108 | 2,015 | 2.14% | 98,115 | 2,231 | 2.27% |
| Loans and advances to customers | 365,070 | 18,532 | 5.08% | 459,223 | 22,174 | 4.83% | 572,411 | 28,287 | 4.94% |
| Investment securities and other interest earning assets | 102,041 | 3,866 | 3.79% | 133,051 | 4,288 | 3.22% | 188,807 | 5,979 | 3.17% |
| Total interest earning assets and interest income | 650,619 | 25,878 | 3.98% | 772,470 | 29,979 | 3.88% | 971,195 | 38,352 | 3.95% |
| Non interest earning assets | 42,840 | — | — | 51,918 | — | — | 58,759 | — | — |
| Total assets and interest income | 693,459 | 25,878 | 3.73% | 824,388 | 29,979 | 3.64% | 1,029,954 | 38,352 | 3.72% |
| **Liabilities and Shareholders' Equity** | | | | | | | | | |
| Due to customers | 617,092 | 8,661 | 1.40% | 752,967 | 9,717 | 1.29% | 936,230 | 12,031 | 1.29% |
| Due to central banks, other banks and financial institutions | 41,305 | 609 | 1.47% | 30,500 | 588 | 1.93% | 37,532 | 854 | 2.28% |
| Subordinated term debt | — | — | — | — | — | — | 6,117 | 275 | 4.50% |
| Total interest bearing liabilities and interest expense | 658,397 | 9,270 | 1.41% | 783,466 | 10,305 | 1.32% | 979,879 | 13,160 | 1.34% |
| Shareholders' equity and non interest bearing liabilities | 35,062 | — | — | 40,922 | — | — | 50,075 | — | — |
| Total shareholders' equity and liabilities | 693,459 | 9,270 | 1.34% | 824,388 | 10,305 | 1.25% | 1,029,954 | 13,160 | 1.28% |

(1) Daily average balance calculated under the PRC GAAP which has been adjusted in accordance with IFRS.

The table below shows changes in our interest income and interest expense due to changes in volume and rates. The changes are those for 2004 compared to 2003 and 2003 compared to 2002. Volume and rate variance have been calculated based on movements in average balances over these periods and changes in interest rates on interest-earning assets and interest-bearing liabilities.

| | 2003 vs. 2002 | | | 2004 vs. 2003 | | |
|---|---|---|---|---|---|---|
| | Increase/(decrease) due to | | Net Increase/ (decrease) | Increase/(decrease) due to | | Net Increase/ (decrease) |
| | Volume | Rate | | Volume | Rate | |
| | (in millions of RMB) | | | (in millions of RMB) | | |
| **Interest-Earning Assets** | | | | | | |
| Cash and balances with central banks | (125) | (69) | (195) | 450 | (96) | 354 |
| Due from other banks and financial institutions | 70 | 162 | 232 | 86 | 130 | 215 |
| Loans and advances to customers | 4,780 | (1,138) | 3,642 | 5,465 | 647 | 6,113 |
| Investment securities and other interest-earning assets | 1,175 | (753) | 422 | 1,797 | (106) | 1,691 |
| Change in interest income | 5,899 | (1,798) | 4,101 | 7,798 | 575 | 8,373 |
| **Interest-Bearing Liabilities** | | | | | | |
| Due to customers | 1,907 | (852) | 1,055 | 2,365 | (50) | 2,315 |
| Due to other banks and financial institutions | (159) | 139 | (20) | 136 | 130 | 266 |
| Subordinated term debt | — | — | — | 275 | 0 | 275 |
| Change in interest expense | 1,748 | (713) | 1,035 | 2,776 | 80 | 2,855 |

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

*Interest Income.* Interest income increased by 27.9% in 2004, from RMB29,979 million in 2003 to RMB38,352 million in 2004, primarily as a result of a 25.7% increase in the average balance of our total interest-earning assets, from RMB772,470 million in 2003 to RMB971,195 million in 2004, and a 7 basis point increase in average yields on total interest-earning assets from 3.88% in 2003 to 3.95% in 2004. Interest income from loans and advances to customers increased by 27.6% from RMB22,174 million in 2003 to RMB28,287 million in 2004 primarily due to a 24.6% increase in the average volume of our loans and advances to customers, from RMB459,223 million in 2003 to RMB572,411 million in 2004, and an 11 basis point increase in average yields on our loans and advances to customers from 4.83% to 4.94%. Our average volume of loans and advances to customers increased primarily as a result of the continued development of the PRC economy and the initiatives we took to retain and expand our customer base for both corporate and retail banking. The 11 basis point increase in average yields on our loans and advances to customers from 2003 to 2004 was primarily a result of strong loan demand resulting from the continued development of the PRC economy, the increase in the proportion of our medium- and long-term loans, the increase in the PBOC benchmark interest rates on Renminbi-denominated loans and deposits that became effective in October 2004, and the increase in the interest rates of some of our loans due to risk pricing.

Interest income from investment securities and other interest-earning assets increased by 39.4% from RMB4,288 million in 2003 to RMB5,979 million in 2004. This increase was principally the result of a 41.9% increase in the average volume of investment securities and other interest-earning assets from RMB133,051 million in 2003 to RMB188,807 million in 2004, which was partially offset by a 5 basis point decline in the average yields on investment securities from 3.22% in 2003 to 3.17% in 2004. Our average volume of investment securities increased primarily due to the increase in our funds available for investment in investment securities, as a result of our deposit growth and the increased funds available resulting from the financial restructuring we did in 2004, and our efforts to increase investment in investment securities to increase our return. Our average yields on investment securities decreased primarily due to our holding of bills with a face value of RMB20,700 million issued by the PBOC, with a fixed annual coupon rate of 1.89%.

Interest income from amounts due from other banks and financial institutions increased by 10.7%, from RMB2,015 million in 2003 to RMB2,231 million in 2004, primarily as a result of a 13 basis point increase in the average yields, from 2.14% in 2003 to 2.27% in 2004, and a 4.3% increase in the average volume of amounts due from other banks and financial institutions, from RMB94,108 million in 2003 to RMB98,115 million in 2004. The increase in the average yields on amounts due from other banks and financial institutions primarily reflected the increase in the PBOC benchmark interest rates in October 2004 and the increase in the U.S. Federal funds rate. Our average volume of amounts due from other banks and financial institutions increased primarily as a result of the growth of our deposits and the increased funds available resulting from financial restructuring, including the investment by HSBC.

Interest income from cash and balances with central banks increased by 23.5% from RMB1,502 million in 2003 to 1,855 million in 2004. The increase was primarily due to a 29.9% increase in the average volume of our cash and balances with central banks, from RMB86,088 million in 2003 to RMB111,863 million in 2004, which was partially offset by an 8 basis point decline in average yields on such deposits, from 1.74% in 2003 to 1.66% in 2004. Our average volume of cash and balances with central banks increased primarily as a result of the increase of the mandatory reserve rate from 7.0% to 7.5% that became effective April 25, 2004 and the increase in our funds with central banks in anticipation of the increase in the PBOC benchmark interest rates. The 8 basis point decline in average yields on such deposits was primarily due to the decrease in the interest rate on deposits with central banks other than mandatory reserves from 1.89% to 1.62% on December 21, 2003. The interest rate on mandatory reserves remained at 1.89%.

*Interest Expense.* Interest expense increased by 27.7% in 2004, from RMB10,305 million in 2003 to RMB13,160 million in 2004, primarily due to a 25.1% increase in the average balance of our total interest-bearing liabilities, from RMB783,466 million in 2003 to RMB979,879 million in 2004 and a 2 basis point increase in the average cost from 1.32% in 2003 to 1.34% in 2004.

Interest expense on amounts due to customers increased by 23.8% in 2004, from RMB9,717 million in 2003 to RMB12,031 million in 2004. This increase was primarily due to a 24.3% increase in the average volume of amounts due to customers, from RMB752,967 million in 2003 to RMB936,230 million in 2004. Our average volume of amounts due to customers increased as a result of increased deposits from our corporate customers, particularly from our large corporate customers, increased bank card deposits from our retail customers and increased pledged deposits.

Interest expense on amounts due to other banks and other financial institutions increased by 45.2%, from RMB588 million in 2003 to RMB854 million in 2004, primarily due a 35 basis point increase in the average cost thereon from 1.93% in 2003 to 2.28% in 2004, and a 23.1% increase in the average volume of amounts due to central banks, other banks and financial institutions, from RMB30,500 million in 2003 to RMB37,532 million in 2004. The 35 basis point increase in the average cost was primarily the result of the increase in the PBOC benchmark interest rates and the increase of the proportion of loans from other banks and other financial institutions, which generally bear interest at higher rates. The 23.1% increase in the average volume of amounts due to central banks, other banks and financial institutions was primarily due to the reclassification of deposits from fund management companies from amounts due to customers to amounts due to other banks and financial institutions.

*Net Interest Income.* As a result of the foregoing, our net interest income in 2004 increased by 28.0%, from RMB19,674 million in 2003 to RMB25,192 million in 2004.

*Net Interest Margin.* Our net interest margin was 2.59% from 2004, compared to 2.55% for 2003.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

*Interest Income.* Interest income increased by 15.8% in 2003, from RMB25,878 million in 2002 to RMB29,979 million in 2003, primarily as a result of an 18.7% increase in the average balance of our total interest-earning assets, from RMB650,619 million in 2002 to RMB772,470 million in 2003, which was partially offset by a 10 basis point decline in average yields from 3.98% in 2002 to 3.88% in 2003.

Interest income from loans and advances to customers increased by 19.7% from RMB18,532 million in 2002 to RMB22,174 million in 2003 primarily due to a 25.8% increase in the average volume of our corporate loans and retail loans, from RMB365,070 million in 2002 to RMB459,223 million in 2003, which was partially offset by a 25 basis point decline in average yields on our loans and advances to customers from 5.08% to 4.83%. Our average volume of loans and advances to customers increased primarily as a result of the continued development of the PRC economy and the initiatives we took to retain and expand our customer base for both corporate and retail banking. The 25 basis point decline in average yields on our loans and advances to customers from 2002 to 2003 was primarily a result of the residual effect of the reduction in the PBOC benchmark interest rates on Renminbi-denominated loans and deposits in February 2002 and increased market competition.

Interest income from investment securities and other interest-earning assets increased by 10.9% from RMB3,866 million in 2002 to RMB4,288 million in 2003. This increase was principally the result of a 30.4% increase in the average volume of investment securities and other interest-earning assets from RMB102,041 million in 2002 to RMB133,051 million in 2003, which was partially offset by a 57 basis point decline in the average yields on investment securities from 3.79% in 2002 to 3.22% in 2003. Our average volume of investment securities increased primarily due to the increase in our funds available for investment in investment securities, as a result of our deposit growth and our efforts to increase investment in investment securities to increase our return. Our average yields on investment securities decreased primarily because the Renminbi-denominated bonds generally available in the market in 2002 and 2003 had comparatively low yields and our older Renminbi-denominated bonds with higher yields were repaid.

Interest income from amounts due from other banks and financial institutions increased by 13.0%, from RMB1,783 million in 2002 to RMB2,015 million in 2003, primarily as a result of a 17 basis point increase in the average yields, from 1.97% in 2002 to 2.14% in 2003, and a 3.9% increase in the average volume of amounts due from other banks and financial institutions, from RMB90,550 million in 2002 to RMB94,108 million in 2003. The increase in the average yields on amounts due from other banks and financial institutions primarily reflected the interest rate increase in the inter-bank money market partially as a result of the increase in the mandatory reserve requirement in August 2003. Our average volume of amounts due from other banks and financial institutions increased primarily as a result of the growth of our deposits.

Interest income from cash and balances with central banks decreased by 11.5% from RMB1,697 million in 2002 to RMB1,502 million in 2003. The decrease was primarily due to a 7.4% decline in the average volume of our cash and balances with central banks, from RMB92,959 million in 2002 to RMB86,088 million in 2003, and a 9 basis point decline in average yields on such deposits, from 1.83% in 2002 to 1.74% in 2003. Our average volume of cash and balances with central banks decreased primarily as a result of our efforts to increase the yields on our investments by increasing our allocation of funds to short-term financing and investment securities. The 9 basis point decline in average yields on such deposits was primarily due to the decrease in the interest rate on mandatory reserve deposits with central banks from 2.07% to 1.89% on February 21, 2002, the decrease in the interest rate on deposits with central banks other than mandatory reserves from 1.89% to 1.62% on December 21, 2003, and the increase in the cash portion of these amounts.

*Interest Expense.* Interest expense increased by 11.2% in 2003, from RMB9,270 million in 2002 to RMB10,305 million in 2003, primarily due to a 19.0% increase in the average volume of our total interest-bearing liabilities and interest expenses, from RMB658,397 million in 2002 to RMB783,466 million in 2003, which was partially offset by a 9 basis point decline in the average cost from 1.41% in 2002 to 1.32% in 2003.

Interest expense on amounts due to customers increased by 12.2% in 2003, from RMB8,661 million in 2002 to RMB9,717 million in 2003. This increase was primarily due to a 22.0% increase in the average volume of amounts due to customers, from RMB617,092 million in 2002 to RMB752,967 million in 2003, which was partially offset by an 11 basis point decline in the average cost thereon from 1.40% in 2002 to 1.29% in 2003. Our average volume of amounts due to customers increased as a result of our efforts to increase deposits from our corporate customers, and, in particular, from our large corporate customers, and bank card deposits from our retail customers. The 11 basis point decline in average cost on amounts due to customers was primarily the residual effect of the reduction in the PBOC benchmark interest rates on Renminbi-denominated loans and deposits in February 2002 and an increase in the proportion of current deposits.

Interest expense on amounts due to other banks and other financial institutions decreased by 3.3%, from RMB609 million in 2002 to RMB588 million in 2003, primarily due to a 26.2% decline in the average volume of amounts due to central banks, other banks and financial institutions, from RMB41,305 million in 2002 to RMB30,500 million in 2003, which was partially offset by a 46 basis point increase in the average cost thereon from 1.47% in 2002 to 1.93% in 2003. The 26.2% decline in the average volume of amounts due to central banks, other banks and financial institutions was primarily due to the withdrawal of deposits from securities companies. The 46 basis point increase in the average cost was primarily the result of the interest rate increase in the inter-bank money market and the increase of the proportion of loans from other banks and other financial institutions, which generally bear interest at higher rates.

*Net Interest Income.* As a result of the foregoing, our net interest income in 2003 increased by 18.5%, from RMB16,608 million in 2002 to RMB19,674 million in 2003.

*Net Interest Margin*. Our net interest margin remained at approximately 2.55% for both 2002 and 2003.

**Net Fee and Commission Income**

Our net fee and commission income mainly includes our fee and commission income from bank card services (including bank card settlement services), settlement services (including international and domestic settlement services), agency services, fund services and other fee-generating services.

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

Our net fee and commission income increased by 44.8%, from RMB1,157 million in 2003 to RMB1,675 million in 2004, primarily due to the increase in fee and commission income from our bank card services, settlement services and fund services.

Our fee and commission income from bank card services increased primarily as a result of the increase in the number of cards we issued, the increase in the usage of our cards, our efforts to expand the distribution channels, and increased acceptance of our cards by merchants.

Our fee and commission income from settlement services increased primarily due to the increase of fee and commission income from international settlement services as a result of the general increase in the export and import businesses in the PRC.

Our fee and commission income from fund services increased primarily as a result of the increase in the number of funds for which we acted as a custodian, the increase in the average size of the funds under our custody and the increase in the fees we received for acting as a fund distribution agent.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

Our net fee and commission income increased by 42.3%, from RMB813 million in 2002 to RMB1,157 million in 2003, primarily due to the increase in fee and commission income from our bank card services, settlement services, agency services and fund services.

Our fee and commission income from bank card services increased primarily as a result of the increase in the number of cards we issued, the increase in the usage of our cards, our efforts to expand the distribution channels, and increased acceptance of our cards by merchants.

Our fee and commission income from settlement services increased primarily due to the increase of fee and commission income from international settlement services as a result of the general increase in the export and import businesses in the PRC.

Our fee and commission income from fund services increased primarily as a result of the increase in the number of funds for which we acted as a custodian and the increase in the average size of the funds under our custody.

In addition, we provide a variety of agency services, which business also grew in 2003.

**Dividend Income**

Our dividend income is primarily derived from our available-for-sale securities and financial assets held for trading.

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

Our dividend income decreased by 32.9% in 2004, from RMB82 million in 2003 to RMB55 million in 2004, primarily due to the decrease in dividend yields on the securities we held and the disposal of some of these investments.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

Our dividend income decreased by 11.8% in 2003, from RMB93 million in 2002 to RMB82 million in 2003, primarily due to the decrease in dividend yields on the securities we held.

**Gains Less Losses Arising from Trading Activities**

Our gains less losses arising from trading activities consist of income on foreign exchange and income on interest rate instruments. Net trading income on foreign exchange includes gains and losses from spot and forward contracts and from the translation of foreign currency monetary assets and liabilities into Renminbi assets and liabilities. Net income on interest rate instruments mainly includes the results of marking interest rate and currency swaps and other derivatives to market.

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

Our gains less losses arising from trading activities decreased by 35.3% in 2004, from RMB502 million in 2003 to RMB325 million in 2004, primarily due to a net loss of RMB269 million on interest rate instruments, which increased from a net loss of RMB16 million in 2003. The net loss of RMB269 million on interest rate instruments in 2004 was primarily due to the losses we incurred on the derivative transactions, such as interest rate swaps and currency swaps, we entered into to hedge our interest rate risk and currency risk arising from the significant increase in our floating rate investment securities and certificates of deposit. Under these swap contracts, we pay floating rate interest and receive fixed rate interest payments. We suffered losses on these swap transactions when the interest rate on US dollars, Singapore dollars and Hong Kong dollars increased in the latter part of 2004. This net loss was partially offset by a 14.7% increase in our gains from foreign exchange from RMB518 million in 2003 to RMB594 million in 2004. This increase in foreign exchange gains primarily resulted from the increase in the volume of our foreign exchange services, and in particular our currency settlement services.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

Our gains less losses arising from trading activities increased by 37.9% in 2003, from RMB364 million in 2002 to RMB502 million in 2003, primarily due to a 34.5% increase in net income on foreign exchange, which increased from RMB385 million in 2002 to RMB518 million in 2003. The increase in net income on foreign exchange primarily resulted from the increase in the volume of our foreign exchange services, and in particular our currency settlement services, which was partially offset by a decrease in the net margin on these trades as a result of increased market competition. Due to the increased volatility of the US dollar in 2003, our customers conducted more foreign exchange transactions in 2003 than in 2002.

**Gains Less Losses Arising from Investment Securities**

Gains less losses arising from investment securities mainly reflects the disposal of our investment securities.

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

We incurred a net gain on investment securities in the amount of RMB77 million in 2004, compared to a net loss of RMB2 million in 2003, due to the gains and interest income we recognized on the disposal of our investment securities in those periods.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

We incurred a net loss on investment securities in the amount of RMB2 million in 2003, compared to a net profit of RMB8 million in 2002, due to the gains and losses we recognized on the disposal of our available-for-sale securities in those periods.

**Other Operating Income**

The table below sets forth the principal components of our other operating income for the periods indicated:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Profit on sales of land use rights and building | 5 | 40 | 214 |
| Penalty income (1) | 16 | 24 | 19 |
| Sales of foreclosed assets and other assets | 47 | 56 | 46 |
| Dormant accounts reversal (2) | 7 | 17 | 5 |
| Revaluation surplus of investment property | — | 138 | — |
| Other miscellaneous income (3) | 211 | 252 | 349 |
| Total | 286 | 527 | 633 |

(1) Including penalty fees on dishonored cheques.
(2) Including the income we recognized on dormant accounts at our Company.
(3) Including income arising from various banking services provided to our customers.

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

Other operating income increased by 20.1%, from RMB527 million in 2003 to RMB633 million in 2004, primarily due to an increase of RMB174 million in profit on sales of land use rights and buildings, from RMB40 million in 2003 to RMB214 million in 2004, and an increase of RMB97 million in other miscellaneous income, from RMB252 million in 2003 to RMB349 million in 2004, which was partially offset by a decrease of RMB138 million in revaluation surplus of investment property from RMB138 million in 2003 to nil in 2004. The increase in our profit on sales of land use rights and buildings was primarily the result of the disposal of land use rights and buildings by our subsidiaries.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

Other operating income increased by 84.3%, from RMB286 million in 2002 to RMB527 million in 2003, primarily as a result of a revaluation surplus of investment property in the amount of RMB138 million, a 19.4% increase in other miscellaneous income, from RMB211 million in 2002 to RMB252 million in 2003, and an increase of RMB35 million in profit on sales of land use rights and buildings, from RMB5 million in 2002 to RMB40 million in 2003.

### Other Operating Expenses

The table below sets forth the principal components of our other operating expenses for the periods indicated:

| | For the year ended December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Staff costs (1) | 3,473 | 3,830 | 4,660 |
| Depreciation (2) | 1,674 | 1,646 | 2,471 |
| Operating lease rentals | 793 | 775 | 747 |
| General and administrative expenses (3) | 2,379 | 2,466 | 2,758 |
| Write-down of foreclosed assets | 349 | 60 | 730 |
| Impairment of other receivables (4) | 290 | 308 | 394 |
| Impairment of available-for-sale securities | 4 | 99 | — |
| Revaluation deficit of property and equipment | — | 448 | 389 |
| Revaluation deficit of investment property | — | — | 32 |
| Business tax and surcharges (5) | 1,050 | 1,260 | 1,639 |
| Regulator's supervision fee | — | — | 185 |
| Provision for outstanding litigation | — | 356 | 633 |
| Professional fees (6) | 6 | 7 | 159 |
| Others (7) | 717 | 1,435 | 2,195 |
| Total | 10,735 | 12,690 | 16,992 |

(1) Including salaries and bonuses, management performance bonuses, pension costs, housing subsidies, and other social security and benefit costs.
(2) Including depreciation on our buildings, equipment, motor vehicles and leasehold improvements.
(3) Including postage and telegraphic expenses, miscellaneous office expenses, business promotion expenses, water and electricity expenses, printing expenses, and other general and administrative expenses.
(4) Other receivables include fees and other amounts we prepaid in connection with our pending litigations and others.
(5) Including business tax, city maintenance and construction tax and education surcharges.
(6) Including legal, accounting and consulting fees.
(7) Including advertising expenses, stamp duty, urban real estate tax, amortization of intangibles, litigation expenses, notary expenses, technology transfer fees, impairment losses for non-lending-related assets, donations, and other miscellaneous expenses.

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

Other operating expenses increased by 33.9% in 2004, from RMB12,690 million in 2003 to RMB16,992 million in 2004, primarily as a result of increases in regulator's supervision fee, staff costs, depreciation, business tax and surcharges, write-down of foreclosed assets, and provision for outstanding litigation.

Our regulator's supervision fee in 2004 was RMB185 million, compared to nil in 2003. The supervision fee was paid to the CBRC pursuant to a new CBRC requirement that became effective in 2004. See also "Supervision and Regulation – Regulatory Authorities – The CBRC".

Staff costs increased by 21.7% in 2004, from RMB3,830 million in 2003 to RMB4,660 million in 2004, primarily due to a 21.2% increase in salaries and bonuses from RMB2,241 million in 2003 to RMB2,717 million in 2004, a 18.9% increase in other social security and benefit costs from RMB792 million in 2003 to RMB942 million in 2004, a 24.0% increase in housing benefits and subsidies from RMB491 million in 2003 to RMB609 million in 2004 and a 28.1% increase in pension costs from RMB306 million in 2003 to RMB392 million in 2004. These costs increased as a result of our efforts to increase our employees' compensation and benefits to maintain our competitiveness in this regard. At the same time, our staff headcount remained relatively unchanged.

Our provision for outstanding litigation increased by 77.8% in 2004, from RMB356 million in 2003 to RMB633 million in 2004, based on our management's assessment of the status of our pending litigation. Our provision for outstanding litigation in 2004 included our provision for the pending Taiyuan incident. For descriptions of the Taiyuan incident, see "Business – Special Events – Taiyuan Incident".

Business tax and surcharges increased by 30.1% in 2004, from RMB1,260 million in 2003 to RMB1,639 million in 2004, primarily due to the increase in our taxable income.

General and administrative expenses increased by 11.8% in 2004, from RMB2,466 million in 2003 to RMB2,758 million in 2004, primarily as a result of the overall growth of our business, but the magnitude of this increase was offset by our cost control measures.

Other expenses increased by 53.0% in 2004, from RMB1,435 million in 2003 to RMB2,195 million in 2004, primarily due to the increase in the expenses incurred by our subsidiaries.

Depreciation increased by 50.1% from RMB1,646 million in 2003 to RMB2,471 million in 2004 primarily due to the revaluation of our property and equipment as of December 31, 2003 and the increased investment in electronic equipment which has a shorter useful life.

Operating lease rentals decreased by 3.6% as we increased our efforts to purchase instead of rent the premises of our outlets.

Professional fees increased from RMB7 million in 2003 to RMB159 million in 2004 primarily due to the increase in fees paid to various intermediaries in connection with share issuances and other professional services.

Our write-down of foreclosed assets was RMB730 million in 2004 compared to RMB60 million in 2003. This increase was primarily due to the disposal of a significant portion of our foreclosed assets in late 2004 and the decrease in the value of certain of our foreclosed assets as a result of the revaluation.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

Other operating expenses increased by 18.2% in 2003, from RMB10,735 million in 2002 to RMB12,690 million in 2003, primarily as a result of increases in staff costs, revaluation deficit of property and equipment, provision for outstanding litigation, business tax and surcharges, general and administrative expenses and other expenses, which was partially offset by the decrease in write-down of foreclosed assets.

Staff costs increased by 10.3% in 2003, from RMB3,473 million in 2002 to RMB3,830 million in 2003, primarily due to a 19.3% increase in salaries and bonuses from RMB1,878 million in 2002 to RMB2,241 million in 2003. These costs increased as a result of our efforts to increase our employees' compensation and benefits to maintain our competitiveness in this regard. At the same time, our staff headcount remained relatively unchanged.

As a result of the revaluation of our property and equipment as of December 31, 2003, a write-down of property and equipment, in the amount of RMB448 million, was recorded. For a detailed discussion of our accounting policy on property and equipment, see "– Critical Accounting Policies – Property and Equipment".

Our provision for outstanding litigation increased from nil in 2002 to RMB356 million in 2003 based on our management's re-assessment of the status of our outstanding litigation.

Business tax and surcharges increased by 20.0% in 2003, from RMB1,050 million in 2002 to RMB1,260 million in 2003, primarily due to the increase in our taxable income.

General and administrative expenses increased by 3.7% in 2003, from RMB2,379 million in 2002 to RMB2,466 million in 2003, primarily as a result of the overall growth of our business, but the magnitude of this increase was offset by our cost control measures.

Other expenses increased by 100.1% in 2003, from RMB717 million in 2002 to RMB1,435 million in 2003, primarily due to the provision for and the write-off of some of our impaired non-lending assets.

Depreciation decreased slightly by 1.7% from RMB1,674 million in 2002 to RMB1,646 million in 2003. Depreciation in 2002 was greater mainly because of the recognition of depreciation expenses in that year as a result of the recategorization of certain assets.

Operating lease rentals decreased by 2.3% as we increased our efforts to purchase instead of rent the premises of our outlets.

We recorded a write-down of foreclosed assets of RMB349 million in 2002. According to our independent appraiser's asset appraisal report, the value of our net foreclosed assets, a substantial portion of which consisted of real estate and land use rights, remained relatively stable throughout 2003. Therefore, we only wrote down such assets by an additional RMB60 million in 2003.

### Impairment Losses on Loans and Advances

Our impairment losses on loans and advances consist of provision for impaired loans and advances to customers, less recovery of loans previously written off, and provision for amounts due from other banks and financial institutions and securities purchased under resale agreements. For a discussion of our provision for impairment losses for loans and advances, see "– Critical Accounting Policies – Allowance for Losses on Loans and Advances".

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

Total impairment losses on loans and advances decreased by 37.1% in 2004, from RMB5,115 million in 2003 to RMB3,215 million in 2004. The decrease in our provisions for impaired losses was primarily due to an decrease in provisions for impaired loans and advances to customers by 36.5%, from RMB4,788 million in 2003 to RMB3,041 million in 2004. This decrease in provisions for impaired loans and advances to customers decreased primarily due to the improvement of our loan portfolio quality a result of our disposal of impaired loans to Cinda in June 2004.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

Total impairment losses on loans and advances increased by RMB4,168 million in 2003, from RMB947 million in 2002 to RMB5,115 million in 2003. The increase in our provisions for impaired losses was primarily due to an increase in provisions for impaired loans and advances to customers by 487.5%, from RMB815 million in 2002 to RMB4,788 million in 2003, primarily as a result of our adopting a more rigorous approach in 2003 in assessing the value of our collateral. See also the section headed "Description of Our Assets and Liabilities – Assets – Loan Quality – Provision for Impairment Losses". Our provisions for impaired amounts due from other banks and financial institutions and securities purchased under resale agreements increased by 157.3%, from RMB178 million in 2002 to RMB458 million in 2003, primarily as a result of the provision we made with respect to the inter-bank loans we made prior to 1998 through the then existing PBOC's financing center and certain other prior investments.

### Profit before Tax

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

As a result of the factors set forth above, profit before tax increased by 87.4% in 2004, from RMB4,135 million in 2003 to RMB7,750 million in 2004.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

As a result of the factors set forth above, profit before tax decreased by 36.3% in 2003, from RMB6,490 million in 2002 to RMB4,135 million in 2003.

### Income Tax

The table below sets forth a breakdown of our current tax and deferred tax for the periods indicated:

| | For the year ended December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Current tax | 544 | 191 | 221 |
| Deferred tax | 1,517 | (432) | 5,925 |
| | 2,061 | (241) | 6,146 |

The income of our Company and each of our subsidiaries established in the PRC is subject to the PRC statutory tax rate of 33%. The income of our Hong Kong branch and our Hong Kong subsidiaries were subject to the Hong Kong profits tax at the rate of 16%, 17.5% and 17.5% for the years ended December 31, 2002, 2003 and 2004, respectively. The income of our other overseas branches is subject to the income tax rate in their respective jurisdiction where they are located. Our effective tax rate on our PRC operations differs from the theoretical amount that would arise using the tax rate of 33%. The table below sets forth a reconciliation of our actual income tax expenses to the tax calculated at the basic tax rate of 33%.

| | For the year ended December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Profit before tax | 6,490 | 4,135 | 7,750 |
| Tax calculated at a tax rate of 33% | 2,142 | 1,365 | 2,557 |
| Effect of different tax rates in other countries | (2) | 6 | 5 |
| Tax credit arising from income not subject to tax | (679) | (842) | (3,747) |
| Tax effect of expenses that are not deductible for tax purposes | 681 | 1,055 | 1,248 |
| Tax effect arising from: | | | |
| Recognition of deferred tax assets net, not previously recognized | (119) | (1,295) | — |
| De-recognition of deferred tax liabilities previously recognized | — | (510) | — |
| De-recognition of deferred tax assets in relation to loan disposal | — | — | 9,671 |
| Recognition of deferred tax assets in relation to tax loss | 38 | (20) | (3,588) |
| Income tax expense | 2,061 | (241) | 6,146 |

We had tax expenses of RMB6,146 million, which were higher than tax expenses calculated at the regulatory tax rate of 33%, primarily as a result of the tax impact in relation to our disposal of impaired loans to Cinda in 2004.

We had previously recognized deferred tax assets for all temporary differences arising from loan impairment amounting to RMB10,015 million before the disposal of impaired loans. Following the disposal of the impaired loans, all of the deferred tax assets in the amount of RMB9,671 million in relation thereto were derecognized.

On January 10 and March 25, 2005, we obtained a written approval from the MOF and the PRC tax authorities, respectively, confirming our accumulated losses in the amount of RMB11,002 million, which amount can be used to offset against future taxable profits from January 1, 2005 onwards. As a result, we recognized deferred tax assets up to RMB3,631 million, being 33% of RMB11,002 million, which reduced our tax expenses by RMB3,588 million.

The tax impact of the disposal of impaired loans was also reflected in the "tax credit arising from income not subject to tax" for the year ended December 31, 2004. This amount is RMB2,932 million, being income tax on profit of the Company for the year ended December 31, 2004. We believe that this amount of profit earned will be income tax exempt in relation to the loss incurred by the Company on its disposal of impaired loans in June 2004.

We had a negative tax expense in the amount of RMB241 million in 2003, primarily as a result of the recognition of deferred tax assets in the amount of RMB1,295 million and the derecognition of deferred tax liability in the amount of RMB510 million.

Prior to January 1, 2003, we did not recognize deferred tax asset for all temporary differences arising from loan impairment because we were uncertain whether the tax authorities would allow those temporary differences be utilized against future taxable profits. Upon discussions with the tax authorities in 2003, we have managed to claim tax deduction of and clarified the basis of tax treatment on these temporary differences. On this basis, management believes that ultimately all temporary differences in this regard can be utilized in full and hence a deferred tax asset was recognized in 2003.

Prior to January 1, 2003, we recognized deferred tax liabilities for certain property and equipment of which the tax base was zero. Upon the approval of the revised tax base by the tax authority after we began to carry its property and equipment at valuation at December 31, 2003, we derecognized deferred tax liabilities in this connection amounting to RMB510 million for the year ended December 31, 2003.

Our effective tax rates have also been affected by other factors over the reporting periods, among which are non-tax deductible expenses and income not subject to tax. The tax impact of non-tax deductible expenses increased from RMB681 million in 2002 to RMB1,055 million in 2003 and further to RMB1,248 million in 2004. The increase was primarily due to increase of non-tax exempt salary expenses as the result of the general increase in our employee salaries. The tax impact of income not subject to tax increased from RMB679 million in 2002 to RMB842 million in 2003 and then to RMB3,747 million in 2004. The increase, excluding the aforementioned RMB2,932 million tax exemption in 2004, was primarily due to increase of interest income from PRC treasury notes as the result of our increased holding of PRC treasury notes.

For related discussions regarding income tax expense, see note 12 to Appendix I – “Accountants’ Report”.

**Net Profit**

*Year Ended December 31, 2004 Compared to Year Ended December 31, 2003*

As a result of the factors set forth above, net profit decreased by 63.3% in 2004, from RMB4,376 million in 2003 to RMB1,604 million in 2004.

*Year Ended December 31, 2003 Compared to Year Ended December 31, 2002*

As a result of the factors set forth above, net profit decreased by 1.2% in 2003, from RMB4,429 million in 2002 to RMB4,376 million in 2003.

## SEGMENTAL OPERATING RESULTS

### Results by Business Segment

Our business is divided into four segments: corporate banking, retail banking, treasury operations and others. For detailed discussions of the products and services offered by those four business segments, see the section headed "Business – Our Principal Business Activities". The following table sets forth the total revenue of each of our business segments for the years ended December 31, 2002, 2003 and 2004. 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. We intend to disclose our results by business segments by the end of 2005. See the section headed "Risk Factors – Risks Relating to Our Business – Our organizational restructuring may not be completed or effectively implemented, which may affect our ability to enhance our competitiveness and may have a material adverse effect on our business operations or prospects".

| | Total Revenue from External Customers [1] | | |
|---|---|---|---|
| | For the year ended December 31, | | |
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Corporate banking | 19,393 | 22,143 | 26,226 |
| Retail banking | 1,265 | 2,492 | 4,187 |
| Treasury operations | 6,752 | 7,348 | 10,324 |
| Others | 286 | 523 | 701 |
| Total | 27,696 | 32,506 | 41,438 |

(1) Consisting of interest income, fee and commission income, dividend income, gains less losses arising from trading activities, gains less losses arising from investment securities and other operating income from external customers.

### Geographic Segments

We have used geographical segments as our primary financial reporting format as we historically operated on a regional, branch-by-branch basis. The table below sets forth the net profit and total revenue of each of our geographic segments for the years ended December 31, 2002, 2003 and 2004.

| | Net Profit | | | Total Revenue [1] | | |
|---|---|---|---|---|---|---|
| | For the year ended December 31, | | | For the year ended December 31, | | |
| | 2002 | 2003 | 2004 | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | | | | |
| Northern China [2] | 1,206 | 580 | 715 | 3,666 | 4,550 | 6,549 |
| North Eastern China [3] | (1,941) | (1,427) | (851) | 2,410 | 2,920 | 3,541 |
| Eastern China [4] | 3,423 | 4,887 | 376 | 15,368 | 16,887 | 21,111 |
| Central and Southern China [5] | 1,104 | (227) | 1,475 | 5,451 | 6,492 | 8,117 |
| Western China [6] | 334 | (103) | (214) | 2,942 | 3,275 | 3,844 |
| Overseas [7] | 303 | 666 | 103 | 2,376 | 2,558 | 2,674 |
| Eliminations | — | — | — | (4,517) | (4,176) | (4,398) |
| Total | 4,429 | 4,376 | 1,604 | 27,696 | 32,506 | 41,438 |

(1) Consisting of interest income, fee and commission income, dividend income, gains less losses arising from trading activities, gains less losses arising from investment securities and other operating income.
(2) Including Beijing Municipality, Tianjin Municipality, Hebei Province, Shanxi Province and Inner Mongolia Autonomous Region.
(3) Including Liaoning Province, Jilin Province and Heilongjiang Province.
(4) Including Shanghai Municipality, Jiangsu Province, Zhejiang Province, Anhui Province, Fujian Province, Jiangxi Province, Shandong Province and our head office in Shanghai.
(5) Including Henan Province, Hunan Province, Hubei Province, Guangdong Province, Guangxi Autonomous Region and Hainan Province.
(6) Including Chongqing Municipality, Sichuan Province, Guizhou Province, Yunnan Province, Tibet Autonomous Region, Shaanxi Province, Gansu Province, Qinghai Province, Ningxia Autonomous Region and Xinjiang Autonomous Region.
(7) Including Hong Kong, New York, Singapore and Tokyo.

## FINANCIAL POSITION

### Assets

Our total assets consist of the following:

- cash and balances with central banks;
- amounts due from other banks and financial institutions;
- trading assets;
- loans and advances to customers;
- investment securities;
- property and equipment;
- deferred tax assets; and
- other assets.

Cash and balances with central banks consist of cash, mandatory reserve deposits and balances with central banks other than mandatory reserve deposits. We are required to place certain deposits with central banks. The amount of the deposits is calculated based on the amount of deposits placed with our Company by our customers in the PRC. The reserve ratio for deposits denominated in RMB is currently 7.5% (compared to 7%, which was required prior to May 2004), and the reserve ratio for deposits denominated in foreign currencies as of January 15, 2005 is 3% (compared to 2% prior to that date). Other than mandatory reserve deposits, the rest of the balance in this category of assets is included in cash and cash equivalents. Mandatory reserve deposits are not available for use by us in our day-to-day operations.

Amounts due from other banks and financial institutions consist of placements with other banks (which are included in cash and cash equivalents), securities purchased under resale agreements (less allowance for impairment losses), loans and advances to other banks and financial institutions (less allowance for impairment losses) and loans purchased under resale agreements.

Trading assets consist of derivative financial instruments, government bonds listed in Hong Kong, other debt securities (listed and unlisted) and other unlisted equity securities.

Loans and advances to customers consist of loans and advances to our corporate and retail customers less allowance for impairment losses.

Investment securities consist of originated loans, available-for-sale investment securities, and held-to-maturity investment securities. Originated loans are debt securities that are purchased at original issuance without the intent to sell immediately or in the short term. Available-for-sale investment securities are investment securities intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Held-to-maturity investment securities are investment securities with fixed maturity, which our management has both the intent and the ability to hold to maturity. Our management determines the appropriate classification of each type of investment security at the time of the purchase.

Property and equipment include land and buildings, construction in progress, equipment, motor vehicles, and leasehold improvements. See also the section headed "– Critical Accounting Policies – Property and Equipment" and note 20 to Appendix I – "Accountants' Report".

Deferred tax assets represent the amount by which the temporary differences, unused tax losses and unused tax credits can be utilized against probable future taxable profits. See the section headed also "– Critical Accounting Policies – Deferred Income Taxes" and note 26 to Appendix I – "Accountants' Report".

Other assets include settlement accounts, other receivables less impairment, foreclosed assets less impairment, prepaid staff housing subsidies, prepaid rental expenses, land use rights, computer software, investment property and others. See note 21 to Appendix I – "Accountants' Report".

**December 31, 2004 Compared to December 31, 2003**

*Cash and balances with central banks.* Our cash and balances with central banks as of December 31, 2004 were RMB128,501 million, representing an increase of 13.6% from RMB113,072 million as of December 31, 2003. The increase reflects a 22.7% increase in mandatory reserve deposits, from RMB50,246 million as of December 31, 2003 to RMB61,670 million as of December 31, 2004, and a 6.9% increase in balances with central banks other than mandatory reserve deposits, from RMB54,452 million as of December 31, 2003 to RMB58,215 million as of December 31, 2004. The increase in our mandatory reserve deposits primarily reflects an increase in the deposits our customers placed with us and the increase of the mandatory reserve rate from 7% to 7.5% that became effective April 25, 2004. The increase in our balances with central banks other than mandatory reserve deposits was primarily a result of our deposit growth and our efforts to maintain sufficient liquidity.

*Due from other banks and financial institutions.* Our amounts due from other banks and financial institutions decreased by 11.0%, from RMB99,935 million as of December 31, 2003 to RMB88,923 million as of December 31, 2004, primarily as a result of our efforts to enhance the yields on our investments by allocating a larger portion of our increased deposits to investment securities and loans. The 11.0% decrease primarily reflects a 38.3% decrease in placement with other banks and included in cash equivalents, from RMB14,462 million as of December 31, 2003 to RMB8,926 million as of December 31, 2004 and a 52.7% decrease in loans purchased under resale agreements, from RMB5,060 million as of December 31, 2003 to RMB2,395 million as of December 31, 2004.

*Trading assets.* Our trading assets as of December 31, 2004 were RMB1,533 million, representing a decrease of 50.6% from RMB3,106 million as of December 31, 2003, primarily as a result of our decreased holdings in bills issued by the Hong Kong Monetary Authority. Our trading assets include unlisted debt securities, which consist principally of bills issued by the Hong Kong Monetary Authority, and government bonds listed in Hong Kong. Unlisted debt securities decreased by 95.6% to RMB121 million as of December 31, 2004 from RMB2,738 million as of December 31, 2003. Government bonds listed in Hong Kong increased by RMB1,084 million to RMB1,191 million as of December 31, 2004 from RMB107 million as of December 31, 2003. This increase was primarily due to the listing of a portion of the bills issued by the Hong Kong Monetary Authority and the acquisition of additional government bonds listed in Hong Kong by our Hong Kong branch to increase the liquidity of its portfolio.

*Loans and advances to customers*. Our loans and advances to customers as of December 31, 2004 was RMB631,612 million, representing an increase of 22.2% from RMB516,675 million as of December 31, 2003. Our gross loans and advances to customers increased by 16.4%, from RMB549,943 million as of December 31, 2003 to RMB640,058 million as of December 31, 2004 primarily due to the general increase in demand for loans as a result of the growth of the PRC economy, partially offset by our disposal of impaired loans in June 2004. Our allowance for impairment losses on loans and advances decreased 74.6%, from RMB33,268 million as of December 31, 2003 to RMB8,446 million as of December 31, 2004 primarily due to the write-off of allowance for impairment losses on loans and advances in the amount of RMB26,935 million as a result of our disposal of impaired loans in June 2004.

*Investment securities*. Our investment securities increased by 68.7%, from RMB148,078 million as of December 31, 2003 to RMB249,854 million as of December 31, 2004 primarily due to an increase in funds available as a result of our financial restructuring and our deposit growth, a significant portion of which we then invested in investment securities to increase our yields on investment. This increase also reflected the bills issued by the PBOC with a face value of RMB20,700 million we received in exchange for the loans we transferred to Cinda in June 2004.

Our originated loans as of December 31, 2004 were RMB159,826 million, representing an increase of 52.7% from RMB104,670 million as of December 31, 2003 primarily due to an increase of RMB67,543 million in originated loans from banks and other financial institutions, from RMB6,569 million as of December 31, 2003 to RMB74,112 million as of December 31, 2004, which was partially offset by a 12.3% decrease in originated loans from central government and central banks, from RMB97,428 million as of December 31, 2003 to RMB85,449 million as of December 31, 2004.

Our available-for-sale investment securities as of December 31, 2004 were RMB90,028 million, representing an increase of RMB53,341 million from RMB36,687 million as of December 31, 2003 primarily due to an increase of RMB33,320 million in available-for-sale securities of central government and central banks from RMB19,909 million as of December 31, 2003 to RMB53,229 million as of December 31, 2004 and an increase of RMB17,415 million in available-for-sale investment securities of banks and other financial institutions, from RMB12,082 million as of December 31, 2003 to RMB29,497 million as of December 31, 2004.

Our held-to-maturity investment securities decreased from RMB6,721 million as of December 31, 2003 to nil as of December 31, 2004. The decrease in our held-to-maturity investment securities was due to the reclassification of all of our held-to-maturity investment securities to available-for-sale investment securities. In 2004, we disposed of held-to-maturity investment securities in the amount of RMB1,014 million and, as a result, our remaining held-to-maturity investment securities were reclassified as available-for-sale investment securities. For a detailed discussion of the applicable accounting policy, see the section headed " – Critical Accounting Policies – Investment Securities".

*Property and Equipment.* Our property and equipment increased by 19.4%, from RMB19,981 million as of December 31, 2003 to RMB23,863 million as of December 31, 2004, primarily due to the revaluation surplus resulting from the revaluation of our property and equipment as of December 31, 2004.

*Deferred Tax Assets.* Our deferred tax assets decreased by 57.1%, from RMB11,712 million as of December 31, 2003 to RMB5,025 million as of December 31, 2004, primarily due to the derecognition of deferred tax assets in the amount of RMB9,671 million as a result of our disposal of impaired loans in 2004. See note 12 to Appendix I – "Accountants' Report".

*Other Assets*. Our other assets increased by 20.8%, from RMB13,361 million as of December 31, 2003 to RMB16,144 million as of December 31, 2004, primarily reflecting a 62.0% increase in settlement accounts, from RMB3,164 million as of December 31, 2003 to RMB5,124 million as of December 31, 2004, and an increase of RMB1,053 million in others, from RMB544 million as of December 31, 2003 to RMB1,597 million as of December 31, 2004. The increase in others was primarily due to the increase in settlement accounts arising from bank cards and outward remittance balances, the increase in the balance of current account overdrafts and the increase in the balance of treasury bonds subscribed from the PBOC to be issued to retail customers on behalf of the PRC government.

*Total assets*. As a result of the above, our total assets as of December 31, 2004 were RMB1,145,455 million, representing an increase of 23.7% from RMB925,920 million as of December 31, 2003.

**December 31, 2003 Compared to December 31, 2002**

*Cash and balances with central banks.* Our cash and balances with central banks as of December 31, 2003 was RMB113,072 million, representing an increase of 35.7% from RMB83,310 million as of December 31, 2002. The increase reflects a 46.2% increase in mandatory reserve deposits, from RMB34,357 million in 2002 to RMB50,246 million in 2003, a 29.6% increase in balances with central banks other than mandatory reserve deposits, from RMB42,027 million in 2002 to RMB54,452 million in 2003 and a 20.9% increase in cash, from RMB6,926 million in 2002 to RMB8,374 million in 2003 primarily as a result of our business growth. The increase in our mandatory reserve deposits primarily reflects an increase in the deposits our customers placed with us and the increase of the mandatory reserve rate from 6% in 2002 to 7% in 2003. The increase in our balances with central banks other than mandatory reserve deposits was primarily a result of our deposit growth and our efforts to maintain sufficient liquidity.

*Due from other banks and financial institutions.* Our amounts due from other banks and financial institutions as of December 31, 2003 were RMB99,935 million, representing an increase of 2.7% from RMB97,293 million as of December 31, 2002, primarily as a result of the growth of our deposits and our efforts to improve the yields on our investments by allocating a larger portion of our increased deposits to investment securities and loans. The increase reflected an increase in placement with other banks and included in cash equivalents of RMB10,245 million from RMB4,217 million in 2002 to RMB14,462 million in 2003 and a 2.5% increase in loans and advances to other banks and financial institutions (less allowance for impairment losses on amounts due from other banks and financial institutions), from RMB50,554 million as of December 31, 2002 to RMB51,814 million as of December 31, 2003, offset by a 32.7% decline in securities purchased under resale agreements (less allowance for impairment losses on securities purchased under resale agreements), from RMB42,522 million as of December 31, 2002 to RMB28,599 million as of December 31, 2003.

*Trading assets.* Our trading assets as of December 31, 2003 were RMB3,106 million, representing an increase of RMB2,965 million from RMB141 million as of December 31, 2002. This increase was primarily due to the increase in unlisted debt securities held by us, from RMB107 million in 2002 to RMB2,738 million in 2003, which reflected our greater participation in the market for notes issued by the Hong Kong Monetary Authority both as a market maker and for our own account in order to take advantage of the increased interest rate volatility.

*Loans and advances to customers*. Our loans and advances to customers as of December 31, 2003 was RMB516,675 million, representing an increase of 30.8% from RMB395,153 million as of December 31, 2002. Our gross loans and advances to customers increased by 28.9% from RMB426,763 million as of December 31, 2002 to RMB549,943 million as of December 31, 2003, primarily due to our efforts to expand our business and the general increase in demand for loans as a result of the growth of the PRC economy. Our allowance for impairment losses on loans and advances increased by 5.2% from RMB31,610 million as of December 31, 2002 to RMB33,268 million as of December 31, 2003.

*Investment securities*. Our investment securities increased by 27.0% from RMB116,638 million as of December 31, 2002 to RMB148,078 million as of December 31, 2003, primarily due to the increase in funds available for investing in investment securities as a result of the increase in our deposits. Our originated loans as of December 31, 2003 were RMB104,670 million, representing an increase of 11.3% from RMB94,057 million as of December 31, 2002 primarily due to an 11.7% increase in originated loans of central government and central banks, from RMB87,188 million as of December 31, 2002 to RMB97,428 million as of December 31, 2003. Our available-for-sale investment securities as of December 31, 2003 were RMB36,687 million, representing a 150.6% increase from RMB14,639 million as of December 31, 2002 primarily due to an increase of RMB18,480 million in available-for-sale securities of central government and central banks from RMB1,429 million as of December 31, 2002 to RMB19,909 million as of December 31, 2003. Our held-to-maturity investment securities decreased by 15.4%, from RMB7,942 million as of December 31, 2002 to RMB6,721 million as of December 31, 2003. Our held-to-maturity investment securities decreased primarily due to an 18.3% decrease in held-to-maturity investment securities of banks and other financial institutions from RMB6,406 million as of December 31, 2002 to RMB5,233 million as of December 31, 2003.

*Property and Equipment*. Our property and equipment increased by 36.2%, from RMB14,672 million as of December 31, 2002 to RMB19,981 million as of December 31, 2003, primarily due to the revaluation surplus resulting from revaluation of our property and equipment as of December 31, 2003.

*Total assets*. As a result of the above, our total assets as of December 31, 2003 were RMB925,920 million, representing an increase of 26.5% from RMB732,003 million as of December 31, 2002.

**Liabilities**

Our total liabilities consist of the following:

- amounts due to other banks and financial institutions;
- trading liabilities;
- amounts due to customers;
- current taxes;
- deferred tax liabilities;
- subordinated term debt; and
- other liabilities.

Amounts due to other banks and financial institutions consist of deposits from other banks and financial institutions and loans from other banks and financial institutions.

Trading liabilities consist of derivative financial instruments, short position of trading securities and debt securities in issue. Debt securities in issue mainly consist of certificates of deposit issued by our Hong Kong branch.

Amounts due to customers consist of corporate current deposits, corporate savings deposits, corporate time deposits, individual current deposits, individual savings deposits, individual time deposits, pledged deposits, promissory notes, customer margin deposits, interest payable and other deposits. Other deposits mainly include deposits we owe to government affiliated enterprises, government agencies and social organizations, finance bureaus, custody funds and housing funds.

Subordinated term debt is fixed term debt issued by us, which may be included as part of our supplemental capital pursuant to applicable PRC regulations.

Other liabilities consist of settlement accounts, dividends payable, staff bonuses payable and others.

**December 31, 2004 Compared to December 31, 2003**

*Amounts due to other banks and financial institutions*. Amounts due to other banks and financial institutions as of December 31, 2004 were RMB31,711 million, representing a 49.9% increase from RMB21,150 million as of December 31, 2003. This primarily reflected a 54.9% increase in deposits from other banks and financial institutions, from RMB10,472 million as of December 31, 2003 to RMB16,224 million as of December 31, 2004 and a 44.8% increase in loans from other banks and financial institutions, from RMB10,678 million as of December 31, 2003 to RMB15,459 million as of December 31, 2004. The increase in deposits from other banks and financial institutions was primarily due to the reclassification of our deposits from fund management companies from amounts due to customers to amounts due to other banks and financial institutions.

*Trading liabilities.* Our trading liabilities as of December 31, 2004 were RMB5,086 million, representing an increase of 46.9% from RMB3,463 million as of December 31, 2003. This increase reflected an increase of RMB2,138 million in debt securities in issue from RMB1,213 million as of December 31, 2003 to RMB3,351 million as of December 31, 2004, and a 97.6% increase in derivative financial instruments, from RMB292 million as of December 31, 2003 to RMB577 million as of December 31, 2004, which was partially offset by a 40.9% decrease in our short position of trading securities from RMB1,958 million as of December 31, 2003 to RMB1,158 million as of December 31,

2004. We issued debt securities in 2004 to take advantage of the active debt market in Hong Kong and Singapore by issuing medium-term certificates of deposit to better match the maturities of our assets and liabilities. Our derivative financial instruments increased as we conducted more interest rate swaps and cross-currency swaps to hedge our interest rate exposure. Our decreased short position of trading securities was associated with the decrease in our holdings of notes issued by the Hong Kong Monetary Authority.

*Amounts due to customers.* Our amounts due to customers as of December 31, 2004 were RMB1,029,941 million, representing an increase of 17.8% from RMB874,159 million as of December 31, 2003, which primarily reflected the positive general economic conditions in the PRC and our marketing efforts to attract more deposits from our customers. This increase was primarily the result of a 31.2% increase in corporate time deposits, from RMB141,936 million as of December 31, 2003 to RMB186,216 million as of December 31, 2004, a 18.8% increase in individual current deposits, from RMB120,745 million as of December 31, 2003 to RMB143,461 million as of December 31, 2004, a 17.9% increase in corporate current deposits, from RMB327,109 million as of December 31, 2003 to RMB385,556 million as of December 31, 2004, and a 70.4% increase in pledged deposits, from RMB31,520 million as of December 31, 2003 to RMB53,705 million as of December 31, 2004. The 70.4% increase in pledged deposits was primarily related to the increase in our off-balance sheet transactions.

*Subordinated term debt.* Our subordinated term debt was RMB12,275 million as of December 31, 2004, including the principal amount of RMB12,000 million of the subordinated term debt we issued in 2004 and the interest payable thereon in the amount of RMB275 million. The interest rate for the subordinated term debt is the one-year time RMB deposit rate plus 252 basis points, and its term is five years plus one month. All of the principal amounts of these notes have been included as part of our supplemental capital in 2004.

*Other liabilities*. Our other liabilities as of December 31, 2004 were RMB12,457 million, representing an increase of 45.1% from RMB8,584 million as of December 31, 2003. This increase reflects a 138.3% increase in others, from RMB1,719 million as of December 31, 2003 to RMB4,097 million as of December 31, 2004, an increase of RMB633 million in provision for outstanding litigation, from RMB356 million as of December 31, 2003 to RMB989 million as of December 31, 2004, and a 7.6% increase in settlement accounts, from RMB4,620 million as of December 31, 2003 to RMB4,971 million as of December 31, 2004. The 138.3% increase in others was primarily due to the increase in other liabilities of our subsidiaries as a result of the loan disposal in June 2004, at which time the subsidiaries assumed liabilities to Cinda that were previously assumed by us. In addition, the gross liabilities and the gross assets of our domestic subsidiaries were separately shown in 2004 while the assets and liabilities of our domestic subsidiaries were shown on a net basis in 2002 and 2003, which also contributed to the increase in other liabilities of our subsidiaries in 2004.

*Total liabilities*. As a result of the changes described above, our total liabilities as of December 31, 2004 were RMB1,091,902 million, representing an increase of 20.3% from RMB907,839 million as of December 31, 2003.

**December 31, 2003 Compared to December 31, 2002**

*Amounts due to other banks and financial institutions.* Amounts due to other banks and financial institutions as of December 31, 2003 were RMB21,150 million, representing a 14.3% decline from RMB24,682 million as of December 31, 2002. This reflects a 32.5% decline in deposits from other banks and financial institutions primarily as a result of the decline in deposits from securities companies, which was offset by a 16.5% increase in loans from other banks and financial institutions.

*Trading liabilities*. Our trading liabilities as of December 31, 2003 were RMB3,463 million, representing an increase of RMB3,283 million from RMB180 million as of December 31, 2002. This increase reflects a 386.7% increase in derivative financial instruments, from RMB60 million as of

December 31, 2002 to RMB292 million as of December 31, 2003, an increase of RMB1,838 million in the short position of trading securities, from RMB120 million as of December 31, 2002 to RMB1,958 million as of December 31, 2003, and an increase in debt securities in issue from nil as of December 31, 2002 to RMB1,213 million in December 31, 2003. Our derivate financial instruments increased as we conducted more interest rate swaps and cross-currency swaps to hedge our interest rate exposure. Our increased short position of trading securities was associated with the increase in our holdings of unlisted debt securities. We issued certificates of deposit to take advantage of the active debt market in Hong Kong by issuing medium-term certificates of deposit to better match the maturities of our assets and liabilities.

*Amounts due to customers*. Our amounts due to customers as of December 31, 2003 were RMB874,159 million, representing an increase of 26.8% from RMB689,153 million as of December 31, 2002. This increase was primarily due to a 23.5% increase in corporate current deposits, from RMB264,936 million to RMB327,109 million, a 36.7% increase in corporate time deposits, from RMB103,817 million to RMB141,936 million, a 28.0% increase in individual current deposits, from RMB94,299 million to RMB120,745 million, a 12.3% increase in individual time deposits, from RMB170,833 million to RMB191,886 million, and a 38.8% increase in pledged deposits, from RMB22,703 million in 2002 to RMB31,520 million in 2003. The increase in our corporate and retail deposits reflected the positive general economic conditions in the PRC, and the increase in pledged deposits was primarily related to the increase in our off-balance transactions.

*Other liabilities.* Our other liabilities as of December 31, 2003 were RMB8,584 million, representing an increase of 5.4% from RMB8,144 million as of December 31, 2002. This increase reflects an 88.6% increase in tax payable, from RMB219 million as of December 31, 2002 to RMB413 million as of December 31, 2003, primarily as a result of the increase in our business tax payable. This increase was primarily offset by a 61.4% decrease in dividends payable from RMB386 million as of December 31, 2002 to RMB149 million as of December 31, 2003, primarily reflecting the fact that we declared less dividends in 2002, while maintaining approximately the same level of actual cash dividend payments.

*Total liabilities.* As a result of the changes described above, our total liabilities as of December 31, 2003 were RMB907,839 million, representing an increase of 25.6% from RMB722,569 million as of December 31, 2002.

**Shareholders' Equity**

The table below sets forth the components of our shareholders' equity as of the dates indicated.

| | As of December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Share capital | 17,033 | 17,108 | 39,070 |
| Capital surplus | 6,579 | 11,035 | 10,872 |
| Other reserves | 10,753 | 10,973 | — |
| Revaluation reserves | 347 | 723 | 3,757 |
| Accumulated losses | (25,278) | (21,758) | (146) |
| Total shareholders' equity | 9,434 | 18,081 | 53,553 |

**December 31, 2004 Compared to December 31, 2003**

*Share capital.* Our share capital increased by RMB21,962 million, from RMB17,108 million as of December 31, 2003 to RMB39,070 million as of December 31, 2004. This increase was due to the following:

- an increase of RMB5,556 million as a result of the subscription of our Shares by the National Council for Social Security Fund at RMB1.8 per share in June 2004;

- an increase of RMB5,000 million as a result of the subscription of our Shares by the MOF at par value in June 2004;
- an increase of RMB3,000 million as a result of the subscription of our Shares by China SAFE Investments Ltd., at par value, in June 2004;
- an increase of RMB631 million as a result of the subscription of our Shares by some of our shareholders at RMB1.8 per share in July 2004; and
- an increase of RMB7,775 million as a result of the subscription of our Shares by HSBC at RMB1.86 per share in August 2004.

*Capital surplus.* Our capital surplus decreased by 1.5%, from RMB11,035 million as of December 31, 2003 to RMB10,872 million as of December 31, 2004. This change was due to the following:

- an increase of RMB4,444 million as a result of the subscription of our Shares by the National Council for Social Security Fund at RMB1.8 per share in June 2004;
- an increase of RMB505 million as a result of the subscription of our Shares by some of our shareholders at RMB1.8 per share in July 2004;
- an increase of RMB6,686 million as a result of the subscription of our Shares by HSBC at RMB1.86 per share in August 2004;
- a decrease of RMB2,763 million as a result of the loss we recognized on disposal of impaired loans to Cinda in June 2004; and
- a transfer of RMB9,035 million from capital surplus to offset accumulated losses. See note 29 to Appendix I – “Accountants’ Report”.

*Other reserves.* Other reserves consist of the non-distributable statutory reserve, discretionary reserve and statutory welfare reserve. Our other reserves as of December 31, 2004 were nil as a result of the transfer of RMB10,973 million from other reserves to offset accumulated losses, compared to RMB10,973 million as of December 31, 2003.

*Revaluation reserves.* Our revaluation reserves increased by RMB3,034 million from RMB723 million as of December 31, 2003 to RMB3,757 million as of December 31, 2004. This increase primarily reflects the valuation surplus of RMB3,098 million arising from revaluation of property and equipment as a result of our revaluation of property and equipment as of December 31, 2004.

*Accumulated losses.* Our accumulated losses decreased by 99.3% from a loss of RMB21,758 million as of December 31, 2003 to a loss of RMB146 million as of December 31, 2004. This decrease in accumulated losses was primarily due to an offset by capital surplus in the amount of RMB9,035 million and other reserves in the amount of RMB10,973 million.

**December 31, 2003 Compared to December 31, 2002**

*Share capital.* Our share capital increased by 0.4%, from RMB17,033 million as of December 31, 2002 to RMB17,108 million as of December 31, 2003. This increase was due to the capitalization of dividends payable to the MOF by issuing shares of our Company to the MOF in lieu of such dividends in November 2003 at the price of RMB2 per share.

*Capital surplus.* Our capital surplus increased by 67.7%, from RMB6,579 million as of December 31, 2002 to RMB11,035 million as of December 31, 2003. This increase was due to the following:

- an increase of RMB75 million to reflect the premium portion of the issuance of shares to the MOF in lieu of dividends payable in November 2003; and
- an increase of RMB4,381 million to reflect the capitalization of a revaluation surplus on fixed assets as approved by the PRC government.

*Other reserves.* Our other reserves increased by 2.0%, from RMB10,753 million as of December 31, 2002 to RMB10,973 million as of December 31, 2003. This increase was due to a transfer of RMB220 million to our discretionary reserve from our accumulated losses account. See note 30 to Appendix I – "Accountants' Report".

*Revaluation reserves.* Our revaluation reserves increased by 108.4% from RMB347 million as of December 31, 2002 to RMB723 million as of December 31, 2003. This increase reflects a revaluation surplus of property and equipment in the amount of RMB4,862 million, which was partially offset by a transfer of RMB4,381 million as capitalization of revaluation surplus to the capital surplus account.

*Accumulated losses.* Our accumulated losses decreased by 13.9% from a loss of RMB25,278 million as of December 31, 2002 to a loss of RMB21,758 million as of December 31, 2003. This decrease in accumulated losses reflects a net profit of RMB4,376 million in 2003, a transfer of RMB220 million to our discretionary reserves, and a declared dividend in the amount of RMB636 million.

### Off-Balance Sheet Arrangements

As part of our commercial banking activities, we are involved in several types of off-balance sheet arrangements, including guarantees, acceptances and letters of credit, to which we are subject to contingent liabilities. See the section headed "– Contingent Liabilities and Commitments". We are also involved in derivative and other foreign exchange and interest rate contracts. See the section headed "– Derivative Financial Instruments".

### Contingent Liabilities and Commitments

Our contingent liabilities and commitments include commitments to extend credit, assets pledged, operating lease commitments and capital commitments. The largest portion of our contingent liabilities and commitments are attributable to acceptances, which amounted to RMB103,348 million as of December 31, 2004. The table below sets forth a breakdown of our commitments to extend credit as of the dates indicated:

| | As of December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| **Commitments to extend credit[1]** | | | |
| Guarantees | 14,657 | 21,912 | 30,867 |
| Issuance of letters of credit | 14,621 | 21,943 | 25,654 |
| Acceptances | 44,674 | 73,017 | 103,348 |
| Other commitments to extend credit | 9,916 | 4,687 | 7,766 |
| **Total commitments to extend credit** | 83,868 | 121,559 | 167,635 |

(1) All figures were extracted from Appendix I – "Accountants' Report".

Guarantees, letters of credit, acceptance and other similar products are important to our strategy to expand our fee-generating business and diversify the range of products we offer to customers. These products are mainly used by customers to meet relatively short-term funding needs, and generate good returns relative to their risks. Demand for these products has increased due to the significant growth of the PRC economy and the increase in trading activities in the past few years.

Assets pledged include assets pledged as collateral under repurchase agreements with other banks and financial institutions, security deposits for our local futures, options and stock exchanges memberships, and mandatory reserve deposits at local central banks which are not available to finance our day-to-day operations. The table sets below sets forth a breakdown of our assets pledged as of the dates indicated:

| | As of December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| **Assets pledged[1]** | | | |
| Balances with central banks | 34,357 | 50,246 | 61,670 |
| Investment securities | — | 450 | 400 |
| Loans | — | — | — |
| **Total** | 34,357 | 50,696 | 62,070 |

(1) All figures were extracted from Appendix I – "Accountants' Report".

Our operating lease commitments represent our minimum lease payment obligations under our operating leases, and they are summarized as follows[1]:

| | As of December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Not later than 1 year | 598 | 559 | 499 |
| Later than 1 year and not later than 5 years | 1,273 | 1,229 | 1,141 |
| Later than 5 years | 589 | 574 | 532 |
| **Total** | 2,460 | 2,362 | 2,172 |

(1) All figures were extracted from Appendix I – "Accountants' Report".

Our capital commitments represent our obligations under our written agreements to purchase, among others, equipment, and they are summarized as follows[1]:

| | As of December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Capital expenditure commitments | 233 | 215 | 490 |

(1) All figures were extracted from Appendix I – "Accountants' Report".

In addition, the credit risk-weighted amount of our off-balance sheet exposures amounted to RMB124,156 million as of December 31, 2004, compared to RMB105,200 million as of December 31, 2003 and RMB55,048 million as of December 31, 2002.

We are involved in legal proceedings in the ordinary courses of our businesses. The total amount of the outstanding claims and the provision for losses related to such claims at the end of each period set forth below are as follows[1]:

| | As of December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB) | | |
| Outstanding claims | 2,185 | 2,174 | 2,601 |
| Provision for losses | — | 356 | 989 |

(1) All figures were extracted from Appendix I – "Accountants' Report".

Provision for losses is made when it is probable that we will be required to make payments in connection with such claims. See also "Business – Legal and Regulatory Proceedings".

**Derivative Financial Instruments**

We utilize currency and interest rate swaps and currency forwards for purposes of interest rate and currency hedging and counter hedging upon customers' demands. Our foreign exchange and interest rate contracts are mostly entered into with other financial institutions. Our management establishes notional limits for these contracts by counterparties, industry sectors and countries while regularly monitoring and controlling our overall actual credit exposures.

The table below provides a detailed breakdown of the contractual or notional amounts and the fair values of our derivative financial instruments outstanding at each year end and period end indicated therein.

| | Contractual/ Notional Amount | Fair values | |
|---|---|---|---|
| | | Assets | Liabilities |
| | (in millions of RMB) | | |
| **As at December 31, 2002** | | | |
| **Foreign exchange derivatives** | | | |
| Currency forwards | 25,528 | 12 | (12) |
| Currency swaps | 20,096 | 7 | (6) |
| | | 19 | (18) |
| **Interest rate derivatives** | | | |
| Interest rate swaps | 298 | — | (42) |
| **Total recognized derivative assets/(liabilities)** | | 19 | (60) |
| **As at December 31, 2003** | | | |
| **Foreign exchange derivatives** | | | |
| Currency forwards | 3,956 | 12 | (2) |
| Currency swaps | 64,003 | 174 | (237) |
| | | 186 | (239) |
| **Interest rate derivatives** | | | |
| Interest rate swaps | 886 | 2 | (53) |
| **Total recognized derivative assets/(liabilities)** | | 188 | (292) |
| **As at December 31, 2004** | | | |
| **Foreign exchange derivatives** | | | |
| Currency forwards | 3,818 | 28 | (13) |
| Currency swaps | 45,234 | 94 | (176) |
| OTC currency options bought and sold | 360 | 7 | — |
| | | 129 | (189) |
| **Interest rate derivatives** | | | |
| Interest rate swaps | 13,536 | 70 | (230) |
| Cross currency interest rate swaps | 3,759 | 17 | (158) |
| OTC interest rate options | 248 | 3 | — |
| **Total recognized derivative assets/(liabilities)** | | 219 | (577) |

**Liquidity**

We are exposed to daily calls on our available cash resources from overnight deposits, current accounts, maturing deposits, loan drawdowns, and from margin and other calls on cash-settled derivatives. Our Board sets limits on the minimum proportion of funds to be made available to meet such calls and on the minimum level of inter-bank and other borrowing facilities that should be available to cover cash calls. We are currently required to deposit 7.5% of our total RMB-denominated deposits and 3% of our total foreign currency-denominated deposits with central banks. In addition, we generally maintain an additional 5% of our total RMB-denominated deposits with central banks to manage our Renminbi liquidity needs. For a detailed discussion of our liquidity risk management, see the section headed "Business – Risk Management and Internal Controls – Liquidity Risk Management". See note 3F to Appendix I – "Accountants' Report" for more information regarding the maturity profile of our assets and liabilities.

In order to manage our liquidity gap between our assets and liabilities with maturities less than one month, in addition to the measures described above and in the section headed "Business – Risk Management and Internal Controls – Liquidity Risk Management", we also require advance notice for any withdrawal in excess of RMB50,000. In addition, our liabilities with maturities less than one month, principally in the form of deposits, including short-term customer deposits and inter-bank deposits, have traditionally remained stable.

**Quantitative and Qualitative Disclosures about Market Risk**

*Interest Rate Risk.* Our primary sources of interest rate risk are mismatches in the maturities or re-pricing periods of interest rate sensitive assets and liabilities and variations in ranges of interest rate changes. We use gap analysis to measure our exposure to interest rate risk. For a more detailed discussion of our interest rate risk management, see the section headed "Business – Risk Management and Internal Controls – Market Risk – Interest Rate Risk Management".

See note 3E to Appendix I – "Accountants' Report" for more information regarding our asset and liability interest rate gap position and sensitivity to interest rate movements.

*Exchange Rate Risk.* We are exposed to exchange rate risk as a result of foreign exchange transactions and currency exposures originating from other general banking activities such as foreign currency deposits and loans. We manage exchange rate risk primarily through hedging activities in the inter-bank markets. See the section headed "Business – Risk Management and Internal Controls – Market Risk Management – Exchange Rate Risk Management" for a more detailed discussion of our exchange rate risk.

The following table sets forth each major foreign currency net position of our assets and liabilities as of the date indicated.

| | As of December 31, 2004 | | | | |
|---|---|---|---|---|---|
| | RMB | USD | HKD | Other Currencies | Total |
| | (in millions) | | | | |
| **Assets** | | | | | |
| Cash and balances with central banks | 125,535 | 1,772 | 637 | 557 | 128,501 |
| Due from other banks and financial institutions | 37,472 | 38,145 | 5,943 | 7,363 | 88,923 |
| Trading assets | — | 168 | 1,351 | 14 | 1,533 |
| Loans and advances to customers | 563,158 | 36,544 | 25,619 | 6,291 | 631,612 |
| Investment securities | | | | | |
| – originated loans | 147,215 | 5,182 | 5,993 | 1,436 | 159,826 |
| – available-for-sale | 60,700 | 18,304 | 4,858 | 6,166 | 90,028 |
| Other assets, including deferred tax assets | 38,814 | 3,464 | 4,568 | (1,814) | 45,032 |
| **Total assets** | 972,894 | 103,579 | 48,969 | 20,013 | 1,145,455 |
| **Liabilities** | | | | | |
| Due to other banks | (18,437) | (5,623) | (2,471) | (5,180) | (31,711) |
| Trading liabilities | — | (1,944) | (2,999) | (143) | (5,086) |
| Due to customers | (900,469) | (78,131) | (39,970) | (11,371) | (1,029,941) |
| Other liabilities, including deferred tax liabilities | (14,376) | (6,586) | (3,569) | (633) | (25,164) |
| **Total liabilities** | (933,282) | (92,284) | (49,009) | (17,327) | (1,091,902) |
| **Net on balance sheet position** | 39,612 | 11,295 | (40) | 2,686 | 53,553 |

**Capital Adequacy**

The New Capital Adequacy Regulations provide a transition period ending on December 31, 2006 for PRC commercial banks to meet the latest capital adequacy requirement, which is a minimum of 8%. During the 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. As of December 31, 2003, our capital adequacy ratio was 7.41%, and as of December 31, 2004, our capital adequacy ratio was 9.72%. Moreover, according to the New Capital Adequacy Regulations, PRC commercial banks are required to maintain a minimum core capital adequacy ratio of 4%. As of December 31, 2003, our core capital adequacy ratio was 6.36%, and as of December 31, 2004, our core capital adequacy ratio was 6.77%. See the section headed "Supervision and Regulation" for a detailed discussion of the PRC capital adequacy requirements. We computed our capital adequacy ratios at each period end in accordance with PBOC and CBRC guidelines and based on PRC GAAP.

The following table sets forth a calculation of our core capital adequacy ratio and our capital adequacy ratio based on applicable PBOC and CBRC guidelines and PRC GAAP as of the dates indicated[(1)]:

| | As of December 31, | | |
|---|---|---|---|
| | 2002 | 2003 | 2004 |
| | (in millions of RMB, except percentages) | | |
| **Core Capital** | | | |
| Paid up ordinary share capital | 15,910 | 17,108 | 39,070 |
| Reserves | 15,370 | 23,392 | 34,948 |
| Profit and loss account | 1,286 | 144 | (26,558) |
| Total core capital | 32,566 | 40,644 | 47,460 |
| **Supplementary Capital** | | | |
| Reserves on revaluation of land and interests in land | 6,817 | — | — |
| General provision for doubtful debts | 8,104 | 9,404 | 9,161 |
| Term subordinated debt | — | — | 12,000 |
| Reserve-net profit of overseas branches retained | 2,006 | — | — |
| Gross value of supplementary capital | 16,927 | 9,404 | 21,161 |
| Eligible value of supplemental capital | 16,927 | 9,404 | 21,161 |
| Total capital base before deductions | 49,493 | 50,048 | 68,621 |
| Deductions | | | |
| Equity investments of 20% or more in non-subsidiary companies | 1,307 | — | N/A |
| General provision for loans overdue over 2 years | 8,955 | 6,549 | N/A |
| Unconsolidated subsidiary investments | N/A | N/A | 1,894 |
| Total capital base after deductions | 39,231 | 43,499 | 66,727 |
| Core capital adequacy ratio | 6.18% | 6.36% | 6.77% |
| Capital adequacy ratio | 8.83% | 7.41% | 9.72% |

(1) All figures were as reported to the PBOC or CBRC except that the percentage data were as disclosed in the PBOC or CBRC annual inspection reports on our Company.

Capital deduction items of the "Equity investments of 20% or more in non-subsidiary companies" and "General provision for loans overdue over 2 years" are calculated in accordance with the "Controls, Monitoring Index and Measurement Formula of the Assets, Liabilities Ratios Management of Commercial Banks" issued by the PBOC on 12 December 1996. These two deduction items were cancelled and replaced by the "Unconsolidated equity investments", which is in accordance with the "Administrative Measures Concerning Capital Adequacy Ratios of Commercial Banks" issued by the China Banking Regulatory Commission on 23 February 2004.

## INDEBTEDNESS

At the close of business on May 31, 2005, being the latest practicable date prior to the printing of this prospectus for the purpose of this indebtedness statement, our indebtedness includes RMB12 billion subordinated term debts which were issued in a private placement in June 2004 and are qualified as our Tier 2 capital. These subordinated term debts have a tenor of 5 years and one month with an interest rate at one year fixed deposit rate of the PBOC plus 252 basis points. The first year interest rate of the subordinated term debts was 4.5%. Moreover, the subordinated term debts cannot be transferred and redeemed before the due date, and any transfer or redemption of these subordinated term debts is subject to the prior approval of the CBRC.

In addition, as of May 31, 2005, we had deposits and money market deposits from customers and other banks in our ordinary course of business, certificates of deposits, securities sold under repurchase agreements, trade-related contingencies and other commitments that arise from our ordinary course of business.

Except as otherwise disclosed in this prospectus, we did not have outstanding at the close of business on May 31, 2005 any mortgages, charges, debentures or other loan capital (issued or agreed to be issued), bank overdrafts, loans, liabilities under acceptance or other similar indebtedness, hire purchase and finance lease commitments or any guarantees or other material contingent liabilities.

## RULES 13.11 TO 13.19 OF THE HONG KONG LISTING RULES

We confirm that we are not aware of any circumstances which will trigger disclosure requirements under Rule 13.11 to Rule 13.19 of the Hong Kong Listing Rules.

## PROFIT FORECAST

The Directors believe that, on the bases and assumptions set out in Appendix IV – "Profit Forecast", and in the absence of unforeseen circumstances, our forecast of the consolidated profit attributable to equity holders for the year ending 31 December 2005 is unlikely to be less than RMB7,874 million. The profit forecast has been prepared by the Directors based on the audited consolidated results of the Company for the year ended December 31, 2004 and a forecast of the consolidated results of the Company for the twelve months ending December 31, 2005.

On a pro forma basis and on the assumption that a total of 44,925,689,216 Shares were issued and outstanding throughout the year ending December 31, 2005, the forecasted earnings per Share for the year ending December 31, 2005 is RMB0.18, representing a price/earnings multiple of 11.83 times or 15.47 times, depending on whether the Offer Price is HK$1.95 per Offer Share or HK$2.55 per Offer Share, respectively.

## DIVIDEND POLICY

The payment of any dividend by us must be approved by shareholders in a shareholders' meeting based on a recommendation from our Board. The decision to make a recommendation for the payment of any dividend and the amount of the dividend will depend on:

- our results of operations and cash flows;
- our financial position;
- statutory capital adequacy requirements as determined under relevant PRC regulations;
- the interests of all of our shareholders;
- general business conditions;
- our future prospects;
- statutory and regulatory restrictions on the payment of dividends by us; and
- any other factor that our Board deems relevant.

We will pay dividends out of our after-tax profits only after we have made the following allowances and allocations:

- recovery of accumulated losses, if any;
- allocations to the statutory common reserve fund equivalent to 10% of our after-tax income, as determined under PRC GAAP;
- allocations to the statutory common welfare fund equivalent to between 5% and 10% of our after-tax income, as determined under PRC GAAP; and
- allocations to a discretionary common reserve fund as approved by the shareholders in a shareholders' meeting.

The minimum and maximum allocations to the statutory funds are 15% and 20% of our after-tax income, as determined under PRC GAAP. When the statutory common reserve fund reaches and is maintained at or above 50% of our registered capital, no further allocations to this fund will be required.

Under PRC law, dividends may be paid only out of distributable profits. Distributable profits means our after-tax profits as determined under PRC GAAP or IFRS, whichever is lower, less any recovery of accumulated losses and allocations to statutory funds that we are required to make. Any distributable profits that are not distributed in a given year are retained and available for distribution in subsequent years. However, ordinarily we will not pay any dividends in a year in which we did not have distributable profits for that year.

Payment of dividends by us is also regulated by relevant PRC banking regulations. If we do not meet the minimum capital adequacy ratio required by the CBRC, we may be prohibited from paying dividends. See the section headed "Supervision and Regulation".

Prior to the Global Offering, as we were required to prepare our financial statements only under PRC GAAP, we had declared and distributed dividends for each year we had distributable profits under PRC GAAP in accordance with applicable PRC law.

## DISTRIBUTABLE RESERVES

We had no reserves available for distribution to our shareholders at December 31, 2004.

### Unaudited Pro Forma Net Tangible Assets

The following unaudited pro forma net tangible assets is based on the audited consolidated net tangible assets of the Group as at December 31, 2004, as shown in the Accountants' Report set forth in Appendix I to this prospectus, adjusted as described below. The unaudited pro forma net tangible assets per Share has been prepared for illustrative purposes only and, because of its nature, it may not reflect the actual net tangible assets of the Group following the Global Offering.

| | Audited consolidated net assets of the Group | Intangible assets of the Group as at December 31, 2004 | Estimated net proceeds from the Global Offering | Adjustment | Unaudited pro forma net tangible assets of the Group | Unaudited pro forma net tangible assets per Share | |
|---|---|---|---|---|---|---|---|
| | | | (in millions of RMB) | | | RMB | HK$ |
| | (Note 1) | | (Note 2) | (Note 3) | | (Note 4) | (Note 5) |
| Based on an Offer Price of HK$1.95 per Share | 53,553 | 256 | 11,639 | 93 | 65,029 | 1.45 | 1.36 |
| Based on an Offer Price of HK$2.55 per Share | 53,553 | 256 | 15,299 | 93 | 68,689 | 1.53 | 1.44 |

Notes:

(1) The audited consolidated net assets of the Group is extracted from the Accountants' Report set out in Appendix I to this prospectus.

(2) The estimated net proceeds from the Global Offering are based on the Offer Price of HK$1.95 to HK$2.55 per H Share, respectively, and take no account of any H Shares which may be issued pursuant to the Over-Allotment Option. If the Over-allotment Option is exercised in full, the adjusted net tangible asset value per Share will be increased.

(3) This reflects, among the estimated fees and expenses that will be deducted from the gross proceeds from the Global Offering, approximately RMB93 million that has been accounted for in our financial statements for the year ended December 31, 2004.

(4) The unaudited pro forma net tangible assets per Share is determined after the adjustment has been made as described in notes 1 and 3 above and on the basis that 44,925,689,216 Shares are in issue and that the Over-allotment Option is not exercised.

(5) Unaudited pro forma net tangible assets per Share is converted into Hong Kong dollars at the PBOC rate of HK$1.00 to RMB1.063 prevailing on June 2, 2005.

## NO MATERIAL ADVERSE CHANGE

Except as disclosed in this prospectus, the Directors believe that there has been no material adverse change in the financial or trading position of our Company since December 31, 2004.

## WORKING CAPITAL

Rule 8.21A(1) and Paragraph 36 of Part A of Appendix 1A of the Hong Kong Listing Rules require this prospectus to include a statement by our Directors that, in their opinion, the working capital available to our Company is sufficient or, if not, how it is proposed to provide the additional working capital our Directors consider to be necessary. We are of the view that the traditional concept of "working capital" does not apply to banking businesses such as ours. We are regulated in the PRC by, among others, the PBOC and the CBRC. These regulatory authorities impose minimum capital adequacy and liquidity requirements on commercial banks operating in the PRC. Rule 8.21A(2) of the Hong Kong Listing Rules provides that such a working capital statement will not be required to be made by an issuer whose business is entirely or substantially that of the provision of financial services, provided that the Hong Kong Stock Exchange is satisfied that the inclusion of such a statement would not provide significant information for investors and the issuer's solvency and capital adequacy are subject to prudential supervision by another regulatory body. In view of the above, pursuant to Rule 8.21A(2) of the Hong Kong Listing Rules, we are not required to include a working capital statement from the Directors in this prospectus.