

PRC REGULATION AND SUPERVISION

Overview

The banking industry is highly regulated in China, with the CBRC and the PBOC acting as the principal regulatory authorities. The CBRC is responsible for regulating and supervising banking institutions, and the PBOC, as the central bank of China, is responsible for formulating and implementing monetary policies. The principal laws and regulations relating to China's banking industry are the PRC PBOC Law, the PRC Commercial Banking Law and the PRC Banking Regulation and Supervision Law, and the rules and regulations promulgated thereunder.

Principal Regulators

CBRC

Functions and Powers

The CBRC is the principal regulatory authority responsible for the regulation and supervision of banking institutions operating in China, including commercial banks, urban credit cooperatives, rural credit cooperatives, other deposit-taking institutions and policy banks, as well as certain non-banking financial institutions, such as asset management companies, trust and investment companies, financial leasing companies and other financial institutions whose establishment is subject to the CBRC's approval. According to the PRC Banking Regulation and Supervision Law, the primary bank regulatory responsibilities of the CBRC include:

- promulgating rules and regulations governing banking institutions and their activities;
- regulating the establishment, change, dissolution and business scope of banking institutions, as well as granting banking licenses for commercial banks and their branches;
- regulating the business activities of banking institutions, including their product and service offerings;
- setting qualification requirements for, and approving or overseeing the nomination of, directors and senior management personnel of banking institutions;
- setting guidelines and standards for internal controls, risk exposure and corporate governance of, and disclosure requirements for, banking institutions;
- conducting on-site inspection and off-site surveillance of the business activities and risk levels of banking institutions;
- monitoring the financial condition of banking institutions, including establishing standards or requirements for capital adequacy, asset quality and other financial ratios; and
- imposing corrective and punitive measures for violations of applicable banking regulations, including suspending the operations of banking institutions.

Examination and Supervision

The CBRC monitors the operations of commercial banks and their branches through on-site examinations and off-site surveillance. On-site examinations generally include visiting a bank's premises and interviewing its employees for significant issues relating to its operations, risk management and senior management and directors, as well as reviewing relevant documents and

materials. Off-site surveillance generally includes reviewing various business reports, financial statements and other reports regularly submitted by banks.

PBOC

As the central bank of China, the PBOC is responsible for formulating and implementing monetary policies and maintaining the stability of China's financial markets. According to the PRC PBOC Law, the PBOC is empowered to:

- formulate and implement monetary policies by establishing benchmark interest rates, setting the deposit reserve ratios for commercial banks, extending loans to commercial banks, accepting discounted bills and conducting open market operations;
- issue PRC treasury bills and other government bonds to financial institutions, as the agent of the MOF;
- regulate the domestic inter-bank lending market and the trading by institutional investors in the inter-bank bond market of debt instruments issued by the PRC government, its agencies and financial institutions;
- set foreign exchange rate policies and manage China's foreign exchange reserves and gold reserves;
- regulate and examine foreign exchange activities; and
- establish anti-money-laundering guidelines and monitor fund transfers for compliance with anti-money-laundering regulations.

Other Regulatory Authorities

In addition to the CBRC and the PBOC, commercial banks in China are also subject to the regulation and supervision by other regulatory authorities, including the SAFE, the CSRC and the CIRC. For example:

- in conducting our foreign currency business, we are subject to the regulation of the SAFE;
- in conducting our funds custodian business and planned investment in fund management business, we are subject to the regulation of the CSRC; and
- in conducting our agent sales of insurance business, we are subject to the regulation of the CIRC.

Licensing Requirements

Basic Requirements

The PRC Commercial Banking Law sets forth the permitted scope of business, licensing standards and other requirements in respect of commercial banks. The establishment of a commercial bank requires the CBRC's approval and issuance of an operating license. In general, the CBRC will not approve an application to establish a commercial bank unless certain conditions are satisfied, including, among others, that:

- the articles of association of the proposed commercial bank must comply with relevant requirements of the PRC Commercial Banking Law and the PRC Company Law;

- the registered capital of the proposed commercial bank must meet the minimum requirement under the PRC Commercial Banking Law, which is RMB1.0 billion, RMB100 million and RMB50 million for a national commercial bank, a city commercial bank and a rural commercial bank, respectively;
- the directors and senior management of the proposed commercial bank must possess the requisite qualifications;
- the organizational structure and management system must be properly established; and
- the safety and security of the business premises and other facilities and their security measures must comply with relevant requirements.

Significant Changes

Banks are required to obtain the CBRC's approval to undertake significant changes, including, among others:

- change of name;
- change of registered capital;
- change of the location of the head office or a branch;
- change of business scope;
- purchase of an equity interest in the bank that results in the purchaser becoming a holder of 5% or more of the bank's shares, and any change of shareholders holding 5% or more of the bank's total capital or shares;
- amendment to the articles of association; and
- entering into a merger or separation transaction.

Establishment of Branches

Domestic Branches

A commercial bank must apply to the CBRC (or its local offices) for approval and issuance of an operating license to establish a branch. In order to obtain this license, the branch must have sufficient operating funds commensurate with its scale and must meet other operating requirements. A commercial bank is required to allocate a minimum amount of operating funds for each branch, and the total of the operating funds provided to all branches of a commercial bank may not exceed 60% of its regulatory capital.

Overseas Branches

The establishment of overseas branches by PRC commercial banks is subject to the CBRC's approval and to applicable regulations in the relevant foreign jurisdiction. In general, the CBRC will not approve an application to establish an overseas branch unless the bank making the application has been approved to engage in foreign exchange business, has engaged in such business for more than three years and has a legitimate source of foreign exchange funds. In addition, in order for its application to establish an overseas branch to be approved, the bank making the application is required to have a minimum of RMB80 million (or the equivalent) of self-owned foreign currency funds.

Scope of Business

Under the PRC Commercial Banking Law, commercial banks in China are permitted to engage in any or all of the following activities:

- taking deposits from the public;
- making short-term, medium-term and long-term loans;
- effecting domestic and overseas payment settlements;
- accepting and discounting instruments;
- issuing bonds;
- acting as agents to issue, honor and underwrite government bonds;
- trading government bonds and bonds from financial institutions;
- engaging in inter-bank lending;
- trading foreign exchange as principal or as agent;
- engaging in bank card business;
- providing letters of credit and guarantee services;
- collecting and making payment as agents and acting as insurance agents as an ancillary business;
- providing safe deposit box service; and
- other businesses approved by the CBRC.

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

Regulation of Principal Commercial Banking Activities

Lending

PRC banking regulations require commercial banks to take into consideration government macroeconomic policies in making lending decisions. Accordingly, commercial banks are encouraged to limit their lending to borrowers in industries whose rate of growth is to be limited in accordance with relevant government policies. For example, in an effort to slow the growth of real estate market in China, the State Council approved the Opinions on Adjusting the Mix of Housing Supply and Stabilizing Housing Prices (關於調整住房供應結構穩定住房價格的意見). Among other measures, effective on June 1, 2006, the opinions increased the minimum down payment requirement from 20% of the purchase price of a mortgaged residential property to 30% (except apartments with a gross floor area of 90 square meters or less used as the purchaser's own residence, for which the minimum down payment remains at 20%).

Commercial banks are required to conduct due diligence investigations on corporate borrowers before extending credit to them. After credit is granted, commercial banks are required to continue to monitor factors that may affect the borrower's ability to repay the loan and to prepare written credit assessments on a regular basis.

In addition, the CBRC issued regulations regulating loans and credit granted to certain specific industries and customers in an effort to control the credit risk of China's commercial banks. For example:

- Under the Group Loans Guidelines, commercial banks are required to treat affiliated companies of the same group as a single group customer and establish a single consolidated credit limit for such group. In addition, commercial banks are required to take measures to diversify its credit risk if the total credit granted to any one group customer accounts for more than 15% of the bank's regulatory capital.
- Under the Real Estate Loan Guidelines, commercial banks are prohibited from making loans to a real estate developer unless the developer has funded a minimum of 35% of the total investment of the real estate development project.
- Under the Automobile Loan Measures (汽車貸款管理辦法) issued by the CBRC on August 16, 2004 and effective on October 1, 2004, commercial banks are prohibited from making loans for personal-use automobiles, commercial automobiles and second-hand automobiles exceeding 80%, 70% and 50%, respectively, of the purchase price of such automobiles.

Foreign Currency Business

Commercial banks are required to obtain approvals from the CBRC and the SAFE in order to conduct foreign currency businesses. Under PRC's anti-money-laundering laws and regulations, PRC financial institutions are required to report timely to the SAFE any large or irregular foreign exchange transactions they encounter.

Securities and Asset Management Businesses

Commercial banks in China are generally prohibited from trading and underwriting equity securities. Commercial banks in China are permitted to:

- underwrite and deal in PRC government bonds and bonds issued by financial institutions, and starting from May 2005, commercial paper issued by qualified non-financial institutions;
- act as agents in transactions involving securities, including bonds issued by the PRC government, financial institutions and other corporate entities;
- provide institutional and individual investors with comprehensive asset management advisory services;
- act as financial advisers in connection with large infrastructure projects, mergers and acquisitions transactions and bankruptcy reorganizations; and
- act as custodians for funds, including securities investment funds and corporate annuity funds.

Under the Trial Administrative Measures on Fund Management Companies Owned by Commercial Banks (商業銀行設立基金管理公司試點管理辦法) jointly promulgated by the PBOC, CBRC, and CSRC on February 20, 2005 and effective on the same date, the Big Four and the Other National Commercial Banks are permitted to establish or acquire fund management companies with the

approval of the CBRC and the CSRC. A commercial bank that intends to invest in or acquire a fund management company must first be approved by the CBRC as meeting certain qualifications before applying to the CSRC for the approval relating to the establishment or acquisition of a fund management company. In addition, a commercial bank is required to file with the PBOC its applications for approvals from the CBRC and the CSRC. Under the trial measures, such fund management companies are permitted to collect and manage funds in accordance with the PRC Law on Securities Investment Fund (中華人民共和國證券投資基金法) promulgated by the Standing Committee of the National People's Congress on October 28, 2003 and effective on June 1, 2004. During the trial period of the trial measures, they are permitted to collect and manage money market funds and bond funds, invest in fixed-income securities, and collect and manage other types of funds.

Under the trial measures, commercial banks are required to implement detailed measures to segregate risks associated with the securities market and the banking sector, which include, among others, segregating client information between commercial banks and their fund management companies, preventing commercial banks' employees from holding concurrent positions in the fund management companies, and prohibiting commercial banks from acting as custodians for the funds managed by their fund management companies.

Under the trial measures, the CBRC is responsible for establishing the relevant risk monitoring criteria for commercial banks that have established or acquired fund management companies and examining and approving the funds raised and managed by such fund management companies. The PBOC is responsible for supervising national inter-bank bond market transactions conducted by fund management companies.

Under the Administrative Measures on Qualifications for Securities Investment Fund Custodianship (證券投資基金托管資格管理辦法) promulgated by the CSRC and the CBRC on November 29, 2004 and effective on January 1, 2005, a commercial bank is permitted to apply for the qualification to engage in fund custodian business of securities investment funds, if, among other requirements, such commercial bank has net assets at the year-end totaling no less than RMB2 billion for each of the latest three fiscal years and its capital adequacy ratio conforms to the relevant regulatory requirement. The fund custodian must ensure the separation of its custodian business from its other businesses and the independence of its fund assets. The CSRC and the CBRC are jointly responsible for examining and approving the qualifications and supervising the activities of fund custodians. In addition, the senior manager to be appointed for a commercial bank's fund custody department must meet certain qualifications and be approved by the CSRC.

Insurance

Commercial banks in China are not permitted to underwrite insurance policies, but are permitted to act as agents to sell insurance products through their distribution network. Commercial banks that conduct agency sales of insurance products are required to comply with applicable rules issued by the CIRC. Pursuant to the Interim Measures on the Administration of Ancillary Agency Insurance Business (保險兼業代理管理暫行辦法) promulgated by the CIRC on August 4, 2000, commercial banks are required to obtain licenses from the CIRC before conducting agency insurance business. Pursuant to the Notice Regarding Standardization of Agency Insurance Business Conducted by Banks (關於規範銀行代理保險業務的通知) issued by the CIRC and the CBRC on June 15, 2006, such licenses are required for all tier-1 branches of commercial banks conducting such business.

Some of our branches and sub-branches have historically conducted agency sales of insurance products without the necessary licenses. At July 31, 2006, a total of 26 business units, or 5.8% of our 451 business units (*i.e.*, sub-branches and the business departments of the branches) engaging in such business, did not have the necessary license. Under the relevant PRC laws and regulations, regulators may require us to suspend the unlicensed agency insurance business, confiscate net fee income earned from such unlicensed activities and impose fines. To date, we have not been subject to such penalties. We have instructed our tier-1 branches and business units that do not have the necessary licenses to suspend any sales of insurance products and apply for the necessary licenses. However, we cannot assure you that we would not be subject to fines or other penalties for our past non-compliance. See “Risk Factors — Risks Relating to Our Business — We are subject to various PRC and overseas regulatory requirements, and our failure to fully comply with such requirements, if any, could materially and adversely affect our business, financial condition, results of operations and our reputation.”

Personal Wealth Management Services

In September 2005, the CBRC issued the Provisional Administrative Measures on the Personal Wealth Management Business of Commercial Banks (商業銀行個人理財業務管理暫行辦法). Under these measures, in respect of certain wealth management services, commercial banks are required to obtain CBRC approval to provide such services whereas in respect of certain other wealth management services, only a report needs to be submitted with the CBRC. They are also subject to certain restrictions in the offering of products under personal wealth management plans. In addition, under the Guidelines on Risk Management Regarding Personal Wealth Management Services of Commercial Banks (商業銀行個人理財業務風險管理指引) issued by the CBRC in September 2005, commercial banks are required to establish an auditing and reporting system in respect of their wealth management services and to report to the relevant authorities any material risk management problems.

Electronic Banking

In January 2006, the CBRC issued administrative measures regulating electronic banking business and security evaluation guidelines on such business in an effort to enhance risk management and security standards in this sector. All banking institutions applying to establish an e-banking business are required to have sound internal control and risk management systems and should not have had any major incidents relating to their primary information management and operations processing systems in the year prior to the application. In addition, all banking institutions conducting e-banking business must adopt security measures to protect the confidentiality of the data and information and prevent unauthorized use of e-banking accounts.

Proprietary Investments

In general, commercial banks in China are prohibited from making domestic investments other than in debt instruments issued by the PRC government, financial institutions, commercial paper and corporate bonds issued by qualified non-financial institutions and certain derivative products. Unless approved by the PRC government, commercial banks are prohibited in China from engaging in trust investment and securities operation business, investing in real estate (other than for their own use) and making equity investments in entities other than commercial banks in China.

Derivatives

On February 4, 2004, the CBRC issued the Provisional Administrative Measures on Derivative Business of Financial Institutions (金融機構衍生產品交易業務管理暫行辦法), which set forth, among other things, detailed regulations on market access and risk management of the derivatives business conducted by financial institutions. In accordance with the provisional measures, commercial banks in China seeking to conduct derivatives business must meet relevant qualification requirements and obtain prior approval from the CBRC. On March 22, 2005, the CBRC issued the Circular on Risk Alert Regarding Trading of Derivative Products by Domestic Banks (關於對中資銀行衍生產品交易業務進行風險提示的通知) to further strengthen the risk management of the derivatives businesses conducted by commercial banks in China.

Securitization of Credit Assets of Financial Institutions

The Trial Measures for the Supervision and Administration of the Securitization of Credit Assets of Financial Institutions (金融機構信貸資產證券化試點監督管理辦法) was promulgated by the CBRC on November 7, 2005 and became effective on December 1, 2005. These trial measures apply to structural financing activities in which a financial institution, as the promoter institution, entrusts the credit assets to a trustee institution, and the trustee institution issues beneficial securities to investing institutions in the form of asset-backed securities and pays the yields for the asset-backed securities by the cash generated from the aforesaid assets. The term “promoter institutions for the securitization of credit assets” refers to the financial institutions that transfer the credit assets by establishing special purpose trusts. For a banking institution to act as a promoter institution, it must meet certain requirements and obtain approval from the CBRC.

Pricing of Products and Services

Interest Rates for Loans and Deposits

Interest rates for RMB-denominated loans and deposits were historically set by the PBOC. In recent years, the PBOC has been gradually liberalizing its regulation of interest rates, allowing banks more discretion in determining the interest rates for RMB-denominated loans and deposits. The following table sets forth, for the periods indicated, the permitted range of interest rates for RMB-denominated loans and deposits.

	Loans			Deposits		
	Between 9/1/99 and 12/31/03 ⁽¹⁾	Between 1/1/04 and 10/28/04 ⁽²⁾	Since 10/29/04 ⁽³⁾	Between 9/1/99 and 12/31/03	Between 1/1/04 and 10/28/04	Since 10/29/04
Maximum interest rates	Up to 130% of the PBOC benchmark rate for SMEs (up to 150% for rural credit cooperatives) and up to 110% for large enterprises	Up to 170% of the PBOC benchmark rate (up to 200% for rural credit cooperatives)	No cap (up to 230% of the PBOC benchmark rate for rural and urban credit cooperatives)	PBOC benchmark rate, except for negotiated deposits	PBOC benchmark rate, except for negotiated deposits	PBOC benchmark rate, except for negotiated deposits
Minimum interest rates	Not lower than 90% of the PBOC benchmark rate	Not lower than 90% of the PBOC benchmark rate	Not lower than 90% of the PBOC benchmark rate	PBOC benchmark rate, except for negotiated deposits	PBOC benchmark rate, except for negotiated deposits	No minimum

- (1) Interest rates for residential mortgage loans, public assistance loans, policy loans and certain other loans specified by the State Council may not exceed the PBOC benchmark rate.
- (2) Interest rates for residential mortgage loans, public assistance loans and certain other loans specified by the State Council may not exceed the PBOC benchmark rate.
- (3) From March 17, 2005 to August 18, 2006, interest rates for residential mortgage loans were regulated in the same way as most other types of loans. Since August 19, 2006, the minimum interest rates for residential mortgage loans have been changed to 85% of the relevant PBOC benchmark rate.

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The following table sets forth, for the periods indicated, the major applicable benchmark interest rates in effect.

PBOC Benchmark Interest Rates for RMB-Denominated Loans and Deposits					
	From 6/10/99 to 02/20/02	From 02/21/02 to 10/28/04	From 10/29/04 to 04/27/06	From 04/28/06 to 08/18/06	After 08/19/06
(% per annum)					
Loans					
Short-term loans:					
Less than six months	5.58	5.04	5.22	5.40	5.58
Six months to one year	5.85	5.31	5.58	5.85	6.12
Medium- and long-term loans:					
One to three years	5.94	5.49	5.76	6.03	6.30
Three to five years	6.03	5.58	5.85	6.12	6.48
More than five years	6.21	5.76	6.12	6.39	6.84
Residential mortgage loans:					
Five years or less	5.31	4.77	4.95 ⁽¹⁾		
More than five years and up to thirty years	5.58	5.04	5.31 ⁽¹⁾		
Deposits					
Demand deposits	0.99	0.72	0.72	0.72	0.72
Time deposits:					
Three months	1.98	1.71	1.71	1.71	1.80
Six months	2.16	1.89	2.07	2.07	2.25
One year	2.25	1.98	2.25	2.25	2.52
Two years	2.43	2.25	2.70	2.70	3.06
Three years	2.70	2.52	3.24	3.24	3.69
Five years	2.88	2.79	3.60	3.60	4.14

(1) Effective March 17, 2005, the PBOC benchmark mortgage rates are the same as the PBOC benchmark rates for loans with the same terms.

Prior to January 1, 2004, all RMB-denominated loans (except mortgage loans and certain specific types of loans) with a maturity of one year or less were required to have fixed interest rates within a specific range based on the applicable PBOC benchmark rates, and all RMB-denominated loans (except mortgage loans and certain specific types of loans) with a maturity longer than one year were required to have interest rates adjusted following each change of the applicable PBOC benchmark rates. When the applicable PBOC benchmark rates changed, the interest rates for all such adjustable loans were generally adjusted on the next anniversary of the loan origination date following the date of change.

On January 1, 2004, the PBOC expanded the range within which banks were allowed to set their interest rates based on the PBOC benchmark rates for the above mentioned loans. In addition, RMB-denominated loans with a maturity longer than one year were allowed to bear either fixed interest rates or adjustable interest rates that adjust on a monthly, quarterly or annual basis following each change of the PBOC benchmark rates. On October 29, 2004, the PBOC further liberalized its interest rate regulation by removing the upper limit for RMB-denominated loans (except mortgage loans and certain specific types of loans), allowing banks to determine their interest rates for such loans so long as they are not lower than 90% of the relevant PBOC benchmark rate.

As for mortgage loans, prior to March 17, 2005, the PBOC fixed the interest rates on residential mortgage loans and entrusted provident housing fund mortgage loans at a level lower than the

benchmark rates of other loans with corresponding terms. Following each change by the PBOC of the interest rates for mortgage loans, banks were required to make the corresponding adjustment of their interest rates for such mortgage loans on January 1 of the year following the date of change. From March 17, 2005 to August 18, 2006, interest rates for residential mortgage loans were regulated in the same way as most other types of loans. Since August 19, 2006, the minimum interest rates for residential mortgage loans have been changed to 85% of the relevant PBOC benchmark rate. Regulation on entrusted provident housing fund loans, however, remains the same.

Beginning on October 29, 2004, commercial banks in China are permitted to set their own interest rates on Renminbi deposits so long as such interest rates are not higher than the relevant PBOC benchmark rates. However, these restrictions do not apply to interest rates on negotiated deposits, which are deposits by insurance companies in amounts of RMB30 million or more or deposits by the SSF in amounts of RMB500 million or more, both with a term longer than five years, or deposits by China Post in amounts of RMB30 million or more with a term longer than three years.

The PBOC generally does not regulate interest rates for foreign currency-denominated loans and generally does not regulate foreign currency-denominated deposits other than U.S. dollar-, Hong Kong dollar-, Japanese yen- or Euro-denominated deposits of less than US\$3 million (or the equivalent) with a maturity of one year or less, the interest rates on which may not exceed the maximum interest rates based on the PBOC benchmark rates.

Commercial banks are generally allowed to set interest rates for discounted bills based on the PBOC rediscount rates. The PBOC rediscount rate was 2.16% from June 10, 1999 to September 10, 2001, 2.97% from September 11, 2001 to March 24, 2004, and has been 3.24% since March 25, 2004.

Pricing for Non-interest-based Products and Services

Under the Tentative Administrative Measures on Pricing of Commercial Banking Services (商業銀行服務價格管理暫行辦法) jointly promulgated by the CBRC and the NDRC on June 26, 2003 and effective on October 1, 2003, the services which are subject to government price guidelines include basic RMB settlement services, such as bank drafts, bank acceptance drafts, promissory notes, checks, remittances, entrusted collection, and other services specified by the CBRC and the NDRC. Fees for other products and services are determined based on market conditions. Commercial banks are also required to report to the CBRC at least 15 business days prior to the implementation of new fee schedules and to post such fee schedules on their premises at least ten business days prior to effectiveness.

Statutory Deposit Reserve and Surplus Deposit Reserve

Commercial banks are required to maintain a percentage of their total deposits as reserves with the PBOC to ensure they have sufficient liquidity to meet customer withdrawals. Currently, most domestic commercial banks are required to maintain a statutory deposit reserve equal to 8.5% of their total outstanding Renminbi deposits calculated under PRC GAAP. Domestic commercial banks which fail to meet certain PBOC standards are required to maintain a statutory deposit reserve ratio of 9.0%. The minimum required statutory deposit reserve ratio for domestic commercial banks was increased from 6.0% to 7.0% in September 2003, 7.5% in April 2004, 8.0% in July 2006 and 8.5% in August 2006.

Prior to January 15, 2005, domestic commercial banks licensed to engage in the foreign exchange business were required to maintain a reserve with the PBOC equal to 2% of their

monthly average foreign currency deposits during a quarter. Foreign-invested commercial banks were required to maintain a statutory deposit reserve equal to 5% of their total deposits with terms of less than three months and 3% of their total deposits with terms of three months or more. From January 15, 2005 to September 14, 2006, both domestic and foreign-invested commercial banks were required to maintain a reserve with the PBOC equal to at least 3% of their total foreign currency-denominated deposits at the end of the previous month, which was increased to 4% beginning September 15, 2006.

In addition, domestic and foreign-invested commercial banks must maintain a surplus deposit reserve with the PBOC, which is defined as deposits exceeding the statutory deposit reserve. Surplus deposit reserve is used in part for settlement purposes. Since the reform of the deposit reserve system in 1998, the PBOC has actively monitored the levels of surplus deposit reserve maintained by commercial banks in the PRC in an effort to ensure that the banks have sufficient funds to meet their settlement obligations.

The PBOC pays interest on deposit reserves maintained by commercial banks. Since February 21, 2002, the interest rate for the statutory deposit reserve has been 1.89%. Since February 21, 2002, the PBOC has twice lowered the interest rate it pays on banks' surplus deposit reserve, from 1.89% to 1.62% on December 21, 2003, and then from 1.62% to 0.99% on March 17, 2005.

Supervision Over Capital Adequacy

Capital Adequacy Guidelines

Prior to March 1, 2004, commercial banks were required to maintain a minimum capital adequacy ratio of 8% and a minimum core capital adequacy ratio of 4%, each calculated based on the following formula under PRC GAAP:

$$\text{Capital adequacy ratio} = \frac{\text{Regulatory capital}}{\text{On- and off-balance sheet risk weighted assets}} \times 100\%$$

$$\text{Core capital adequacy ratio} = \frac{\text{Core capital}}{\text{On- and off-balance sheet risk weighted assets}} \times 100\%$$

On February 23, 2004, the CBRC promulgated the New Capital Adequacy Regulations, which became effective on March 1, 2004. While the New Capital Adequacy Regulations did not change the existing requirements of an 8% capital adequacy ratio and a 4% core capital adequacy ratio, it amended the risk weighting for various assets, adjusted the components of capital and included capital charge for market risk in the calculation for capital adequacy ratios. In addition, the New Capital Adequacy Regulations require commercial banks to make adequate allowances for various impairment losses, including those associated with loans, before calculating their capital adequacy ratios. These changes resulted in a more stringent capital adequacy requirement. The new measures provide for a phase-in period in which all domestic commercial banks will be required to meet the minimum capital adequacy ratios by January 1, 2007. Banks not immediately in compliance with the new measures must formulate and implement a capital replenishment plan under the supervision of the CBRC.

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In accordance with the New Capital Adequacy Regulations, capital adequacy ratio and core capital adequacy ratio are calculated based on the following formula under PRC GAAP:

$$\text{Capital adequacy ratio} = \frac{\text{Regulatory capital}}{\text{Risk-weighted assets} + (12.5 \times \text{capital charge for market risk})} \times 100\%$$

$$\text{Core capital adequacy ratio} = \frac{\text{Core capital} - \text{core capital deductions}}{\text{Risk-weighted assets} + (12.5 \times \text{capital charge for market risk})} \times 100\%$$

Components of Capital

Regulatory capital is composed of core capital and supplementary capital after subtracting relevant capital deductions. Supplementary capital may not exceed core capital.

Core capital includes the following:

- paid-in capital or common shares;
- capital reserves;
- surplus reserves, including statutory and discretionary surplus reserves and the statutory public welfare fund;
- retained earnings; and
- minority interests.

Supplementary capital includes the following:

- up to 70% of the revaluation reserve;
- the general allowances for impairment losses under the CBRC's requirements (see “— Loan Classification, Allowances and Write-offs — Loan Classification” and “— Loan Classification, Allowances and Write-offs — Loan Allowances”);
- preference shares;
- qualifying bonds convertible into common shares;
- qualifying subordinated debt with a maturity exceeding five years, not exceeding 50% of core capital; and
- hybrid capital bonds.

Capital deductions consist of the following:

- goodwill;
- equity investments in non-consolidated financial institutions; and
- capital investments in enterprises and real estate not used for the bank's own operations or equity investments in non-banking financial institutions or non-financial institutions.

Core capital deductions consist of the following:

- goodwill;
- 50% of equity investments in non-consolidated financial institutions; and

- 50% of capital investments in enterprises and real estate not used for the bank's own operations or equity investments in non-banking financial institutions or non-financial institutions.

Risk-weighted Assets

The New Capital Adequacy Regulations provide for the calculation of risk-weighted assets net of any allowances for impairment losses by multiplying on-balance sheet items by their corresponding risk weighting, after taking into account risk mitigating factors. Off-balance sheet items, including foreign exchange contracts, interest rate contracts and other derivative contracts, are first converted to balance sheet credit-equivalent amounts by multiplying the nominal principal amount by a credit conversion factor. In addition, assets secured by certain types of pledges or guarantees are allocated the risk-weighting of the pledges or guarantors. Partially pledged or guaranteed loans receive such lower risk-weighting only on the portion of the loan that is pledged or guaranteed. The following table sets forth risk-weightings for different assets.

<u>Risk-Weighting</u>	<u>Assets</u>
0%	<ul style="list-style-type: none"> ● cash on hand ● gold ● claims on PRC incorporated commercial banks with an original maturity of four months or less ● claims on the PRC central government or deposits at the PBOC ● claims on the PBOC ● claims on PRC policy banks ● bonds issued by PRC financial asset management companies for the purpose of acquiring non-performing loans from state-owned banks ● claims on non-PRC central governments or central banks in countries or regions where the sovereign or region is rated AA- or above⁽¹⁾ ● claims on multilateral development banks
20%	<ul style="list-style-type: none"> ● claims on PRC incorporated commercial banks with an original maturity of more than four months ● claims on non-PRC commercial banks and securities companies incorporated in other countries or regions where the sovereign or region is rated AA- or above⁽¹⁾
50%	<ul style="list-style-type: none"> ● personal residential mortgages ● claims on PRC public-sector entities invested by the PRC central government ● claims on non-PRC public-sector entities invested by governments of countries or regions where the sovereign or region is rated AA- or above⁽¹⁾
100%	<ul style="list-style-type: none"> ● all other assets

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

Market Risk Capital

Since the first quarter of 2005, domestic banks with trading books greater than the lower of RMB8.5 billion and 10% of the bank's total on- and off-balance sheet assets are required to take into consideration market risk arising from trading activities when determining capital adequacy. Market risk capital refers to the capital reserve that a bank is required to maintain for the market risks relating to its assets. Market risk refers to the risk of losses in on- and off-balance sheet asset value arising from movements in market prices and includes risks relating to interest-rate sensitive financial instruments and securities under trading accounts, the foreign exchange risk and risks relating to the products of commercial banks.

Issuance of Subordinated Debt and Subordinated Bonds

Since November 26, 2003, pursuant to the Notice of Including the Fixed-term Subordinated Debt in the Supplementary Capital (關於將次級定期債務計入附屬資本的通知) issued by the CBRC, commercial banks have been permitted to issue fixed-term debt for which the repayment of the principal and interest is subordinated to the bank's other liabilities but is senior to the bank's equity capital. Commercial banks may include such fixed-term subordinated debt in the bank's supplementary capital. To qualify for inclusion in supplementary capital, the subordinated debt must have a minimum term of five years and the proceeds must not be used to offset a bank's operating losses. Subordinated debt can be issued only through private placements to certain legal person institutions. Moreover, subordinated debt cannot be issued to other commercial banks. The issuance of subordinated debt by commercial banks is subject to the approval of the CBRC.

Since June 17, 2004, commercial banks have been permitted to issue bonds which are subordinated to the bank's other liabilities but are senior to the bank's equity capital, according to the Measures for Administration on Issuance of Subordinated Bonds of Commercial Banks (商業銀行次級債券發行管理辦法) jointly issued by the PBOC and the CBRC. Commercial banks may, upon approval by the CBRC, include such subordinated bonds in the bank's supplementary capital. Subordinated bonds can be issued either in a public offering in the inter-bank bond market or in a private placement. Commercial banks may not hold an aggregate amount of subordinated bonds issued by other banks in excess of 20% of their core capital. The issuance of subordinated bonds by commercial banks is subject to the approval of the CBRC. The PBOC regulates the issuance and trading of subordinated bonds in the inter-bank bond market.

On December 12, 2005, the CBRC issued the Notice Regarding the Issuance of Hybrid Capital Bonds by Commercial Banks for the Replenishment of Supplementary Capital (關於商業銀行發行混合資本債券補充附屬資本有關問題的通知), permitting eligible commercial banks to issue hybrid capital bonds in the inter-bank market and include such bonds in their supplementary capital. The introduction of hybrid capital bonds in China opened a new channel for commercial banks to replenish their supplementary capital and improve their capital adequacy ratio.

CBRC Supervision of Capital Adequacy

The CBRC is responsible for supervising the capital adequacy of banking institutions in China. It reviews and evaluates banking institutions' capital adequacy through both on-site examination and off-site surveillance. Commercial banks are required to report to the CBRC their unconsolidated capital adequacy ratios on a quarterly basis and their consolidated capital adequacy ratios on a semiannual

basis. Commercial banks are classified into three categories based on their capital adequacy ratios as follows:

<u>Category</u>	<u>Capital Adequacy Ratio</u>		<u>Core Capital Adequacy Ratio</u>
Adequately capitalized banks	not less than 8%	and	not less than 4%
Undercapitalized banks	less than 8%	or	less than 4%
Significantly undercapitalized banks	less than 4%	or	less than 2%

If a bank is not in compliance with the capital adequacy requirement, depending on the degree of its undercapitalization, the CBRC may take various actions, including:

- issuing a supervisory notice letter;
- requiring the bank to submit and implement an acceptable capital restoration plan within two months;
- restricting asset growth;
- reducing higher-risk assets;
- restricting the purchase of fixed assets; and
- restricting dividends and other forms of distributions.

In addition, depending on the risk level of the bank and its implementation of the capital restoration plan, the CBRC may prohibit such bank from establishing new branches or launching new services or suspend the bank's entire business (except for low-risk activities).

The CBRC may require significantly undercapitalized banks to take further actions, including changes to senior management, transfer of control, restructuring of operations, or, in the most severe case, closure in accordance with relevant laws and regulations.

Basel Accords

Basel I was introduced by the Basel Committee in 1988. Basel I is a capital measure system for banks that provides for the implementation of a credit risk management framework with a minimum capital equivalent to at least 8% of the bank's risk-weighted assets. Since 1999, the Basel Committee has issued certain proposals for Basel II to replace Basel I. Basel II retains the key elements of Basel I, including the minimum capital requirement of 8%, but seeks to improve the capital framework through the introduction of three new "pillars." Pillar 1 seeks to improve the capital framework's sensitivity to the risk of credit losses generally by aligning capital requirements more closely to the level of credit risk presented by a bank's borrowers, introducing three different options for measuring credit risk based on external or internal credit risk ratings, and establishing an explicit capital charge for a bank's exposure to the risk of loss caused by operational failures. Pillar 2 introduces standards for the supervisory review of a bank's internal assessments of its overall risks. Pillar 3 seeks to subject banks to increased market discipline by enhancing the degree of transparency in public reporting. Basel II will be available for implementation in its entirety at the end of 2007.

The CBRC has advised that the New Capital Adequacy Regulations issued in February 2004 was based on Basel I while taking into consideration certain aspects of Basel II.

Loan Classification, Allowances and Write-offs

Loan Classification

Banks in China are currently required to classify loans under a five-category loan classification system based on the estimated likelihood of repayment of principal and interest. The five-category classification was initially promulgated by the PBOC in 1999 on a pilot basis and in 2002 banks were formally required to adopt it under the PBOC's Loan Classification Principles. The primary factors for evaluating the likelihood of repayment include the borrower's cash flow, financial condition and credit history. The table below sets forth the five categories and their corresponding definitions.

<u>Classification</u>	<u>Description⁽¹⁾</u>
Normal	Borrowers can honor the terms of their loans. There is no reason to doubt their ability to repay principal and interest in full on a timely basis.
Special mention	Borrowers currently are able to service their loans, although repayment may be adversely affected by specific factors.
Substandard	Borrowers' abilities to service their loans are in question as they cannot rely entirely on normal business revenues to repay principal and interest. Losses may ensue even when collateral or guarantees are enforced.
Doubtful	Borrowers cannot repay principal and interest in full and significant losses will need to be recognized even when collateral or guarantees are enforced.
Loss	Only a small portion of or no principal and interest can be recovered after taking all possible measures and exhausting all legal remedies.

(1) Banks are permitted to implement more detailed guidelines consistent with these definitions.

Loan Allowances

According to the Loan Classification Principles, a loan classified as substandard, doubtful or loss is considered to be non-performing, and commercial banks are required to make provisions based on a reasonable estimate of the probable loss on a prudent and timely basis. Allowance for impairment losses consists of general allowance, specific allowance and special allowance. General allowance refers to the allowance for all unidentified but possible losses, which are made based on certain percentages of the balance of total outstanding loans; specific allowance refers to the allowance made for specific losses in connection with an individual loan based on its categorization under the Loan Classification Principles; and special allowance refers to the allowance made for the risks specifically related to certain countries, regions, industries, or certain types of loans.

Under the Guidelines on Loan Loss Provisions, commercial banks are required to make provisions for impairment losses on a quarterly basis and to have a general allowance of not less than 1% of the total loans outstanding at December 31 of any year. The guidelines further provide guidance on the level of specific provisions as a percentage of the outstanding amount of loans for each loan category: 2% for special mention loans; 20%-30% for substandard loans; 40%-60% for doubtful loans and 100% for loss loans. Commercial banks may make special provisions in accordance with special risk factors (including risks in association with certain industries and countries), general loss rates and historical experience.

The PBOC issued a notice with the promulgation of the Guidelines on Loan Loss Provisions, permitting banks to increase (or decrease) their loan loss provisions gradually to meet the loan loss

provision requirement, but the requirement must be met no later than 2005. The Guidelines on Loan Loss Provisions further provide that banks are not permitted to distribute dividends if they do not have sufficient loan loss provisions.

CBRC Supervision of Loan Classification and Loan Allowances

Commercial banks are required to formulate detailed internal procedures that clearly define the responsibilities of each relevant department with respect to loan classification, approval, review and related matters. In addition, beginning in 2002, commercial banks have been required to submit quarterly and annual reports to the CBRC on the classification of their loan portfolios and their allowances for loan losses. Based on a review of these reports, the CBRC may require commercial banks to explain significant changes in loan classification and loan loss allowance levels, or may carry out further inspections.

In 2003, the CBRC published a circular that reiterated the implementation of the PBOC's Loan Classification Principles and provided additional guidance on loan classification criteria. The CBRC supervises and examines commercial bank's implementation of relevant guidelines on loan classification and loan allowances.

Loan Write-offs

Under the regulations issued by the PBOC and the MOF, commercial banks are required to establish a strict review and approval process to write off loan losses. In order to be written off, a loan needs to meet the standards set by the MOF. Losses realized upon writing off loans are deductible for tax purposes, but such deduction is subject to the review and approval of the tax authorities as to whether the loans written off were in compliance with the MOF's standards.

Allowance and Regulatory General Reserve for Impairment Losses

Pursuant to the Measures on Reserves for Risk-bearing Assets and a subsequent notice issued by the MOF, financial institutions in China are required to maintain adequate allowance for impairment losses against their assets. In addition, financial institutions are also required to set up a regulatory general reserve to cover potential impairment losses not yet identified. Financial institutions are required to assess the risk profile of their assets in determining the regulatory general reserve level, which in principle shall not be less than 1% of the aggregate amount of each financial institution's risk-bearing assets before allowance for impairment losses at the balance sheet date. Financial institutions are not allowed to make profit distribution to shareholders until adequate allowance for impairment losses and regulatory general reserve have been made. Financial institutions that cannot meet the requirement of maintaining adequate regulatory general reserve as stipulated in the MOF regulations at July 1, 2005 are required to take necessary steps to ensure that such requirement can be met in approximately three years, but in any case not more than five years, from July 1, 2005. At December 31, 2005, 1% of the aggregate amount of our risk-bearing assets before allowance for impairment losses amounted to RMB6.7 billion, and we have set aside RMB3.0 billion as regulatory general reserve. We plan to set aside additional amount in each of 2006 and 2007 as regulatory general reserve, with the goal of meeting this requirement by the end of 2007, within the grace period provided for by the MOF regulations.

Other Operational and Risk Management Ratios

The Core Indicators (Provisional) promulgated by the CBRC, which became effective on January 1, 2006, superseded the Examination Measures and Supervision Indicators Relating to the Administration of Assets and Liabilities Ratios of Commercial Banks (資產負債比例管理監控、監測指標和考核辦法) (the “Examination Measures”) issued by the PBOC in 1996. The Core Indicators (Provisional) amended certain liquidity and operating ratios required under the Examination Measures and introduced certain new ratios. The Core Indicators (Provisional) are implemented on a trial basis in 2006, and the CBRC has encouraged commercial banks to submit suggestions for amending the Core Indicators (Provisional) to the CBRC.

The following table sets forth the required ratios as provided in the Core Indicators (Provisional) and our ratios at June 30, 2006, which were calculated based on our unaudited balance sheet data prepared in accordance with PRC GAAP. Although the CBRC has not requested commercial banks to report these ratios, it has requested commercial banks to submit certain data that are used to calculate some of these ratios.

Risk Level	Primary Indicators	Secondary Indicators	Requirement	At June 30, 2006	
Risk Level					
Liquidity risk	Liquidity ratio ⁽¹⁾		≥ 25%	Renminbi	54.1%
				Foreign Currency	134.1%
	Core liabilities ratio ⁽²⁾		≥ 60%		46.60%
	Liquidity gap ratio ⁽³⁾		≥ (10%)		(74.94%)
Credit risk	Non-performing asset ratio ⁽⁴⁾		≤ 4%		1.21%
		Non-performing loan ⁽⁵⁾ ratio	≤ 5%		2.30%
	Credit concentration to a single group customer ⁽⁶⁾		≤ 15%		11.20%
		Loan concentration to a single customer ⁽⁷⁾	≤ 10%		9.70%
	Overall credit exposure to connected parties ⁽⁸⁾		≤ 50%		10.34%
Market risk	Cumulative foreign currency exposure ratio ⁽⁹⁾		≤ 20%		11.24%
Risk Cushion					
Profitability	Cost to income ratio ⁽¹⁰⁾		≤ 45%		37.95%
	Return on assets ⁽¹¹⁾		≥ 0.6%		0.72%
	Return on capital ⁽¹²⁾		≥ 11%		19.50%
Allowance adequacy	Allowance adequacy ratio for asset impairment ⁽¹³⁾		≥ 100%		unable to calculate ⁽¹⁴⁾
		Allowance adequacy ratio for loan impairment ⁽¹⁵⁾	≥ 100%		216.75%
Capital adequacy	Capital adequacy ratio ⁽¹⁶⁾		≥ 8%		8.36%
		Core capital adequacy ratio ⁽¹⁶⁾	≥ 4%		6.44%

(1) Calculated as follows: Liquidity ratio = Current assets/Current liabilities. Current assets include cash, gold, surplus deposit reserve, net inter-bank money market placement with maturities within one month, interest receivable and other receivables due within one month, qualified loans with maturities within one month, investment in debt securities with maturities within one month, debt securities that can be liquidated in the international secondary market any time and other liquid assets with maturities within one month (excluding the non-performing portion of such assets). Current liabilities include demand deposits (excluding policy deposits), time deposits with remaining

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maturities within one month (excluding policy deposits), inter-bank money market taking due within one month, issued debt securities with maturities within one month, interest payable and other payables due within one month, borrowings from the PBOC due within one month and other liabilities due within one month.

- (2) Calculated as follows: Core Liabilities ratio = Amount of core liabilities/amount of total liabilities. Core liabilities refer to the combined amount of time deposit with remaining maturities of three months or longer, issued debt securities and 50% of demand deposits. Total liabilities refer to total liabilities on the Assets and Liabilities table prepared under PRC GAAP.
- (3) Calculated as follows: Liquidity gap ratio = Liquidity gap/Amount of on- or off-balance sheet assets with maturities within 90 days. Liquidity gap refers to the amount of on- or off-balance sheet assets with maturities within 90 days subtracted by the amount of on- or off-balance sheet liabilities.
- (4) Calculated as follows: Non-performing asset ratio = Amount of non-performing assets/Amount of assets subject to credit risk. Non-performing assets include non-performing loans and other assets categorized as non-performing. The categorization of non-loan assets are in accordance with relevant CBRC regulations.
- (5) Calculated as follows: Non-performing loan ratio = Amount of non-performing loans/Amount of total loans. Non-performing loans refer to loans in the substandard, doubtful and loss categories according to the PBOC and CBRC's five-category loan classification system.
- (6) Calculated as follows: Credit concentration to a single group customer = Total credit granted to the largest group customer/Regulatory capital. Largest group customer refers to the group customer granted with the highest credit limit at the end of the period.
- (7) Calculated as follows: Loan concentration to a single customer = Total loans to the largest customer/Regulatory capital. Largest customer refers to the customer with the highest amount of loans outstanding at the end of the period.
- (8) Calculated as follows: Overall credit exposure to related parties = Total granted credit limit to all related parties/Regulatory capital. Related parties refer to parties defined in the Related Party Transactions Measures. Total granted credit limit to all related parties refers to total credit limit granted to such parties subtracted by cash deposit guarantees and collateral in the form of bank deposits and PRC government bonds.
- (9) Calculated as follows: Cumulative foreign currency exposure ratio = Amount of cumulative foreign currency exposure/Regulatory capital. Cumulative foreign currency exposure refers to interest sensitive foreign currency assets subtracted by interest sensitive foreign currency liabilities.
- (10) Calculated as follows: Cost to income ratio = Operating expenses (including amortization)/Operating income.
- (11) Calculated as follows: Return on assets = Net profit/Average balance of total assets for the period.
- (12) Calculated as follows: Return on capital = Net profit/Average balance of shareholders' equity for the period.
- (13) Calculated as follows: Allowance adequacy ratio for asset impairment = Actual amount of allowance for assets subject to credit risk/Required amount of allowance for assets subject to credit risk.
- (14) As the CBRC has not provided the required level of allowance for assets subject to credit risk other than loans, we were not able to calculate our ratio.
- (15) Calculated as follows: Allowance adequacy ratio for loan impairment = Actual amount of allowance for loans/required amount of allowance for loans.
- (16) See "— Supervision Over Capital Adequacy."

At June 30, 2006, we did not meet certain requirements set forth in the Core Indicators (Provisional), including the core liabilities ratio and liquidity gap ratio. At the same date, we were unable to calculate the allowance adequacy ratio for asset impairment because the CBRC had not specified the required level of allowance for assets subject to credit risk other than loans, which is necessary for calculating this ratio. As requested by the CBRC, we have provided our comments to the CBRC for its consideration in revising the regulation. According to the Core Indicators (Provisional), the CBRC may issue risk warning notices based on their analysis of the data submitted by the banks.

In addition, the Core Indicators (Provisional) defined certain other ratios without providing the regulatory requirement for those ratios, including ratios relating to interest rate risk sensitivity, operational risk and loan migration. The CBRC may provide the regulatory requirement for those ratios in the future.

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The following table sets forth, at the dates indicated, the required operational ratios for commercial banks in China according to the Examination Measures, as well as our ratios as reported to the PBOC and the CBRC, calculated in accordance with the formula under the PRC Commercial Banking Law and the Examination Measures and based on our balance sheet data prepared in accordance with PRC GAAP.

		At December 31,		
	Requirement	2003	2004	2005
		(in percentages)		
Liquidity ratios				
RMB current assets to Renminbi current liabilities	≥ 25.0	56.2	52.6	52.2
Foreign currency current assets to foreign currency current liabilities	≥ 60.0	75.4	71.7	90.4
Loan-to-deposit ratios				
Renminbi loans to Renminbi deposits	≤ 75.0	62.1	63.6	60.7
Foreign currency loans to foreign currency deposits	≤ 85.0	52.4	48.0	49.0
Borrower concentration ratios				
Total outstanding loans to one single borrower to regulatory capital	≤ 10.0	6.0	4.9	7.9
Total loans granted to top ten borrowers to regulatory capital	≤ 50.0	48.3	38.3	42.8
Inter-bank ratios				
Total RMB inter-bank borrowings from other banks and financial institutions to total RMB deposits	≤ 4.0	0.02	0.29	0
Total RMB inter-bank lending to other banks and financial institutions to total RMB deposits	≤ 8.0	2.70	0.70	1.08
Reserve ratios				
RMB reserve deposits with the PBOC plus RMB cash to RMB deposits	≥ 5.0	14.3	12.3	11.1
Foreign currency deposits with other financial institutions plus cash in foreign currencies to total foreign currency deposits	≥ 5.0	4.7	4.9	3.9

At December 31, 2005, we were not in compliance with the ratio of foreign currency deposits with other financial institutions plus cash in foreign currencies to total foreign currency deposits. The Examination Measures has been superseded by the Core Indicators (Provisional) at January 1, 2006 and this ratio is no longer required by the CBRC under the Core Indicators (Provisional). We have not been subject to any regulatory actions or penalties in the past due to non-compliance of the ratios set forth in the Examination Measures.

Corporate Governance

Corporate Governance

In accordance with the PRC Company Law, the PRC Commercial Banking Law and other relevant regulations, joint stock commercial banks are required to appoint at least two independent directors and the board of directors of such banks is required to establish a related party transactions committee, risk management committee and audit committee. Board of directors of banks with registered capital exceeding RMB1 billion is also required to establish a nomination committee, remuneration committee and strategy committee. In addition, commercial banks are required to establish a board of supervisors with at least two external supervisors.

Internal Controls

Under the Internal Control Guidelines for Commercial Banks (商業銀行內部控制指引) issued by the PBOC on September 18, 2002, commercial banks are required to establish internal controls to

ensure effective risk management for their business activities. Commercial banks are also required to establish a risk management department that formulates and implements risk management policies and procedures. In addition, banks are required to establish an internal audit department that can independently supervise and evaluate all aspects of their operations.

On December 25, 2004, the CBRC published the Trial Measures on the Evaluation of Internal Controls (商業銀行內部控制評價試行辦法), which set forth the procedures, measures and ranking standards for the CBRC's internal control evaluation of commercial banks. The CBRC can, based on its evaluation of the performance of commercial banks' internal control system, take various supervisory measures, such as interviewing the person in charge of internal control or the chairman of the board of directors, issuing warnings, and increasing the scope and frequency of on-site examinations. In the event of non-compliance with the Trial Measures on the Evaluation of Internal Controls, the CBRC may impose sanctions including, among others, request for a change of senior management, suspension of business, revocation of the practice license of persons involved, or delay of approval or not accepting applications for the establishment of new branch outlets or new business. Since February 2005, the CBRC has been conducting such evaluations periodically and has taken regulatory actions based on the results of its evaluations.

On June 27, 2006, the CBRC issued the Internal Audit Guidelines for Financial Institutions in the Banking Industry (銀行業金融機構內部審計指引), which became effective on July 1, 2006. Pursuant to the guidelines, banks are required to establish an audit committee of the board of directors with at least three members, a majority of whom must be non-executive directors. Banks are also required to have an internal audit department with employees who meet certain qualifications, which shall in principle represent 1% of the bank's total number of employees. The guidelines set forth the required scope of the internal audit. Banks are required to evaluate the risk of each business unit at least once per year and conduct internal audit of each business unit at least once every two years. The number of employees we assign to internal audit is based on our risk management needs. We are currently not in compliance with the 1% requirement set forth in the guidelines. The guidelines do not specify any penalties or disciplinary measures for non-compliance with this requirement. We are in the process of increasing the number of our internal audit employees to meet this requirement, and the directors confirm that this non-compliance will not have a material adverse effect on our business or financial condition.

Disclosure Requirements

Under the Provisional Measures on Information Disclosure of Commercial Banks (商業銀行信息披露暫行辦法) issued by the PBOC on May 15, 2002, commercial banks with total assets of RMB1.0 billion or more or deposits of RMB500 million or more are required to publish financial statements audited by qualified accounting firms in their annual reports. In addition, such banks are required to disclose information relating to its risk management, corporate governance, ten largest shareholders, related party transactions and other significant information relating to the bank during the relevant fiscal year. The annual reports are required to be published within four months after each fiscal year.

Transactions with Related Parties

In April 2004, the CBRC promulgated the Related Party Transactions Measures, which provided more stringent and detailed requirements on related party transactions of commercial banks. The measures require commercial banks to adhere to the principles of honesty and fairness in

conducting related party transactions. Commercial banks are not allowed to grant unsecured loans to related parties or to grant secured loans to such persons on terms more favorable than those offered to other borrowers.

In accordance with the Related Party Transactions Measures, related parties include, among others, (i) shareholders holding 5% or more of the bank's outstanding shares; (ii) legal persons or other organizations under direct or indirect common control with the bank; (iii) such legal persons' or organizations' individual controlling shareholders, directors and key officers; (iv) directors, senior management, loan officers and their respective close relatives, and organizations in which the above persons have investments or serve as executive officers; and (v) other individuals, legal persons or other organizations that have direct, indirect or joint control over the commercial banks or that may exert significant influence over them.

Pursuant to the Related Party Transactions Measures, transactions with related parties include, among other things, credit extensions, asset transfers, and provision of services. Such transactions are required to be reported to the CBRC and published in the annual reports, if required, of the commercial banks. Commercial banks are required to adopt appropriate policies and procedures to manage related party transactions and to establish a committee of the board of directors to supervise the implementation of, and compliance with, such policies and procedures.

Transactions with related parties are subject to certain limitations. For example, when a related party transaction involves an amount exceeding 1% of the bank's regulatory capital, or when a related party transaction will cause the total outstanding value of transactions with that related party to exceed 5% of the bank's regulatory capital, the transaction must be reviewed by the bank's related party transactions committee, approved by its board of directors and reported to its board of supervisors and to the CBRC within ten business days after such board approval. Any related party transaction that does not exceed the threshold level has to be reviewed and approved according to the bank's internal authorization procedure and submitted to its related party transactions committee for filing or approval.

In addition, commercial banks may not extend credit secured by the bank's own equity. They may not provide security for the financing activities of related parties, unless such related parties provide adequate security in the form of deposit certificates and treasury bonds as a counter-collateral. If a commercial bank suffers a loss from loans granted to a related party, it may not provide loans to that related party in the next two years except as otherwise approved by the board of directors. Moreover, a related party transaction may not be resubmitted for consideration within six months after it has been rejected. The total credit facilities granted to a single related party may not exceed 10% of the commercial bank's regulatory capital, and the total credit facilities granted to all affiliates of a related party may not exceed 15% of the bank's regulatory capital. The aggregate amount of credit facilities granted to all related parties of a bank may not exceed 50% of the bank's regulatory capital.

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

Risk Management

Since its inception, the CBRC has published numerous risk management guidelines and rules in an effort to improve risk management of Chinese commercial banks. For example, CBRC published guidelines in an effort to control credit risk relating to real estate loans, loans to group borrowers, automobile loans and derivatives transactions. See “— Regulation of Principal Commercial Banking Activities.” The CBRC also promulgated the Core Indicators (Provisional) as a basis for applying risk supervision on commercial banks. The CBRC established requirements for certain ratios relating to risk level and risk cushion in the Core Indicators (Provisional) and is expected to establish requirements for certain ratios relating to risk migration. The Core Indicators (Provisional) serve as the framework for evaluating and monitoring the risks of commercial banks. See “— Other Operational and Risk Management Ratios.” The CBRC periodically collects data through off-site surveillance to analyze such indicators, and evaluate and give early warnings of the risks in a timely manner. The CBRC also published regulations concerning operational risk management, market risk management and risk rating.

Operational Risk Management

On March 22, 2005, the CBRC issued the Circular on Strengthening Control of Operational Risk (關於加大防範操作風險工作力度的通知) to further strengthen commercial banks’ ability to identify, manage and control operational risk. Under this circular, commercial banks are required to establish internal policies and procedures specifically for the management and control of operational risk. A bank’s internal audit department and business operations departments are required to conduct independent and ad hoc reviews and examinations of the bank’s business operations from time to time, and ongoing reviews and examinations for business areas involving a greater degree of operational risk. Moreover, a commercial bank’s head office is required to assess the implementation of and compliance with its internal policies and procedures on operational risk.

In addition, the circular sets forth detailed requirements relating to, among other things, establishing a system through which branch officers in charge of business operations are required to rotate on a regular basis; establishing a system to encourage full compliance with applicable regulations and internal rules and policies by all employees; improving the timely reconciliation of the account statements between commercial banks and their customers and those between the operational departments and accounting departments; segregating persons in charge of account-keeping from those in charge of account reconciliation; and establishing a system to strictly control and manage specimen signatures and banking transaction documents.

Market Risk Management

On December 29, 2004, the CBRC promulgated the Guidelines on Market Risk Management of Commercial Banks (商業銀行市場風險管理指引), which became effective on March 1, 2005, to strengthen the market risk management of commercial banks. These guidelines address, among other things, (1) the responsibilities of the board of directors and senior management in supervising market risk management, (2) policies and procedures for market risk management, (3) the detection, quantification, monitoring and control of market risk, and (4) responsibilities for internal controls and conducting external audits.

Under these guidelines, commercial banks are required to establish formal written policies and procedures to manage market risk. These policies and procedures must cover, among other things:

- permitted business activities, such as the trading of and investment in certain financial instruments;
- market risk appetite of the bank;
- the organizational structure for market risk management;
- procedures for the detection, quantification, monitoring and control of market risk; and
- an information system for market risk management.

Risk Rating System

All joint stock commercial banks in China are subject to evaluation by the CBRC based on a provisional risk rating system. Under this system, capital adequacy, asset quality, management quality, profitability, liquidity and exposure to market risk of joint stock commercial banks are evaluated and scored by the CBRC on a continuous basis. Each bank is classified into one of five risk rating categories based on the scores. The CBRC's supervisory activities in respect of a certain bank, including the frequency and scope of its on-site examinations, depend on such bank's risk rating category. The risk rating also forms the basis for the CBRC's evaluation of a bank's applications for new business licenses and the evaluation of its senior management. These risk ratings are currently not publicly available.

Ownership and Shareholder Restrictions

Regulations on Equity Investment in Banks

Any natural or legal person intending to acquire 5% or more of the total equity interest of a commercial bank is required to obtain the prior approval of the CBRC. If any existing shareholder of a commercial bank increases its shareholding in excess of the 5% threshold without obtaining the CBRC's prior approval, that shareholder will be subject to CBRC sanctions, which include, among others, rescission of the acquisition and disgorgement of profits, if any. Furthermore, the bank and the relevant shareholder may also be subject to fines imposed by the CBRC for not obtaining the prior approval from the CBRC.

Under the Administrative Measures on Equity Investments of Overseas Financial Institutions in Domestic Financial Institutions (境外金融機構投資入股中資金融機構管理辦法), certain foreign financial institutions may make equity investments in domestic commercial banks, subject to the CBRC's approval. However, no single foreign financial institution may own 20% or more of the equity of such a bank. In addition, if foreign investment in the aggregate exceeds 25% of the total equity interest in a non-listed domestic commercial bank, such bank will be regulated as a foreign-invested commercial bank. A listed domestic commercial bank is regulated as a domestic bank even if foreign investment in the aggregate exceeds 25% of its total equity interest.

Shareholder Restrictions

The Corporate Governance Guidelines impose certain additional requirements on shareholders of China's joint stock commercial banks. For example:

- in the event that a commercial bank encounters liquidity problems, its shareholders are required to immediately repay outstanding loans due and repay in advance outstanding loans not yet due from the bank;
- if a commercial bank fails to meet the required capital adequacy ratios, its shareholders are obligated to support measures determined by the bank's board of directors that are aimed at increasing the capital adequacy level; and
- if shareholders of a commercial bank fail to repay outstanding loans when due, their voting rights will be restricted for the period during which the relevant loan is overdue.

In addition, the PRC Company Law and relevant PBOC rules and regulations impose certain restrictions on the ability of a commercial bank's shareholders to pledge their shares. For example, a joint stock commercial bank may not accept its own shares as collateral.

Anti-money-laundering Regulation

Pursuant to the PBOC's anti-money-laundering regulations issued in 2003, commercial banks are required to establish an internal anti-money-laundering procedure. Commercial banks are also required to either establish an independent anti-money-laundering department or designate a relevant department to implement their anti-money-laundering procedure and report the same to the PBOC. In addition, commercial banks are required to establish a system to record the identities of all customers and their respective deposits, settlement and other transactions with the bank. Upon the detection of any suspicious transactions or transactions involving large amounts, commercial banks are required to report the transactions to the PBOC or the SAFE, as applicable. Where necessary and pursuant to appropriate judicial proceedings, commercial banks are required to cooperate with government authorities in preventing money laundering activities and in freezing assets. The PBOC supervises and conducts on-site examinations of commercial banks' compliance with its anti-money-laundering regulations, and may impose penalties for any violations thereof. Currently, the PRC authorities are drafting the Anti-money-laundering Law, which could impose further anti-money-laundering obligations on banks in China.

Regulation of Foreign-invested Banking Institutions Operating in China

Currently, foreign financial institutions meeting the minimum total asset value requirement may establish branches, joint venture banks or wholly owned banks in China. Such branches, joint venture banks or wholly owned banks must satisfy requirements on minimum operational funds and registered capital. Foreign-invested financial institutions currently can provide foreign currency services in the PRC without geographic and client restrictions. With respect to the Renminbi business, foreign-invested commercial banks, upon approval, may provide services to corporate customers and non-Chinese nationals in 25 cities. By December 2006, any existing measures restricting the geographic presence, customer base and operational licenses of foreign banks operating in China, including restrictions on establishing new branches, are required to be eliminated under China's WTO commitments.

Other Requirements

Use of Funds

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

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

PRC SECURITIES LAWS AND REGULATIONS

As our A Shares have been listed on the SHSE since April 2002, we are subject to PRC Securities Law and the Shanghai Listing Rules. The Shanghai Listing Rules regulate share listing and information disclosure by the listed companies, including us, and seek to maintain the orderly operation of the stock exchange market and protect the interests of the investors. As a company with A Shares listed on the SHSE, we are subject to a number of obligations under the Shanghai Listing Rules, including:

- publishing annual, semiannual and quarterly reports;
- disclosing all information that may have a material impact upon our share price;
- making announcements in relation to certain corporate matters; and
- appointing a secretary to the Board of Directors, who is responsible for, among other things, certain corporate administration matters and information disclosure matters.

In addition, as a domestic publicly listed commercial bank, we are required to disclose our financial information based on both PRC GAAP and IFRS in our annual report.

We are also subject to a number of PRC laws governing the securities markets. The CSRC is responsible for drafting regulatory provisions governing securities markets, supervising securities companies, regulating public offerings of securities by public PRC companies, and regulating trading of securities. For example, a listed company is prohibited from using insider information in connection with the issue of or trading in securities. A company that has securities listed in China and overseas must also simultaneously disclose material information to the investing public pursuant to both the laws and regulations of China and the applicable laws and regulations of the other market in which such company's securities are listed. Further information is set forth in the section headed "Appendix IX — Summary of Principal Legal and Regulatory Provisions."

REGULATION AND SUPERVISION OF OUR OVERSEAS OPERATIONS

Hong Kong

We operate in Hong Kong, through our Hong Kong branch, as a licensed bank subject to the Banking Ordinance and the regulation of the HKMA. In addition, our subsidiary, CMBI, is licensed by the SFC to conduct Type 1 (dealing in securities) and Type 6 (advising on corporate finance) activities pursuant to the SFO.

The principal function of the HKMA is to promote the general stability and effectiveness of the banking system in Hong Kong. The HKMA is responsible for supervising compliance with the provisions of the Banking Ordinance and also supervises compliance with the HKMA guidelines, and legislation promulgated by the SFC. The HKMA has responsibility for regulating banking institutions and granting banking licenses, and has discretion to attach conditions to a bank's operating license. The HKMA requires every authorized institution to implement a comprehensive risk management system to identify, measure, monitor and control the various types of risks relating to its activities and, where appropriate, to hold capital to cover those risks.

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

The HKMA introduced its loan classification guidelines in 1994, which were further updated in 1999. The HKMA loan classification guidelines also employ a five-category classification system (*i.e.*, pass, special-mention, substandard, doubtful and loss). The HKMA five-category classification system is substantially similar to the five-category system under the PBOC's Loan Classification Principles. However, differences do exist between the HKMA five-category system and that of the PBOC's Loan Classification Principles. For example, the period of time for which the loan is overdue is a determining factor under the HKMA loan classification guidelines, but not under the PBOC's Loan Classification Principles.

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

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

New York

We currently maintain a U.S. representative office in New York, and we plan to convert such office into a New York State licensed branch, which requires approval of both the Board of Governors of the Federal Reserve System and the New York State Banking Department.

HONG KONG FINANCIAL DISCLOSURE REQUIREMENTS

Pursuant to Rule 4.10 of the Hong Kong Listing Rules, the financial information to be disclosed in our Accountants' Report must be in accordance with best practice, which at the minimum is that required to be disclosed in respect of specific matters in the accounts of a company under the Companies Ordinance, IFRS, the Banking Ordinance, and guidelines issued by the HKMA, namely "Financial Disclosure by Locally Incorporated Authorized Institutions" and "New Hong Kong Accounting Standards: Impact on Interim Financial Disclosure" ("the Guidelines").

We are currently unable to provide certain disclosures required by the Guidelines as described below because such information is currently not available. We believe that the financial disclosures which we are currently unable to provide are immaterial to potential investors of the Global Offering. However, we are endeavoring to collect the relevant information so that we will be in a position to provide such required disclosures under the Guidelines within a reasonable time in the future, as outlined below. We have applied for, and the Hong Kong Stock Exchange has granted, a waiver from strict compliance with the requirement under Rule 4.10 of the Hong Kong Listing Rules to the extent that our disclosure does not fully comply with the Guidelines and the Companies Ordinance.

The Guidelines require separate disclosure of the movements in the allowance for loan impairment losses for individually assessed loans and for collectively assessed loans. We did not break down the movements in the allowance for loan impairment losses into allowances for individually assessed loans and collectively assessed loans, and, in lieu of that, we have disclosed the movements on an aggregate basis in Note 17(c) to the consolidated financial statements included in the Accountants' Report in Appendix I to this prospectus. We expect to be able to make disclosure according to the separate categories by the end of 2008.

The Guidelines also require separate disclosure of the charge and release of provisions for individually assessed loans and for collectively assessed loans. We did not break down the charge and release of provisions for individually assessed loans and collectively assessed loans, and, in lieu of that, we have disclosed the charge and release of provisions on an aggregate basis in Note 17(c) to the consolidated financial statements included in the Accountants' Report in Appendix I to this prospectus. We have applied for and the Hong Kong Stock Exchange has granted a waiver from strict compliance with the disclosure of the charge and release of provisions separately for collectively assessed and individually assessed loans in the period as required by the Guidelines. We expect to be able to make disclosure according to the separate categories by the end of 2008.

Paragraph 13(1)(g) of Tenth Schedule to the Companies Ordinance requires separate disclosure of interest income from listed and from unlisted investments. We did not segregate the amount of interest income as such, and in lieu of that, we disclosed the total amount of interest income from investment in Note 3 to the consolidated financial statements included in the Accountants' Report in Appendix I to this prospectus. We expect to be able to make disclosure according to the separate categories by the end of 2008.