Management Discussion and Analysis

1. OPERATION OVERVIEW

In 2006, the Group successfully achieved all of its yearly performance targets and brought its scale of operation and profitability to new heights. As of 31 December 2006, the Group's total assets was RMB1,719.483 billion, representing an increase of 20.80% as compared with the beginning of the year. The Group realized a net profit of RMB12.274 billion, representing an increase of 32.71% compared to the previous year. Return on assets reached 0.71% and return on shareholders' equity reached 13.57%, representing an increase of 0.06 percentage points and 2.44 percentage points, respectively, as compared with the previous year. Return on average assets was 0.78% and return on average shareholders' equity reached 14.15%, representing an increase of 0.06 percentage points and 0.47 percentage points, respectively, compared to the previous year. Net interest spread was 2.70%, representing an increase of 12 basis points from the previous year. Net interest margin was 2.75%, representing an increase of 11 basis points over last year. Impaired loan ratio was 2.53%, representing a decrease of 0.27 percentage points compared to the beginning of the year. Provision coverage reached 72.83%, representing an increase of 14.44 percentage points, as compared with the beginning of the year. Capital adequacy ratio and Tier-1 capital adequacy ratio were 10.83% and 8.52%, respectively, representing a decrease of 0.37 percentage points and 0.26 percentage points, respectively, as compared with the beginning of the year.

2. FINANCIAL RESULTS

The Group continued to strengthen its management foundation. Operating profitability increased steadily and the cost to income ratio remained under effective control. Return on assets and return on shareholders' equity also saw continuous growth.

(1) Operating profit before tax

For the year ended 31 December 2006, operating profit before tax was RMB17.405 billion, representing an increase of RMB4.562 billion or 35.52% over the last year. The primary sources of operating profit before tax were net interest income and net fee and commission income.

The table below shows certain information of the Group's operating profits before tax for the periods indicated:

	31 December 2006 Amount	31 December 2005 Amount
	(in millions of RMB)	
Net interest income	**39,803**	31,591
Net fee and commission income	**2,873**	2,109
Impairment losses on loans and advances	**(5,538)**	(4,298)
Operating profit before tax	**17,405**	12,843

2. FINANCIAL RESULTS *(Continued)*

(2) Net interest income

For the year ended 31 December 2006, the Group realized a net interest income of RMB39.803 billion, representing an increase of RMB8.212 billion or 25.99% as compared with the previous year.

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

	As of 31 December	
	2006	2005
	(in millions of RMB, except percentages)	
Interest income		
Balances with central banks	**2,096**	1,815
Due from other banks and financial institutions	**6,141**	3,375
Trading securities	**—**	9
Loans and advances to customers	**45,321**	36,305
Investment securities	**10,855**	8,114
Others	**130**	62
Total interest income	**64,543**	49,680
Interest expense		
Due to other banks and financial institutions	**(3,548)**	(1,548)
Due to customers	**(21,192)**	(16,541)
Total interest expense	**(24,740)**	(18,089)
Net interest income	**39,803**	31,591
Net interest spread(1)	**2.70%(3)**	2.58%
Net interest margin(2)	**2.75%(3)**	2.64%

Notes:

(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.

(3) This eliminates the impact of wealth management products.

Net interest spread and net interest margin increased slightly as compared with the previous year. The increase was mainly due to: (1) the loan structure adjustment so that among the total customer loans, the discounted bills decreased whereas the mid and short term loans increased; (2) the two time revision of benchmark interest rate by the People's Bank of China during the year. Such revision is favorable to the increase in return on loans, thus resulting in an increase of 32 basis points from the previous year; and (3) a significant increase in market interest rate of US dollars as compared to the last year, leading to an increase in the return on the relevant assets.

2. FINANCIAL RESULTS *(Continued)*

(2) Net interest income *(Continued)*

The table below shows the average daily balances and the interest rates of the Group's interest-earning assets and interest-bearing liabilities for the dates indicated:

	As of 31 December					
	2006			2005		
	Average balance[1]	**Interest income (expense)**	**Average Yield/ (cost)**	Average balance[1]	Interest income (expense)	Average yield/cost
	(in millions of RMB, except percentage)					
Assets						
Cash and balances with central banks	**146,190**	**2,096**	**1.43%**	125,179	1,815	1.45%
Due from other banks and financial institutions	**142,158**	**6,141**	**4.32%**	112,776	3,375	2.99%
Loans and advances to customers	**818,166**	**45,321**	**5.54%**	694,903	36,305	5.22%
Investment securities and others	**351,993**	**10,985**	**3.12%**	265,921	8,185	3.08%
Total interest-earning assets	**1,446,109[2]**	**64,005[2]**	**4.42%**	1,198,779	49,680	4.14%
Non interest-earning assets	**71,814**			50,988		
Total assets	**1,517,923[2]**			1,249,767		
Liabilities and Shareholders' equity						
Due to customers	**1,303,524**	**21,192**	**1.63%**	1,095,578	16,541	1.51%
Due to other banks and financial institutions	**100,215**	**2,974**	**2.97%**	51,793	991	1.91%
Subordinated bonds	**12,000**	**574**	**4.78%**	12,210	557	4.56%
Total interest-bearing liabilities	**1,403,341[2]**	**24,202[2]**	**1.72%**	1,159,581	18,089	1.56%
Shareholders' equity and non interest-bearing liabilities	**114,582**			90,186		
Total liabilities and shareholders' equity	**1,517,923[2]**			1,249,767		

Notes:

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

(2) This eliminates the impact of wealth management products.

2. FINANCIAL RESULTS *(Continued)*

(2) Net interest income *(Continued)*

The table below shows the changes in the Group's interest income and interest expenses due to changes in transaction volume and interest rates. Transaction volume and interest rate variances 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.

	2006 vs. 2005 Increase/(decrease) due to			2005 vs. 2004 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	**305**	**(24)**	**281**	221	(261)	(40)
Due from other banks and financial institutions	**879**	**1,887**	**2,766**	333	811	1,144
Loans and advances to customers	**6,434**	**2,582**	**9,016**	6,053	1,965	8,018
Investment securities and other interest-earning assets	**2,651**	**149**	**2,800**	2,442	(236)	2,206
Change in interest income	**10,269**	**4,594**	**14,863**	9,049	2,279	11,328
Interest-Bearing Liabilities						
Due to customers	**3,140**	**1,511**	**4,651**	2,048	2,462	4,510
Due to other banks and financial institutions	**925**	**1,058**	**1,983**	325	(188)	137
Subordinated bonds	**(10)**	**27**	**17**	274	8	282
Changes in interest expenses	**4,055**	**2,596**	**6,651**	2,647	2,282	4,929

2. FINANCIAL RESULTS *(Continued)*

(3) Net Fee and Commission Income

The Bank launched "Bocom Pacific-Walmart credit card" jointly with Walmart Stores, the largest global retailer.

For the year ended 31 December 2006, the Group achieved a net fee and commission income of RMB2.873 billion, representing an increase of RMB0.764 billion or 36.23% compared to the previous year. The increase was primarily due to the following reasons: (1) the Pacific Credit Card business recorded simultaneous increases in card volume and consumption per card, giving rise to a robust growth in the card business income. Transaction volume of and revenue from international settlement increased significantly; (2) In 2006, the Bank underwrote thirteen short-term financing bonds. For the year ended 31 December 2006, the commission income of underwriting business amounted to RMB88.44 million, representing an increase of 215% over the previous year. The total market share of the Group was 10.95%, ranked fourth in the country. (3) For the year ended 31 December 2006, the value of assets under custody increased by 24% compared to the previous year, giving rise to an income from custodian business of RMB143 million, representing an increase of 23% from the previous year.

(4) Other operating expenses

For the year ended 31 December 2006, the other operating expenses of the Group amounted to RMB20.895 billion, representing an increase of RMB2.883 billion or 16.01% from the previous year.

The cost-to-income ratio of the Group continued its descending trend: from 51.24% in the previous year to 47.66% as of the end of the Reporting Period, representing a decrease of 3.58 percentage points. The decrease was mainly due to a substantial increase in operating income by 24.71%, which exceeded the 16.01% increase in operating expenses. A series of cost control measures also attributed to this satisfactory result.

(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 the provision for balances due from other banks and financial institutions as well as securities purchased under resale agreements.

The impairment losses on loans and advances increased from RMB4.298 billion in the previous year to RMB5.538 billion in the Reporting Period. The credit cost ratio reached 0.60%, representing an increase of 0.04 percentage points.

2. FINANCIAL RESULTS *(Continued)*

(6) Income tax

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

	As of 31 December	
	2006	2005
	(in millions of RMB)	
Current Tax	**7,139**	927
Deferred Tax	**(2,003)**	2,673

For the period ended 31 December 2006, the Group and its subsidiaries which were established in the PRC were subject to the PRC statutory tax rate of 33%. The Group's Hong Kong branch and its subsidiaries in Hong Kong were subject to a tax rate of 17.5% for the period ended 31 December 2006. The Group's other overseas branches were subject to the income tax rates of the respective jurisdictions where they are located.

3. ASSETS

As of 31 December 2006, the Group's total assets amounted to RMB1,719.483 billion, achieving an increase of RMB296.044 billion, or 20.80% from the previous 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 52.94%, 22.56%, 6.90% and 14.77%, respectively of the Group's total assets.

(1) Loan business

In response to China's macroeconomic reform policy, the Group made great efforts in maintaining the growth of the loan business within a sustainable scale at a moderate pace, restructuring the loan portfolio and diverging from the relatively less profitable bill discounting business. As of 31 December 2006, the Group's total outstanding loans and advances to customers (before provision and after interest, similarly hereinafter unless otherwise stated) amounted to RMB927.405 billion, representing an increase of RMB156.031 billion or 20.23% from the beginning of the year; while the loans to deposits ratio (excluding any interest receivable and interest payable) reached 65.52%, achieving an increase of 2.07 percentage points from the beginning of the year. The customers loans other than discounted bills became the major component contributing to the surge of loans and advances to customers. Such loans increased by RMB143.356 billion or 20.23% from the beginning of the year and accounted for 91.88% of the increase in the total loans and advances to customers. The balance of discounted bills increased by RMB11.929 billion or 19.60% from the beginning of the year, contributing to 7.65% of the increase in the total loans and advances to customers.

3. ASSETS *(Continued)*

(1) Loan business *(Continued)*

(i) *Loan concentration by industries*

The Group has effectively managed industry risk, by adjusting policy on loan portfolio, strengthening industry-specific guidance, refining the loan concentration by industries and maintaining a sustainable loan portfolio. The Group's loan portfolio covered a wide spectrum of industries, with relative concentration in manufacturing, trading, real estate, transportation and public utilities. Of such industries, loans to the manufacturing industry recorded a net increase of RMB30.386 billion over the beginning of the year and accounted for 25.96% of the total loans and advances to customers, representing a decrease of 1.31 percentage points compared to the beginning of the year. Loans to the trading industry recorded a net increase of RMB8.968 billion over the beginning of the year and accounted for 8.84% of the total loans and advances to customers, representing a decrease of 0.62 percentage points compared to the beginning of the year. Loans to the real estate industry recorded a net increase of RMB5.049 billion over the beginning of the year and accounted for 7.11% of the total loans and advances to customers, representing a decrease of 0.79 percentage points compared to the beginning of the year. Loans to the transportation and public utilities sectors recorded a net increase of RMB40.968 billion over the beginning of the year and accounted for 16.86% of the total loans and advances to customers, representing an increase of 1.91 percentage points compared to the beginning of the year.

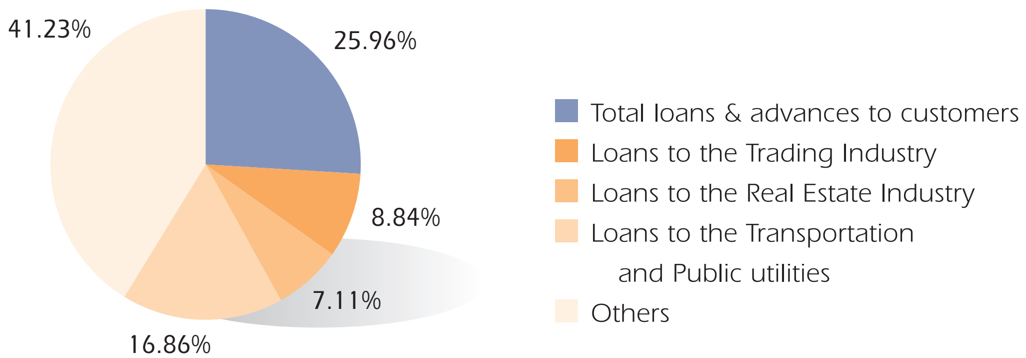
(ii) *Borrower concentration*

Under the existing PRC banking regulations, the total outstanding credit exposure to a single group customer must not exceed 15% of the net regulatory capital of a bank whereas the total outstanding loans to a single borrower shall not exceed 10% of the net regulatory capital of a bank. The Group currently complies with these regulatory requirements.

(iii) *Loan concentration by geographical locations*

The Group's loans and advances to customers concentrated in the Yangtze River Delta, the Bohai Rim Economic Zone and the Pearl River Delta regions. Loans to borrowers from the above regions accounted for 64.26% of the total loans and advances to customers outstanding (excluding interest receivable) as of 31 December 2006.

Loan Business



3. ASSETS *(Continued)*

(1) Loan business *(Continued)*

(iv) *Loan Quality*

The Group continued to enhance asset risk management to maintain stable loan quality. Supervision efficiency significantly improved as a result of the following measures: having regular meetings for key risk projects; establishing and operating a centralized and inter-departmental asset risk management system; launching the "Qianliyan Economic Intelligence System" as a risk monitoring system; and expanding the scope of the risk monitoring system to the three main areas including credit risk, market risk and operational risk. As of 31 December 2006, the impaired loan ratio was 2.53%, down by 0.27 percentage points as compared with the percentage as of the end of the previous year; credit-cost ratio was 0.60%, up by 0.04 percentage points as compared with the ratio as of the end of the previous year; and the provision coverage of impaired loans has increased from 58.39% at the end of last year to 72.83%. Taking into account the statutory and general reserves of RMB4.428 billion, the Group's provision coverage of impaired loans stood at 91.69%. According to the methods of computation adopted by the PRC regulatory authorities, the Group's provision coverage of non-performing loans at the end of Reporting Period reached 114.69%.

Impaired loan is a concept defined under the International Financial Reporting Standards. A loan is impaired if there is objective evidence that not all amounts due would be recovered under the original contract terms of such loan.

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

	31 December 2006	31 December 2005
	(in millions of RMB, except percentage)	
Individually identified impaired loans	**23,477**	21,579
Loans overdue by 90 days or more	**18,369**	17,267
Loans with impairment to gross loans balance (percentage)	**2.53%**	2.80%

The Group monitors the quality of its loan portfolio in accordance with the five- category loan classification guidelines prescribed by the People's Bank of China. Pursuant 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)*

(iv) *Loan Quality (Continued)*

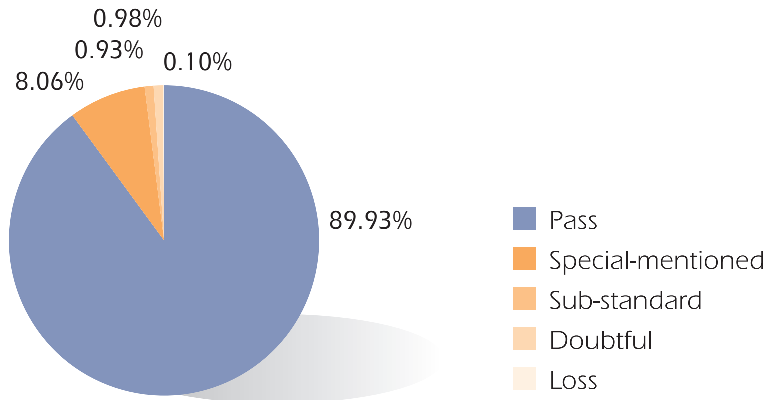
The table below sets forth the five-category loan classification of the Group's loan balance as of the dates indicated:

	31 December 2006		31 December 2005	
	Amount	**% of Total**	Amount	% of Total
	(in millions of RMB, except percentage)			
Pass	**807,023**	**89.93%**	652,653	85.52%
Special-mentioned	**72,303**	**8.06%**	92,473	12.11%
Sub-standard	**8,358**	**0.93%**	9,770	1.28%
Doubtful	**8,787**	**0.98%**	7,935	1.04%
Loss	**889**	**0.10%**	363	0.05%
Percentage of non-performing loans to gross loan balance		**2.01%**		2.37%

(v) *Borrowers' Structure*

Over the recent years, the Group strives to optimize its credit structure through geographical, industrial, clientele and business diversity. Targeting at prominent enterprises in quality industries located at key regions, the Group implemented various measures such as enhancement of credit policy, provision of more guidance to front line personnel and improvement of quality and efficiency of customer sales and marketing services in order to optimize the customer structure. As of 31 December 2006, corporate customers of the Group's domestic institutions were classified based on the 10-class credit rating system. Compared to the beginning of the year, the proportion of outstanding loans to class 1 to class 5 high quality customers increased by 4.30 percentage points to 71.90% while those of class 6 to class 7 customers decreased by 6.10 percentage points to 20.60%, and those of class 8 to class 10 high risk customers decreased by 0.20 percentage points to 2.20%. Credit business for small enterprises improved significantly, as a result of product innovation and operational improvement. The launch of the new product "Zhanye Tong" (展業通), the design and development of our small enterprise credit rating assessment score card, and the enhancement of small enterprise credit process, altogether contributed to the growth in this business segment. As of 31 December 2006, total loan outstanding to domestic small enterprises increased by 27.70% compared to the previous year.

The Operating Results of each
of the Bank's Business Segment



3. ASSETS *(Continued)*

(2) Treasury operation

The Group strengthened its fund management business. It deployed non-credit assets, taking into consideration the liquidity and security of these assets. In addition, the Group carried out innovations in treasury products and improved its profit position in the treasury operation. As of 31 December 2006, the Group's average balance of investment securities amounted to RMB351.993 billion, representing an increase of RMB86.072 billion or 32.37% from the previous year. This increase was higher than the growth rate in balances with central banks and other banks, thereby enhancing the future profitability of the Group's assets.

As of 31 December 2006, the Group ranked fifth in the RMB money market in terms of the aggregate transaction amount. It continues to maintain an active trading market position.

4. LIABILITIES

As of 31 December 2006, the total liabilities of the Group amounted to RMB1,628.988 billion, representing an increase of RMB288.695 billion or 21.54% from the previous year. The amount due to customers represented 87.19% of the Group's total liabilities. The principal sources of funds were 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 17.58% and 12.14%, respectively, thereby providing a stable source of funds for loan and investment business.

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

	31 December 2006	31 December 2005
	(in millions of RMB)	
Corporate deposits	**755,719**	642,735
in which: Corporate current deposits	**457,839**	407,228
Corporate savings deposits	**5,878**	4,232
Corporate time deposits	**292,002**	231,275
Individual deposits	**488,599**	435,718
in which: Individual current deposits	**185,521**	162,757
Individual savings deposits	**14,182**	9,725
Individual time deposits	**288,896**	263,236

5. GEOGRAPHICAL SEGMENTS

(1) Segmental operating results by geographical segments

A geographical segment refers to a specific economic environment under which the Group operates and which gives rise to risks and returns that are different from other economic environments in which the Group operates.

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

	31 December 2006		31 December 2005	
	Net profit/ (loss)	**Total revenue(1)**	Net profit/ (loss)	Total revenue(1)
	(in millions of RMB)			
Northern China(2)	**1,888**	**11,383**	2,122	8,880
Northeastern China(3)	**(770)**	**4,907**	(547)	4,174
Eastern China(4)	**7,036**	**37,646**	5,825	28,382
Central and Southern China(5)	**2,361**	**12,751**	1,076	9,954
Western China(6)	**957**	**5,588**	(377)	4,514
Overseas(7)	**797**	**6,241**	1,144	4,206
Eliminations	**—**	**(9,335)**	—	(6,433)
Total(8)	**12,269**	**69,181**	9,243	53,677

Notes:

(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 (similarly hereinafter).

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

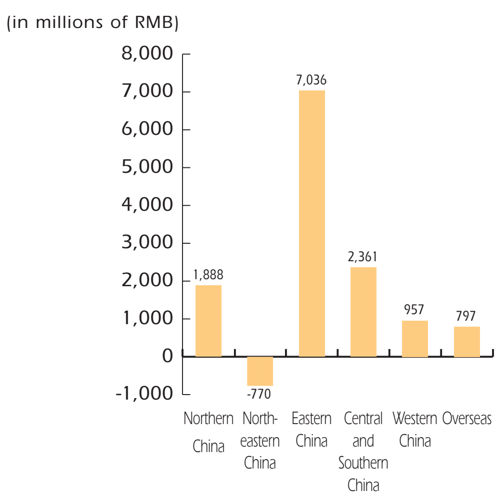
(3) Including Liaoning Province, Jilin Province and Heilongjiang Province (similarly hereinafter).

(4) Including Shanghai Municipality, Jiangsu Province, Zhejiang Province, Anhui Province, Fujian Province, Jiangxi Province and Shandong Province (similarly hereinafter).

(5) Including Henan Province, Hunan Province, Hubei Province, Guangdong Province, Guangxi Autonomous Region and Hainan Province (similarly hereinafter).

(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 (similarly hereinafter).

The Operating Results of each of the Group's geographical segments



5. SEGMENTAL OVERVIEW *(Continued)*

(1) Segmental operating results by geographical segments *(Continued)*

Notes: (Continued)

(7) Including overseas subsidiaries and branches in Hong Kong, New York, Singapore, Tokyo and Seoul (similarly hereinafter).

(8) Including minority interests.

(2) Segmental deposit/loan results by geographical segments

The table below sets forth the deposit balance and loan balance from each of the Group's geographical segments as of the dates indicated:

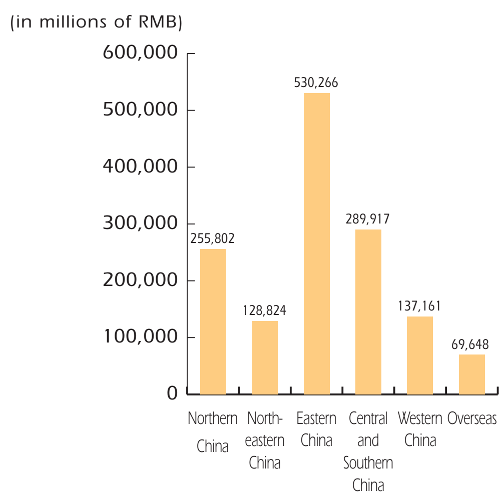
	31 December 2006		31 December 2005	
	Deposit Balance(1)	**Loan Balance(2)**	Deposit Balance(1)	Loan Balance(2)
	(in millions of RMB)			
Northern China	**255,802**	**164,116**	216,346	129,729
Northeastern China	**128,824**	**58,739**	113,906	53,962
Eastern China	**530,266**	**381,356**	456,569	320,533
Central and Southern China	**289,917**	**182,059**	243,909	148,064
Western China	**137,161**	**81,658**	119,048	71,027
Overseas	**69,648**	**56,897**	63,047	46,225
Total	**1,411,618**	**924,825**	1,212,825	769,540

Notes:

(1) Net of interest payable.

(2) Net of interest receivable.

Deposits/Loan Results of the Group's geographical segments



5. SEGMENTAL OVERVIEW *(Continued)*

(3) Segmental operating results by business segments

The Group's business is mainly divided into four business segments: corporate banking, retail banking, treasury and others. Corporate banking segment remained the primary source of profit for the Group and accounted for 88.91% of its profit before tax.

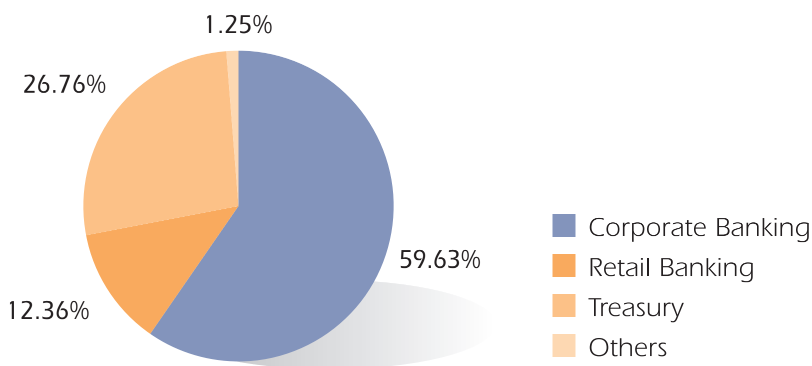
The table below shows the operating results of each of the Bank's business segments as of the dates indicated:

	Year ended 31 December		
	2006 Total Revenue	2005 Total Revenue	**2006 Operating Profit before Tax**
		(in millions of RMB)	
Corporate banking	**41,254**	33,248	**15,474**
Retail banking	**8,548**	6,282	**4,870**
Treasury	**18,512**	13,323	**1,648**
Others	**867**	824	**(4,587)**
Total[1]	**69,181**	53,677	**17,405**

Note:

(1) Including minority interest.

The Operating Results of each of the Bank's Business Segments



6. CAPITAL ADEQUACY RATIO

As of 31 December 2006, the Group's capital adequacy ratio was 10.83% and the Tier-1 capital adequacy ratio was 8.52%, representing a decrease of 0.37 percentage points and 0.26 percentage points, respectively, from the previous year. The decrease in the Group's capital adequacy ratio was due to (1) the increase in the weighted risk assets resulting from normal business growth; and (2) the relatively strained growth of net capital, as the Group had no external financing during the Reporting Period and subordinated bonds, which were recorded in the supplementary capital, decreased gradually over the years.

In addition, the Group's strong and stable management system, optimized business structure and sound operating performance, altogether curtailed the drop in capital adequacy ratio.

The capital adequacy ratio above is calculated in accordance with the formula promulgated by CBRC and relevant methods of computation.