# United for Success

# Management Discussion and Analysis

## 1. OPERATION OVERVIEW

**Successful listing of the Group in 2005.**

On 23 June 2005, the Group was successfully listed on the Main Board of the Hong Kong Stock Exchange and became the first international public listed bank in the PRC. Following the completion of the listing, reforms in respect of corporate governance, organizational structure, risk management and human resources management were proved to be effective.

**The Group proactively responded to market changes, speeded up business development and focused on risk management, achieving satisfactory operating results in 2005.**

As of the end of the reporting period, the Group's total assets amounted to RMB1,423.4 billion, representing an increase of 24.43% as compared with last year;

The Group's net profit amounted to RMB9.249 billion, representing an increase of 476.62% as compared with last year, and is 17.46% above the forecasted figure of RMB7.874 billion in the prospectus;

ROAA and ROAE reached 0.72% and 13.68% respectively;

Compared with the beginning of the year, impaired loan ratio accounted for 2.80%, which represented a decrease of 0.20 percentage point;

Provision coverage was 58.39%, which represented an increase of 14.38 percentage points;

CAR and Tier-1 CAR were 11.20% and 8.78%, which represented an increase of 1.48 percentage points and 2.01 percentage points respectively.

**The effectiveness of strategic transformation was demonstrated with the constant optimization of the Group's operations.**



## 1. OPERATION OVERVIEW *(Continued)*

As of the end of the reporting period, individual deposits balance increased by RMB66.817 billion, while individual loans balance also increased by RMB18.276 billion. Income from retail business reached RMB6.282 billion, accounted for 11.70% of total revenue and 1.60 percentage points up from the corresponding period of last year.

Net fee and commission income amounted to RMB2.109 billion, accounted for 6.00% of operating income. Among the RMB2.109 billion, net fee and commission income from bank cards amounted to RMB808 million, representing an increase of 24.12%. The underwriting business for short-term corporate bonds was doing well. Four short-term corporate bonds were issued by the Group with a total issue amount of RMB13.750 billion, accounting for approximately 10% of the market share.

The credit cards business unit under the cooperation with HSBC also operated well, and 657,000 dual-currency credit cards were issued.

**The Group took an active approach in expanding its scope and line of business.**

With the approval of the regulatory authorities, the Group was among the first group of banks which were in the list of market makers of the inter-bank foreign exchange market in the PRC and was licensed to carry out offshore guarantee business and wealth management of domestic and foreign currencies. We became one of the commercial banks which were granted approval to provide external financing guarantee for overseas investment enterprises following the Bank of China.

With the focus on global financial market, a new branch was established in Seoul, Korea and it commenced business on 18 August 2005.

# Management Discussion and Analysis (Continued)

## 1. OPERATION OVERVIEW *(Continued)*

The integration of operation was making progress with the establishment of the Bank of Communications & Schroders Fund Management Co. Ltd. The company was duly set up on 12 August 2005 and has successfully launched its first fund product.

**Our work has been widely recognized by the community.**

The CBRC upgraded the supervisory rating of the Group.

International rating institutions, such as Standard & Poor's upgraded the Group's credit rating.

The Group was awarded "**The Best Transactions Award in China Region 2005**" and the "**Best Commercial Bank in China 2005**" in various assessments by international authoritative organizations and renowned financial media.

## 2. FINANCIAL RESULTS

The Group achieved a steady growth in profitability. During the reporting period, the Group's operating profit before tax amounted to RMB12.843 billion, representing an increase of RMB5.093 billion or 65.72% as compared with last year. Net profit amounted to RMB9.249 billion, representing an increase of RMB7.645 billion as compared with last year. Cost to income ratio was 51.24%, down by 9.54 percentage points as compared to last year. Net interest spread was 2.58%, representing a decrease of 3 basis points compared to last year. Net interest margin was 2.64%, representing an increase of 5 basis points compared to last year. Return on total asset was 0.65%, representing an increase of 0.51 percentage point compared to last year. Return on shareholders' equity was 11.13%, representing an increase of 8.05 percentage points as compared with last year.

### (1) Profits

The principal sources of profits included: (1) net interest income of RMB31.591 billion, representing an increase of 25.40% as compared with last year; (2) non-interest income of RMB4.452 billion (excluding exchange losses of RMB890 million resulting from the appreciation of the RMB), representing an increase of 61.01% compared with last year, and non-interest income accounted for 12.35% of the revenue, representing an increase of 2.46 percentage points; (3) other operating expenses of RMB18.012 billion, representing an increase of 6.00% compared with last year, but was 19.74 percentage points lower than the growth rate of income.

## 2. FINANCIAL RESULTS *(Continued)*

### (1) Profits *(Continued)*

The table below shows certain details of the Group's sources of profits as of the dates indicated:

| | **31 December 2005 Amount** | 31 December 2004 Amount |
|---|---|---|
| | (in millions of RMB) | |
| Net interest income | **31,591** | 25,192 |
| Non-interest income | **3,562** | 2,765 |
| Impairment losses on loans and advances | **(4,298)** | (3,215) |
| Other operating expenses | **(18,012)** | (16,992) |
| Operating profit before tax | **12,843** | 7,750 |

*Segmental operating results by geographical segments*

A geographical segment means a specific economical environment which generates risks and returns that are different from other economical environments in which the Group operates. The Group's primary sources of net profit are from Eastern China and Northern China, with an aggregate profit of RMB7.947 billion, which accounted for 85.98% of the Group's net profit.

The table below sets forth the net profit and total revenue from each of the Group's geographical segments for the dates indicated:

| | **31 December 2005** | | 31 December 2004 | |
|---|---|---|---|---|
| | **Net profit** | **Total revenue[1]** | Net profit | Total revenue[1] |
| | (in millions of RMB) | | | |
| Northern China[2] | **2,122** | **8,880** | 715 | 6,549 |
| Northeastern China[3] | **(547)** | **4,174** | (851) | 3,541 |
| Eastern China[4] | **5,825** | **28,382** | 376 | 21,111 |
| Central and Southern China[5] | **1,076** | **9,954** | 1,475 | 8,117 |
| Western China[6] | **(377)** | **4,514** | (214) | 3,844 |
| Overseas[7] | **1,144** | **4,206** | 103 | 2,674 |
| Eliminations | **–** | **(6,433)** | – | (4,398) |
| **Total[8]** | **9,243** | **53,677** | 1,604 | 41,438 |

## 2. FINANCIAL RESULTS *(Continued)*

### (1) Profits *(Continued)*

*Segmental operating results by geographical segments (Continued)*

(1) Including interest income, fee and commission income, dividend income, gains less losses arising from trading activities, gains less losses arising from de-recognition of 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 and Shandong Province.

(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, Tokyo and Seoul.

(8) Including minority interests.

*Segmental operating results by business segments*

The Group's business is mainly divided into four segments: corporate banking, retail banking, treasury and others. Our corporate banking segment was still the principal source of profit for our business, while the contribution from retail banking segments recorded significant growth. The table below sets forth the operating results of each of the Bank's business segments for the dates indicated:

| | Total revenue from external customers[1] | | Operating profit before tax |
|---|---|---|---|
| | **31 December 2005** | 31 December 2004 | **1 October to 31 December 2005** |
| | | (in millions of RMB) | |
| Corporate banking | **33,248** | 26,226 | **2,276** |
| Retail banking | **6,282** | 4,187 | **1,024** |
| Treasury | **13,323** | 10,324 | **649** |
| Others | **824** | 701 | **(1,291)** |
| Total | **53,677** | 41,438 | **2,658** |

(1) Including interest income, fee and commission income, dividend income, gains less losses arising from trading activities, gains less losses arising from de-recognition of investment securities and other operating income.

## 2. FINANCIAL RESULTS *(Continued)*

### (2) Net interest income

Net interest income amounted to RMB31.591 billion, representing an increase of RMB6.399 billion and an increase of 25.40% as compared with last year.

The table below sets forth the principal components of the Group's interest income, interest expense and the associated net interest margin and net interest spread, for the dates indicated:

| | As of 31 December | |
|---|---|---|
| | **2005** | 2004 |
| | (in millions of RMB, except percentages) | |
| **Interest Income** | | |
| Balances with central banks | **1,815** | 1,855 |
| Due from other banks and financial institutions | **3,375** | 2,231 |
| Trading securities | **9** | 6 |
| Loans and advances to customers | **36,305** | 28,287 |
| Investment securities | **8,114** | 5,885 |
| Others | **62** | 88 |
| Total interest income | **49,680** | 38,352 |
| **Interest expense** | | |
| Due to other banks and financial institutions | **(1,548)** | (1,129) |
| Due to customers | **(16,541)** | (12,031) |
| Total interest expense | **(18,089)** | (13,160) |
| Net interest income | **31,591** | 25,192 |
| **Net interest spread** (1) | **2.58%** | 2.61% |
| **Net interest margin** (2) | **2.64%** | 2.59% |

(1) This represents the difference between the average yield on the Group's total average interest-earning assets and the average cost of total average interest-bearing liabilities.

(2) This represents the ratio of net interest income to the average interest-earning assets.

The Group's net interest income was affected by the difference between the yields on the Group's interest-earning assets and the cost of the Group's interest-bearing liabilities, as well as the average volumes of these assets and liabilities. The average interest-earning assets increased by RMB227.585 billion as compared with last year and net interest spread decreased by 3 basis points to 2.58%. The decrease of net interest spread was mainly due to: (1) the impact of the "free currency, tight credit" macro environment, under which interest income was affected by the reduction in interest rate in the money market; and (2) the increase in the percentage of time deposits which brought up the cost of interest-bearing liabilities in the Group.

# Management Discussion and Analysis *(Continued)*

## 2. FINANCIAL RESULTS *(Continued)*

### (2) Net interest income *(Continued)*

The net interest margin increased by 5 basis points and reached 2.64%. This was primarily due to the Group's active adjustment by its assets and liabilities structure in response to the adverse impact imposed by the market's capital sufficiency on interest spread. Average loan deposit ratio grew significantly, and it brought up the net interest margin as well as the net interest income of the Group to a certain extent.

The table below shows the average daily balance and interest rates of our interest-earning assets and interest-bearing liabilities for the period indicated:

| | As of 31 December | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | | 2004 | | |
| | Average balance[1] | 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 | **125,179** | **1,815** | **1.45%** | 111,863 | 1,855 | 1.66% |
| Due from other banks and financial institutions | **112,776** | **3,375** | **2.99%** | 98,115 | 2,231 | 2.27% |
| Loans and advances to customers | **694,903** | **36,305** | **5.22%** | 572,411 | 28,287 | 4.94% |
| Investment securities and others | **265,921** | **8,185** | **3.08%** | 188,807 | 5,979 | 3.17% |
| Total interest earning assets | **1,198,779** | **49,680** | **4.14%** | 971,195 | 38,352 | 3.95% |
| Non interest earning assets | **50,988** | | | 58,759 | | |
| **Total assets** | **1,249,767** | | | 1,029,954 | | |
| **Liabilities and Shareholders' equity** | | | | | | |
| Due to customers | **1,095,578** | **16,541** | **1.51%** | 936,230 | 12,031 | 1.29% |
| Due to other banks and financial institutions | **51,793** | **991** | **1.91%** | 37,532 | 854 | 2.28% |
| Subordinated term debt | **12,210** | **557** | **4.56%** | 6,117 | 275 | 4.50% |
| Total interest bearing liabilities | **1,159,581** | **18,089** | **1.56%** | 979,879 | 13,160 | 1.34% |
| Shareholders' equity and non interest bearing liabilities | **90,186** | | | 50,075 | | |
| **Total liabilities and shareholders' equity** | **1,249,767** | | | 1,029,954 | | |

(1) Daily average balance calculated in accordance with the PRC GAAP and adjusted in accordance with IFRS.

## 2. FINANCIAL RESULTS *(Continued)*

### (2) Net interest income *(Continued)*

The table below shows the changes in the Group's interest income and interest expense due to changes in volume and rates. 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.

| | **2005 vs. 2004** | | | 2004 vs. 2003 | | |
|---|---|---|---|---|---|---|
| | **Increase/(decrease) due to** | | | Increase/(decrease) due to | | |
| | **Volume** | **Interest rate** | **Net increase/ (decrease)** | Volume | Interest rate | Net increase/ (decrease) |
| | | | (in millions of RMB) | | | |
| **Interest-Earning Assets** | | | | | | |
| Cash and balances with central banks | **221** | **(261)** | **(40)** | 450 | (96) | 354 |
| Due from other banks and financial institutions | **333** | **811** | **1,144** | 86 | 130 | 215 |
| Loans and advances to customers | **6,053** | **1,965** | **8,018** | 5,465 | 647 | 6,113 |
| Investment securities and other interest-earning assets | **2,442** | **(236)** | **2,206** | 1,797 | (106) | 1,691 |
| Change in interest income | **9,049** | **2,279** | **11,328** | 7,798 | 575 | 8,373 |
| **Interest-Bearing Liabilities** | | | | | | |
| Due to customers | **2,048** | **2,462** | **4,510** | 2,365 | (50) | 2,315 |
| Due to other banks and financial institutions | **325** | **(188)** | **137** | 136 | 130 | 266 |
| Subordinated term debts | **274** | **8** | **282** | 275 | – | 275 |
| Changes in interest expenses | **2,647** | **2,282** | **4,929** | 2,776 | 80 | 2,855 |

## 2. FINANCIAL RESULTS *(Continued)*

### (3) Non-interest income

As of 31 December 2005, our non-interest income was RMB4.452 billion (excluding exchange losses of RMB890 million due to the appreciation of the RMB), representing an increase of RMB1.687 billion or 61.01% compared with last year.

Among the non-interest income, the Group's net fee and commission income was RMB2.109 billion, representing an increase of RMB434 million and 25.91% compared with last year. This increase was primarily due to the following reasons: (i) the Pacific Card business recorded simultaneous increase in card issuance and consumption per card, giving rise to an increase in the card business income. (ii) the Group's asset custody business recorded good results despite the relatively depressing Chinese securities market. As of 31 December 2005, the investment custody accounts increased by 35.15% as compared with last year, and the custodian fee income increased by 16% as compared with last year.

The Group's gains less losses arising from trading activities (excluding exchange loss of RMB890 million due to the appreciation of the RMB) were RMB1.310 billion, representing an increase of RMB985 million or 303.08% compared to last year. The Group's gains less losses arising from de-recognition of investment securities was RMB359 million, representing an increase of RMB282 million or 366.23% compared to last year. This was mainly due to the profit gained from the sale of investment securities as a result of active trading in securities and the fall in market interest rate.

### (4) Other operating expenses

As of 31 December 2005, the other operating expenses of the Group were RMB18.012 billion, representing an increase of RMB1.020 billion or 6.00% compared to last year. The increase was mainly due to an increase in regulator's supervision fee, staff costs, business tax and surcharges, among which (i) regulator's supervision fee was RMB259 million, representing an increase of RMB74 million or 40.00% compared to last year. (ii) the staff costs (including salaries and bonuses, pension costs, housing benefits and subsidies and other social security and benefit costs) were RMB5.776 billion, representing an increase of RMB1.116 billion or 23.95% compared to last year. (iii) business tax and surcharges were RMB2.109 billion, representing an increase of RMB470 million or 28.68% compared to last year.

## 2. FINANCIAL RESULTS *(Continued)*

### (4) Other operating expenses *(Continued)*

Our cost to income ratio decreased significantly from 60.78% to 51.24% as of the end of the reporting period, representing a decrease of 9.54 percentage points compared to last year. This decrease was mainly due to a substantial increase in operating income by 25.74%, which exceeded the increase in operating expenses of 6.00%. A series of cost control measures brought good results.

### (5) Impairment losses on loans and advances

The Group's impairment losses on loans and advances consisted of impairment losses on impaired loans and advances to customers, less recovery of loans previously written off, and impairment losses on amounts due from other banks and financial institutions and securities purchased under resale agreements.

The impairment losses on loans and advances increased from RMB3.215 billion for last year to RMB4.298 billion as of the end of the reporting period.

### (6) Income tax

The table below shows a breakdown of the Group's current tax and deferred tax for the period indicated:

| | As of 31 December | |
|---|---|---|
| | **2005** | 2004 |
| | (in millions of RMB) | |
| Current tax | **927** | 221 |
| Deferred tax | **2,673** | 5,925 |

For the periods ended 31 December 2005, the Group and its subsidiaries, which were established in the PRC, subject to the PRC statutory tax rate of 33%. The Group's Hong Kong branch and the subsidiaries, which were established in Hong Kong, subject to Hong Kong tax rate of 17.5% for the year ended 31 December 2005. The Group's other overseas branches is subject to the income tax rates of the respective jurisdictions where they are located.

## 3. ASSETS

The Group's total assets as of 31 December 2005 were RMB1,423.4 billion, representing an increase of 24.43% from RMB1,144.0 billion for last year. The four principal components of our assets were loans and advances to customers, investment securities, due from other banks and financial institutions, and cash and balances with central banks, representing 53.31%, 22.08%, 11.95% and 9.86% respectively of the Group's total assets.

### (1) Loan business

As of the end of the reporting period, our overall risk management strategy had been steadily implemented. The Credit Approval Centers in five regions were established successively, marking a critical step forward in establishing an independent, vertical and professional credit approval system. Under its risk control, the Group managed to maintain a moderate growth in its loan business and the loans/deposits ratio was 63.45% (excluding any interest receivable and payable), up by 1.03 percentage points from the beginning of last year. Among such loans, corporate loans had a net increase of RMB95.600 billion or 18.78% as compared with the beginning of the Year and accounted for 78% of loans, representing a decrease of 2 percentage points as compared with the beginning of the Year. Individual loans had a net increase of RMB18.276 billion or 21.31% as compared with the beginning of the Year and accounted for 14% of loans, representing an increase of 1 percentage point as compared with the beginning of the Year. The discounted bills business had a net increase of RMB16.880 billion or 38.37% and accounted for 8% of loans, representing an increase of 1 percentage point as compared with the beginning of the Year.

## 3. ASSETS *(Continued)*

### (1) Loan business *(Continued)*

(i) Loan concentration by industries

Our corporate loan portfolio spanned a wide spectrum of industries, relatively concentrated in the industries of manufacturing, trading, real estate, transportation and utilities. Of such sectors, loans to the manufacturing industry had a net increase of RMB30.338 billion or 16.85% as compared to the beginning of the Year and accounted for 34.79% of our corporate loan portfolio, representing a decrease of 0.58 percentage points as compared to the beginning of the Year. Trading loans had a net increase of RMB5.131 billion or 7.56% as compared to the beginning of the Year and accounted for 12.07% of our corporate loan portfolio, representing a drop of 1.26 percentage points as compared to the beginning of the Year. Real estate loans had a net decrease of RMB2.408 billion or 3.80% as compared to the beginning of the Year and accounted for 10.07% of our corporate loan portfolio, representing a decrease of 2.37 percentage points as compared to the beginning of the Year. Loans to the transportation and utilities sectors had a net increase of RMB35.795 billion or 44.99% as compared to the beginning of the Year and accounted for 19.08% of our corporate loan portfolio, representing a rise of 3.45 percentage points as compared to the beginning of the Year.

(ii) Customer structure of corporate loans

Credit structure experienced a sustained optimization and the adjustment made to the credit structure proved to be effective. Customer structure for domestic branches also continued to display improvement. Compared with the beginning of the year, in the 10-category classification system, the proportion of outstanding loan to class 1 to 5 high quality customers increased by 5.26 percentage points to 67.55% while those of class 6 to 7 customers decreased by 5.43 percentage points to 26.77%, and those of class 8 to 10 decreased by 0.77 percentage point to 2.43%.

(iii) Borrower concentration

Under the current banking regulations in China, the aggregate amount of bank loans granted to any single borrower may not exceed 10% of its net capital, and the balance of bank loans granted to the top ten borrowers may not exceed 50% of its net capital. The Group currently complies with these regulatory requirements.

## 3. ASSETS *(Continued)*

### (1) Loan business *(Continued)*

(iii) Borrower concentration *(Continued)*

| | As of 31 December 2005 | | | |
|---|---|---|---|---|
| | **Industry** | **Company category** | **Outstanding balance** | **Internal credit rating** |
| | | (in millions of RMB) | | |
| Customer A | Steel | Joint-stock | 3,617 | 4 |
| Customer B | Services | State-owned | 3,514 | 5 |
| Customer C | Transportation & warehousing | State-owned | 3,436 | 5 |
| Customer D | Petrochemical | Joint-stock | 3,152 | 2 |
| Customer E | Transportation & warehousing | State-owned | 2,400 | 5 |
| Customer F | Petrochemical | Sino-foreign joint venture | 2,097 | 5 |
| Customer G | Post and telecommunications | Wholly-foreign owned | 2,031 | 4 |
| Customer H | Post and telecommunications | State-owned | 2,020 | 5 |
| Customer I | Petrochemical | State-owned | 2,000 | 3 |
| Customer J[1] | Finance and insurance | Limited liabilities | 1,924 | – |
| **Total top ten customers** | | | **26,191** | |

(1) According to Hong Kong Monetary Authority, our Hong Kong branches are required to classify its loans into five categories. Under such requirement, this credit customer was classified as the "**pass**" category, which is the highest class among the five, as of 31 December 2005.

## 3. ASSETS *(Continued)*

### (1) Loan business *(Continued)*

(iv) Loan concentration by geographical locations

The table below shows the geographical distribution of the Group's loan balance excluding interest receivables, as of the dates indicated:

| | **31 December 2005** | 31 December 2004 |
|---|---|---|
| | (in millions of RMB) | |
| Northern China[1] | **129,729** | 105,139 |
| North-east China[2] | **53,962** | 50,423 |
| Eastern China[3] | **320,533** | 260,251 |
| Central and Southern China[4] | **148,064** | 126,306 |
| Western China[5] | **71,027** | 60,213 |
| Overseas[6] | **46,225** | 36,452 |
| loan balance, excluding interest receivables | **769,540** | 638,784 |

(1) Including Beijing Municipality, Tianjin Municipality, Hebei Province, Shanxi Province, and Inner Mongolia Autonomous Region.

(2) Including Liaoning Province, Jilin Province and Heilongjiang Province.

(3) Including Shanghai Municipality, Jiangsu Province, Zhejiang Province, Anhui Province, Fujian Province, Jiangxi Province and Shandong Province.

(4) Including Henan Province, Hunan Province, Hubei Province, Guangdong Province, Guangxi Autonomous Region and Hainan Province.

(5) Including Chongqing Municipality, Sichuan Province, Guizhou Province, Yunnan Province, Xizang Autonomous Region, Shaanxi Province, Gansu Province, Qinghai Province, Ningxia Autonomous Region and Xinjiang Autonomous Region.

(6) Including Hong Kong, New York, Singapore, Tokyo and Seoul.

## 3. ASSETS *(Continued)*

### (1) Loan business *(Continued)*

(iv) Loan concentration by geographical locations *(Continued)*

The Group has been focusing on the areas which are more economically developed, in particular, the Yangtze River Delta, the Bohai Rim Economic Zone and the Pearl River Delta. The Group's loans to borrowers from the Yangtze River Delta, the Bohai Rim Economic Zone and the Pearl River Delta accounted for 63.40% and 64.27% of the loan balance excluding interest receivables, as of 31 December 2004 and 2005, respectively. The increase in the Group's relative loan distributions to the Yangtze River Delta, the Bohai Rim Economic Zone and the Pearl River Delta was primarily due to the Group's focus on these areas.

(v) Loan Quality

The risk management and internal control structure, which were established by following an advanced international model, operates smoothly. The risk management committee of the Board properly played its role in monitoring and assessing the Group's overall risks and providing relevant strategic advice. Under the leadership of the president, the risk management committee is responsible for determining management policies on credit risks, market risks, liquidity risks and operation risks as well as significant events. Various risk management tools were introduced with the assistance of our working partner, HSBC, and continuous improvement had been made to our risk management.

Impaired loan is a concept under IFRS. A loan is impaired if there is objective evidence that not all amounts due will be recovered under the original contractual terms of such loan.

## 3. ASSETS *(Continued)*

### (1) Loan business *(Continued)*

(v) Loan Quality *(Continued)*

The table below shows certain information regarding the Group's individually identified impaired loans and loans overdue by 90 days or more, as of the dates indicated:

| | **31 December 2005** | 31 December 2004 |
|---|---|---|
| | (in millions of RMB, except percentage) | |
| Individually identified loans with impairment | **21,579** | 19,193 |
| Loans overdue by 90 days or more | **17,267** | 11,178 |
| Individually identified loans with impairment to loans and advances to customer (percentage) | **2.80%** | 3.00% |

We control the quality of our loan portfolio in accordance with the five-category loan classification guidelines set by the PBC. According to the guidelines, commercial banks in the PRC are required to classify their loans into the following five categories of asset quality: (1) "**pass**", (2) "**special-mentioned**", (3) "**sub-standard**", (4) "**doubtful**" and (5) "**loss**". A loan is classified as a "**non-performing loan**" if it is classified as "**sub-standard**", "**doubtful**" or "**loss**".

## 3. ASSETS *(Continued)*

### (1) Loan business *(Continued)*

(v) Loan Quality *(Continued)*

The table below sets forth our five-category loan classification as of the dates indicated:

| | **31 December 2005** | | 31 December 2004 | |
|---|---|---|---|---|
| | **Amount** | **% of Total** | Amount | % of Total |
| | (in millions of RMB, except percentages) | | | |
| Pass | **652,653** | **85.52%** | 521,203 | 81.67% |
| Special-mentioned | **92,473** | **12.11%** | 98,395 | 15.42% |
| Sub-standard | **9,770** | **1.28%** | 11,742 | 1.84% |
| Doubtful | **7,935** | **1.04%** | 6,582 | 1.03% |
| Loss | **363** | **0.05%** | 226 | 0.04% |
| Gross loans[1] | **763,194** | **100.00%** | 638,147 | 100.00% |
| Percentage of non-performing loans out of loan balance | | **2.37%** | | 2.91% |

(1) Calculated under PRC GAAP

### (2) Treasury business

The Group aimed at reinforcing the management of its funding operations by actively adjusting its investment strategies, making allocations to its investment portfolio and diversifying its operating risks based on the market conditions. Through inter-bank placements, note investment, bond investment and derivatives transactions, the Group can ensure the safety, liquidity and profitability of funds. In 2005, the Group's average balance of investment securities amounted to RMB265.9 billion with an increase of 40.84% over the corresponding period of last year, which is higher than the growth in the amounts due from Central Bank and other banks, thereby enhancing the profitability of the Group's assets.

## 3. ASSETS *(Continued)*

### (2) Treasury business *(Continued)*

The table below sets forth the information of our treasury business as of the dates indicated:

| | **31 December 2005** | 31 December 2004 |
|---|---|---|
| | (in millions of RMB) | |
| **Average balance of investment securities** | **265,921** | 188,807 |
| Average balance of amounts due from other banks | **112,776** | 98,115 |
| Average balance of cash and amounts due from Central Bank | **125,179** | 111,863 |

With the development of the short-term bond market, there was a remarkable increase of 163.92% in the Group's holdings in securities issued by corporate entities.

The table below sets forth the components of our investment securities as of the dates indicated:

| | **31 December 2005** | 31 December 2004 |
|---|---|---|
| | (in millions of RMB) | |
| **Securities – loans and receivables:** | **28,372** | 31,205 |
| in which: Central governments and central banks | **26,527** | 28,911 |
| Public sector entities | **464** | 125 |
| Banks and other financial institutions | **1,381** | 2,169 |
| **Securities-available-for-sale:** | **285,971** | 215,523 |
| in which: Central governments and central banks | **115,653** | 108,582 |
| Public sector entities | **2,644** | 2,398 |
| Banks and other financial institutions | **154,734** | 99,640 |
| Corporate entities | **12,940** | 4,903 |

## 4. LIABILITIES

As of 31 December 2005, the total liabilities of the Group were RMB1,340.3 billion, representing an increase of 22.75% from RMB1,091.9 billion for the last year. The amount due to our customers represented 91.09% of our total liabilities. The Group financed its funding for its lending and investment activities through various channels, both domestically and internationally. The principal sources of funds came from corporate and individual deposits. The sound deposits structure ensured a stable source of funds for the Group. During the reporting period, corporate deposits and individual deposits recorded an increase of 11.43% and 18.11% respectively.

The table below sets forth our corporate and individual deposits structure as of the dates indicated:

| | **31 December 2005** | 31 December 2004 |
|---|---|---|
| | (in millions of RMB) | |
| **Corporate deposits** | **642,735** | 576,783 |
| in which: Corporate current deposits | **407,228** | 385,556 |
| Corporate savings deposits | **4,232** | 5,011 |
| Corporate time deposits | **231,275** | 186,216 |
| **Individual deposits** | **435,718** | 368,901 |
| in which: Individual current deposits | **162,757** | 143,461 |
| Individual savings deposits | **9,725** | 14,879 |
| Individual time deposits | **263,236** | 210,561 |

## 5. CAPITAL ADEQUACY RATIO

As of 31 December 2005, The Group's CAR reached 11.20%, representing an increase of 1.48 percentage points from 9.72% for the last year. This increase was mainly due to an increase of RMB17.402 billion in Tier-1 capital raised in the Group's IPO. In addition, the Group's efforts to increase operating income and control rising costs, resulted in a net profit of RMB9.249 billion and an increase in Tier-1 capital accordingly. The Group has also strengthened its assets risk management, so that the growth rate of total weighted risk assets was lower than that of capital.

The CAR was calculated in accordance with the formula promulgated by CBRC and based on the financial data prepared under the PRC GAAP.

## 6. INITIATIVE TO COPE WITH THE IMPACT OF RMB APPRECIATION

On 21 July 2005, the PBC announced reforms on the RMB exchange-rate formulating mechanism whereby the Yuan to the US dollar pegging system was switched to one that referred to a basket of currencies. The exchange rate of the RMB to US dollar will be increased by 2%. To accommodate the impact, the Group has drawn up the "**Opinions on Coping with Changes in Exchange Rate Policies to ensure the Accomplishment of the Annual Operation Targets**". Pursuant to this document, aggressive steps will be taken to dilute the disadvantages and maximize the advantages of RMB appreciation, with focus on the impact on exchange rate risk, asset quality and international business. The conversion to RMB of capital raised from our IPO had been successfully completed. As of 21 October 2005, a total of HK$16.8 billion raised from the IPO had been converted. As of the end of the reporting period, the Group had offset an exchange loss of RMB890 million arising from RMB appreciation, and reported satisfactory operating results.

## 7. SMOOTH OPERATION OF THE BANK OF COMMUNICATIONS SCHRODERS FUND MANAGEMENT CO., LTD.

The Bank of Communications & Schroders Fund Management Co., Ltd. was jointly promoted and established by the Group, Schroder Investment Management Limited (UK) and China International Marine Container (Group) Limited in a shareholding ratio of 65%, 30% and 5% respectively. Founded on 12 August 2005, the company's headquarter was in Shanghai, with a registered capital of RMB200 million. Its establishment was an important step to the Group in its attempt to introduce comprehensive operations to improve the Group's revenue structure. It also represented an important opportunity for the Group to be further involved in a securities investment fund business. The Bank of Communications & Schroder Fund Management Co., Ltd. had its first product, the BoCom Schroders Core Fund launched on 26 August 2005, with a total subscription of 4.873 billion units as of 26 September 2005, the closing day of the issuance. As of 30 December 2005, which was the last trading day, the BoCom Schroders Core Fund had a net asset value of RMB1.0291 per unit and achieved outstanding results.

## 8. OUTLOOK FOR 2006

The year of 2006 is the first full operating year since the Group's listed. It is a year when the protection period set by the World Trade Organisation ("**WTO**") expires, the financial sectors should fully open up and financial reform should continue to be implemented. It is also a year for the Group to make strategic adjustments to the business structure and quicken the pace of strategic transformation. Sustained economic development and improvement in the financial environment offer opportunities for the Group's operation management. However, there are increased uncertainties as to the external environment and intensified challenges from competitors.

## 8. OUTLOOK FOR 2006 *(Continued)*

From a macro perspective, the financial sector of the PRC will be better regulated, and a sound financial environment will develop. Steady growth in domestic and global economy stimulates active investment and financing by domestic enterprises and individuals. The changes in the development model of enterprises and accumulation of national wealth facilitate business expansion in terms of scale and scope, as well as business transformation of the Group's banking operation. Strengthening of financial reform, changes in regulatory policies, regulating authorities' relaxation of restrictions on market entry and financial innovation, acceleration of market-oriented development of the financial sector and the expansion of the comprehensive operation network provide a more favourable environment for the Group to reinforce its core competitiveness.

In 2006, the banking industry in the PRC is experiencing intensified competition, and the Group will face considerable pressure. The Group will further consolidate its competitive edge with the continuous reform of state-owned commercial banks' shareholding system. However, the implementation of policy reform on the banking industry may divert business resources of commercial banks. In addition, following the expiry of the WTO protection period in the near future, foreign banks will, leveraging on their advantages of brand names and products, compete with PRC banks. This may cause a loss of high-end customers, talented professionals and quality businesses. Other joint-stock banks have also commenced reform. Development of retail business, fee-generating business and various innovative businesses has become the common objective of all banks. Increasingly intensive competition within the banking industry has brought much pressure on the business, human resources and profitability of the Group.

## 8. OUTLOOK FOR 2006 *(Continued)*

The Group also faces many adverse impacts brought by changes in the market environment. The increasingly market-oriented interest rate leads to the continuous development of the bond market, gradual recovery of the stock market and rapid growth of the insurance and fund industry. The issue of short-term corporate bonds by the Central Bank reduces the role of commercial banks as intermediaries of funds and imposes a higher demand on the Group's pricing and risk management capability. The reform measures of the exchange rate-formulating mechanism of RMB have been promulgated and implemented. However, due to the absence of market-oriented risk hedging instruments, measures that can be taken to hedge RMB exchange risks are limited and the exchange risks may adversely affect the profitability of the Group. The increasing pace of reform for the deposit insurance system may increase the costs of the Group.

Adhering to the objective of developing into an outstanding international public bank, the Group will focus on the following aspects in 2006. Firstly, the Group will adopt a performance-based incentive system to stimulate the growth of business and profits. Secondly, the Group will utilise its sound nationwide service networks to improve the speed of service by consolidating its organizational structure, channel, information system, product and marketing system, so as to raise the service standard of retail business. Thirdly, the Group will speed up the development of fee-generating business. The Group will put more effort in developing core business and core brands and will set reasonable price strategy to increase its fees. Fourthly, the Group will speed up reform, implement its fifteen key projects and enhance the restructuring and integration of business and management flow. Fifthly, further measures will be taken to enhance management of financial products, increase the innovation capability of products and technologies, and to speed up such innovation. The Group will actively promote products, which are in line with market penetration, entry barrier relaxation and financial innovation, with an aim to improve its core competitiveness. Sixthly, the Group plans to provide strong support to small corporate customers by launching products that cater to their actual needs for development. Seventhly, the Group will take further reform in human resources management by setting up a new management framework for positions, salary and performance and developing a multi-form and multi-channel model for education and training to increase training efficiency. Eighthly, the Group will further promote the full implementation of risk management measures and exert its best efforts on lowering risks, in order to improve loan quality.