1 ORGANISATION, PRINCIPAL ACTIVITIES AND DETAILS OF PRINCIPAL SUBSIDIARY

(a) Organisation

The Bank is a commercial bank incorporated in Shenzhen, the People's Republic of China (the "PRC"). With the approval of the China Securities Regulatory Commission ("CSRC") of the PRC, the A-Shares of the Bank were listed on Shanghai Stock Exchange on 9 April 2002.

On 22 September 2006, the Bank's H-Shares were listed on the Main Board of the Stock Exchange of Hong Kong Limited.

As at 31 December 2006, apart from the Head Office, the Bank had branches in Shenzhen, Shanghai, Beijing, Shenyang, Nanjing, Guangzhou, Wuhan, Lanzhou, Xi'an, Chengdu, Chongqing, Hangzhou, Fuzhou, Jinan, Tianjin, Dalian, Urumqi, Kunming, Hefei, Zhengzhou, Harbin, Nanchang, Changsha, Xiamen, Ningbo, Wenzhou, Wuxi, Suzhou, Hong Kong, Qingdao, Dongguan, Shaoxing, Yantai, Quanzhou, Changzhou, Taiyuan and Foshan. In addition, the Bank has two representative offices in Beijing and New York.

(b) Principal activities of the Bank

The Bank provides deposits taking, clearing and other related services. It also engages in the provision of credit and bills discounting, other treasury related activities; and acts as issuing agent and underwriter for government bonds.

(c) Details of the subsidiary consolidated

The particulars of the Bank's subsidiary as at 31 December 2006 are set out below.

Name of company	Place of incorporation and operation	Particulars of the issued and paid up capital	% of ownership held by the Bank	Principal activities
CMB International Capital Corporation Limited	Hong Kong	HK$50 million	100%	Investment advisory services

2 SIGNIFICANT ACCOUNTING POLICIES

(a) Statement of compliance and basis of preparation

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRSs") and its interpretations promulgated by the International Accounting Standards Board ("IASB"), and the disclosure requirements of the Hong Kong Companies Ordinance. These financial statements also comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited. A summary of the significant accounting policies adopted by the Group is set out below.

All IFRSs in issue which are effective for the accounting period beginning on 1 January 2006 and which are relevant to the Group have been applied. IFRS 7 Financial Instruments: Disclosures ("IFRS 7") and Amendment to International Accounting Standard 1 Presentation of Financial Statements: Capital Disclosures, both of which were issued in August 2005 and which are effective for the period beginning on 1 January 2007 have not been adopted in these financial statements. IFRS 7 requires more detailed qualitative and quantitative disclosure primarily on fair value information and risk management. The Group has assessed the impact of IFRS 7 and concluded that IFRS 7 would only affect the level of details in the disclosure of the financial statements, and would not have an impact on the Group's results or the state of affairs of the Group or the Bank.

(b) Basis of measurement

Unless stated otherwise, the financial statements are presented in Renminbi ("RMB"), which is the Group's functional and presentation currency, rounded to the nearest million.

The financial statements are prepared using the historical cost basis except that financial assets and liabilities at fair value through profit or loss including derivatives, and available-for-sale assets are stated at their fair value; and certain non-financial assets are stated at deemed cost.

The preparation of the financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances. The results of such estimates and assumptions form the basis of judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of IFRSs that have significant effect on the financial statements and estimates with a significant risk of material adjustment in the subsequent period are discussed in Note 40.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(c) Basis of consolidation

The financial statements include the financial statements of the Bank and its subsidiary. Subsidiaries are those enterprises controlled by the Bank. Control exists when the Bank has the power, directly or indirectly, to govern the financial and operational policies of an enterprise so as to obtain benefits from its activities. The results and affairs of subsidiaries are included from the date that control commences until the date that control ceases.

The results of the subsidiary are included in the consolidated results of the Group. All significant inter company transactions and balances, and any unrealised gains or losses arising from inter company transactions, have been eliminated on consolidation.

In the Bank's balance sheet, an investment in a subsidiary is stated at cost less allowances for impairment losses.

In view of the immateriality of the subsidiary's assets and liabilities, all notes are prepared on consolidated balances only.

(d) Financial instruments

(i) Recognition and measurement

All financial assets and financial liabilities are recognised in the consolidated balance sheet when and only when, the Group becomes a party to the contractual provisions of the instrument. Financial assets are derecognised on the date when the contractual rights to the cash flows expire or substantially all the risks and rewards of ownership are transferred. A regular way purchase or sale of financial assets is recognised using settlement date accounting, except for derivatives which are recognised using trade date accounting.

Financial liabilities are derecognised on the date when the obligations specified in the contracts are discharged, cancelled or expire.

At initial recognition, all financial assets and liabilities are measured at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include observable market data.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(d) Financial instruments *(continued)*

(i) Recognition and measurement *(continued)*

Financial assets and financial liabilities are categorised as follows:

- financial assets and financial liabilities at fair value through profit or loss include those financial assets and financial liabilities held principally for the purpose of short term profit taking and those financial assets and liabilities that are designated by the Group upon recognition as at fair value through profit or loss.

  All derivatives not qualified for hedging purposes are included in this category and are carried as assets when their fair value is positive and as liabilities when their fair value is negative;

- Financial instruments are designated at fair value through profit or loss upon initial recognition when:

  - the assets or liabilities are managed, evaluated and reported internally on a fair value basis;

  - the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise;

  - the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract; or

  - the separation of the embedded derivative from the financial instrument is not prohibited;

- held-to-maturity financial assets are non-derivative financial assets with fixed or determinable payments and fixed maturity that the Group has the positive intent and ability to hold to maturity;

- loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than those that the Group intends to sell immediately or in the near term, and those that are designated as available-for-sale upon initial recognition;

- available-for-sale assets are non-derivative financial assets that are designated as available-for-sale or are not classified as financial assets at fair value through profit or loss, loans and receivables or held-to-maturity financial assets; and

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(d) Financial instruments *(continued)*

(i) Recognition and measurement *(continued)*

– financial liabilities, other than that at fair value through profit or loss and designated at fair value through profit or loss, are measured at amortised cost using the effective interest method.

Subsequent to initial recognition, financial assets and financial liabilities are measured at fair value, without any deduction for transaction costs that may occur on sale or other disposal except for loans and receivables, held-to-maturity financial assets and financial liabilities not at fair value through profit or loss, which are measured at amortised cost using the effective interest method. Financial assets and financial liabilities that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are stated at cost.

Gains and losses from changes in the fair value of financial instruments at fair value through profit or loss are included in the consolidated income statement when they arise.

Gains and losses arising from a change in the fair value of available-for-sale assets are recognised directly in equity, except for impairment losses and foreign exchange gains and losses on monetary assets, until the financial asset is derecognised at which time the cumulative gains or losses previously recognised in equity will be recognised in the consolidated income statement.

For financial assets and liabilities carried at amortised cost, a gain or loss is recognised in the consolidated income statement when the financial asset or liability is derecognised, impaired and amortised.

(ii) Fair value measurement principles

The fair value of financial instruments is based on their quoted market price in an active market at the valuation date without any deduction for transaction costs. If a quoted market price is not available, the fair value of the instrument is estimated using pricing models referenced to the fair value of another instrument that is substantially the same (without deduction for transaction costs) or discounted cash flow techniques. Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate is a market rate at the valuation date for an instrument with similar terms and risk profile.

(iii) Hedge accounting

The Group does not have derivative financial instruments which meet the criteria for hedge accounting.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(d) Financial instruments *(continued)*

(iv) Specific instruments

Cash equivalents

Cash equivalents comprise balances with banks and the central bank, and short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value, having been within three months of maturity at acquisition.

Placements with and takings from banks and other financial institutions

Banks represent other banks approved by the People's Bank of China (the "PBOC"). Other financial institutions represent insurance companies, securities firms, and investment trusts etc. Placements with banks and other financial institutions are accounted for as loans or investment receivables.

Investments

Equity investments are accounted for as trading or available-for-sale financial assets. Debt investments are classified as financial assets at fair value through profit or loss, held-to-maturity financial assets, loans and receivables, and available-for-sale financial assets in accordance with the Group's holding intention at acquisition.

Loans and advances

Loans and advances directly granted by the Group to customers or participation in syndicated loans are accounted for as loans and receivables.

(v) Derivative financial instruments

The Group's derivative financial instruments include spot, forward and foreign currency swaps, interest rate swaps and option contracts undertaken in response to customers' needs or for the Group's own asset and liability management purposes. To hedge against risks arising from derivative transactions undertaken for customers, the Bank enters into similar derivative contracts with other banks.

Derivative financial instruments are stated at fair value, with gains and losses arising recognised in the consolidated income statement.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(d) Financial instruments *(continued)*

(vi) Embedded derivatives

An embedded derivative is a component of a hybrid (combined) instrument that includes both the derivative and a host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. The embedded derivatives are separated from the host contract and accounted for as a derivative when (a) the economic characteristics and risks of the embedded derivative are not closely related to the host contract; and (b) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the consolidated income statement.

When the embedded derivative is separated, the host contract is accounted for in accordance with note 1(d)(i) above.

(e) Fixed assets and depreciation

Fixed assets, including investment properties, are stated at cost or deemed cost less accumulated depreciation. These also include land held under operating leases and buildings thereon, where the fair value of the leasehold interest in the land and buildings cannot be measured separately at the inception of the lease and the building is not clearly held under an operating lease.

Depreciation is calculated to write off the cost of fixed assets over their following estimated useful lives, after taking into account an estimated residual value at 3% of the cost of each asset, on a straight-line basis:

Land and buildings	20 years
Investment properties	20 years
Computer equipment	5 years
Motor vehicles and other equipment	5 years
Leasehold improvements	the shorter of the unexpired term of lease and the estimated useful lives, being no more than 5 years

Construction in progress represents property under construction and is stated at cost less impairment losses. Cost comprises the direct and indirect cost of construction. Construction in progress is transferred to an appropriate class of property and equipment when the asset is ready for its intended use. No depreciation is provided for construction in progress.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(e) Fixed assets and depreciation *(continued)*

The carrying amount of fixed assets is reviewed periodically in order to assess whether the recoverable amount has declined below the carrying amount. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The amount of impairment loss is recognised in the consolidated income statement. The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present values.

Subsequent expenditure relating to a fixed asset is capitalised only when it is probable that future economic benefits associated with the fixed assets will flow to the Group. All other expenditure is recognised in the consolidated income statement as an expense as incurred.

Profits or losses on disposal of fixed assets are determined as the difference between the net disposal proceeds and the carrying amount of the fixed assets and are accounted for in the consolidated income statement as they arise.

(f) Land use rights

Land use rights are stated at cost, and are amortised on a straight-line basis over the respective lease periods of 40 – 50 years.

(g) Repossessed assets

Repossessed assets are measured at the lower of the carrying value of the related loans and advances and fair value less costs to sell at the date of exchange. They are not depreciated or amortised.

Impairment losses on initial classification and on subsequent remeasurement are recognised in the consolidated income statement.

(h) Operating leases

Leases of assets under which the lessor assumes substantially all the risks and benefits of ownership are classified as operating leases. Payments made under the leases are charged to the consolidated income statement in equal instalments over the accounting periods covered by the lease term.

(i) Repurchase and resale agreements

Securities sold under repurchase agreements are considered to be, in substance, secured loans borrowed. Therefore, the amounts received are included in "Amounts due to central bank" or "Placements from banks and other financial institutions", depending on the identity of the counterparty. Conversely securities or loans purchased subject to commitment to resell are considered as loans granted, and the amounts paid are accounted for as "Balances with central bank" or "Placements with banks and other financial institutions", depending on the identity of the counterparty.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(i) Repurchase and resale agreements *(continued)*

The difference between the purchase and resale consideration or sale and repurchase consideration is amortised over the period of the transaction using the effective interest method and is included in interest income or expense, as appropriate.

(j) Impairment

(i) Financial assets

Financial assets are assessed at each balance sheet date to determine whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset and that event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

Losses expected as a result of future events, no matter how likely, are not recognised because the necessary loss event has not yet occurred.

Impairment losses on loans and advances

The Group uses two methods of assessing impairment losses on loans and advances: those assessed individually and those assessed on a collective basis.

– *Individually assessed*

Loans and advances which are considered individually significant are assessed individually for impairment. This includes all loans and advances in the corporate lending portfolios.

Impairment allowances are made on individually impaired loans when there is objective evidence of impairment that will impact the estimated future cash flows of the loan. Individually impaired loans and advances are graded as substandard or below.

Impairment allowances of an individually impaired loan is measured as the difference between the loan's carrying amount and the present value of estimated future cash flows discounted at the loan's original effective interest rate. The carrying amount of the loan is reduced through the use of the allowances for impairment losses.

The calculation of the present value of the estimated future cash flows of a collateralised loan or receivable reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(j) Impairment *(continued)*

(i) Financial assets (continued)

Impairment losses on loans and advances (continued)

– *Collectively assessed*

Impairment allowances are calculated on a collective basis for the following:

– in respect of losses which have been incurred but have not yet been identified for loans subject to individual assessment for impairment; and

– for homogeneous groups of loans that are not considered individually significant, representing the retail lending portfolios.

Incurred but not yet identified impairment

If no objective evidence of impairment exists for an individually assessed loan on an individual basis, whether significant or not, the loans are grouped in a pool of loans with similar credit risk characteristics for the purpose of calculating a collective impairment allowance. This allowance covers loans that are impaired at the balance sheet date but will not be individually identified as such until some time in the future. As soon as information is available that specifically identifies objective evidence of impairment on individual loans in the pool of loans, those loans are removed from the pool. Loans that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment for impairment. The collective assessment allowance is determined after taking into account:

– the structure and risk characteristics of the Group's loan portfolio (indicating the borrower's ability to repay all loans) and the expected loss of the individual components of the loan portfolio based primarily on the historical loss experience;

– the emergence period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan; and

– management's judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(j) Impairment *(continued)*

(i) Financial assets (continued)

Impairment losses on loans and advances *(continued)*

– *Collectively assessed (continued)*

Homogeneous groups of loans

Portfolios of homogeneous loans are collectively assessed using roll rate or historical loss rate methodologies. Overdue period represents the major observable objective evidence for impairment.

Impairment losses are recognised in the consolidated income statement.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed. The reversal shall not result in a carrying amount of the loan that exceeds the amortised cost at the date the impairment is reversed had the impairment not been recognised. The amount of the reversal is recognised in the consolidated income statement.

Where the loan has no reasonable prospect of recovery, the loan is written off. Amount recovered from a loan that has been written off will be recognised as income through the impairment loss account in the consolidated income statement.

In the recovery of impaired loans, the Group may take repossession of the collateral assets through court proceedings or voluntary delivery of possession by the borrowers. Upon the seizure of these assets, the carrying value of the related loan principal and interest receivable are initially transferred to "Repossessed assets", and the respective allowances for impairment losses are transferred to "impairment allowance for repossessed assets".

Impairment losses on available-for-sale financial assets

When a decline in the fair value of an available-for-sale financial asset has been recognised in equity and there is objective evidence that an available-for-sale financial asset is impaired, the cumulative loss that had been recognised directly in equity is removed from equity and is recognised in the consolidated income statement even though the financial assets has not been derecognised.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(j) Impairment *(continued)*

(i) Financial assets *(continued)*

Impairment losses on available-for-sale financial assets *(continued)*

The amount of the cumulative loss that is recognised in the consolidated income statement is the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that asset previously recognised in consolidated income statement. For an available-for-sale asset that is not carried at fair value as its fair value cannot be reliably measured, such as an unquoted equity instrument, the amount of any impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increases can be objectively related to an event occurring after the impairment loss was recognised in the consolidated income statement, the impairment loss is reversed, with the amount of the reversal being recognised in the consolidated income statement.

Impairment losses recognised in the consolidated income statement for an investment in an equity instrument classified as available-for-sale are not reversed through the consolidated income statement. Any subsequent increase in the fair value of these assets is recognised directly in equity.

(ii) Impairment losses on other assets

The carrying amounts of the Group's other assets are reviewed periodically by the Directors to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. The recoverable amount is the estimated cash proceeds from the disposal of the assets or the present value of the future cash inflow. An impairment loss is recognised in the consolidated income statement when the net carrying amount of an asset exceeds its recoverable amount.

If there are evidences that the impairment losses previously recognised do not exist or have been reduced, reversals of the impairment losses are credited to the consolidated income statement in the period in which the reversals are recognised.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(k) Convertible bonds issued

At initial recognition the liability component of the convertible bonds issued is calculated as the present value of the future interest and principal payments, discounted at the market rate of interest applicable at the time of initial recognition to similar debt securities that do not have a conversion option. The liability component is subsequently carried at amortised cost until it is converted or redeemed. Any excess of proceeds over the amount initially recognised as the liability component is in substance an option and is recognised as the equity component in the capital reserve.

If the bond is converted into shares, the carrying value of the liability component and any interest payable at the time of conversion, are transferred to "share capital" based on the numbers of shares issued at par and the differences are recognised as share premium in capital reserve.

(l) Financial guarantee issued, provisions and contingent liabilities

(i) Financial guarantees issued

Financial guarantees are contracts that require the issuer (i.e. the guarantor) to make specified payments to reimburse the beneficiary of the guarantee (the holder) for a loss the holder incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.

Where the Group issues a financial guarantee to customers, the fair value of the guarantee (being the guarantee fees received) is initially recognised as deferred income within other liabilities.

The deferred income is amortised in the income statement over the term of the guarantee as income from financial guarantees issued. In addition, provisions are recognised in accordance with note 2(l)(ii) if and when (i) it becomes probable that the holder of the guarantee will call upon the Group under the guarantee, and (ii) the amount of that claim on the Group is expected to exceed the amount currently carried in other liabilities in respect of that guarantee i.e. the amount initially recognised, less accumulated amortisation.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(l) Financial guarantee issued, provisions and contingent liabilities *(continued)*

(ii) Other provisions and contingent liabilities

Provisions are recognised for liabilities of uncertain timing or amount when the Group has a legal or constructive obligation arising as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made. Where the time value of money is material, provisions are stated at the present value of the expenditures expected to settle the obligation.

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the obligation is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

(m) Income recognition

(i) Interest income

Interest income is recognised in the consolidated income statement on an accruals basis, taking into account the effective interest rate of the instrument or an applicable floating rate. Interest income includes the amortisation of any discount or premium or other differences between the initial carrying amount of any interest bearing instrument and its amount at maturity calculated on an effective interest rate basis.

When a financial asset or a group of financial assets are impaired, interest income is recognised on the impaired financial assets using the rate of interest used to discount future cash flows for the purpose of measuring the related impairment loss.

(ii) Fee and commission income

Fee and commission income is recognised in the consolidated income statement when the corresponding service is provided.

(iii) Dividend income

– Dividend income from listed investments is recognised when the underlying investment is declared ex-dividend.

– Where the investments are unlisted, interim dividend income is recognised when declared by the Board of Directors of the investees. Final dividend income is recognised only when the amount proposed by the Board of Directors of the investees is approved by shareholders at general meetings.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(n) Taxation

(i) Income tax

Income tax in the consolidated income statement comprises current tax and movement in deferred tax. Income tax is recognised in the consolidated income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year calculated based on the Accounting Standards for Business Enterprises issued by Ministry of Finance of the PRC (the "MOF"), the Accounting Regulations for Financial Enterprises (2001), and other relevant regulations issued by the MOF collectively and adjusted for items based on the prevailing tax laws and interpretations, using PRC tax rates enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided, using the balance sheet liability method, for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantially enacted at the balance sheet date.

When it is probable that the future taxable profit will be available to utilise the above timing differences, a deferred tax asset will be recognised. Deferred tax assets are reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the related tax benefit to be utilised.

(ii) Other taxes

Other taxes, including business tax and surcharges and property tax, are calculated at respective tax rates enacted at the balance sheet date and are included in the operating expenses.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(o) Foreign currency translations

Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated into RMB at the foreign exchange rates ruling at that date. Non-monetary assets and liabilities, and share capital which are measured at historical cost in a foreign currency are translated into RMB at the foreign exchange rates ruling at the date of the transaction, whilst those stated at fair value are translated into RMB at the foreign exchange rate ruling at the date of valuation. Income and expenses denominated in foreign currencies are translated at the exchange rates ruling at the dates of the transactions. When the gain or loss on a non-monetary item is recognised directly in equity, any exchange component of that gain or loss is recognised directly in equity, all other foreign exchange differences arising on settlement and translation of monetary and non-monetary assets and liabilities are recognised in the consolidated income statement.

(p) Offsetting

Financial assets and liabilities are offset and the net amount is reported in the consolidated balance sheet when the Group has a legally enforceable right to set off the recognised amounts and the transactions are intended to be settled on a net basis.

(q) Employee benefits

(i) Salaries and staff welfare

Salaries, bonus and other benefits are accrued in the period in which the associated services are rendered by employees.

(ii) Post employment benefits

The Group participates in a number of defined contribution retirement benefit schemes managed by different provincial governments or independent insurance companies. Obligation for contributions to these schemes are jointly borne by the Group and the staff, and contributions paid by the Group are recognised as an expense in the consolidated income statement as incurred.

(r) Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel, significant shareholders and/or their close family members) or other entities and include entities which are under the significant influence of related parties of the Group where those parties are individuals, and post-employment benefit plans which are for the benefit of employees of the Group or of any entity that is a related party of the Group.

2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(s) Segmental reporting

A segment is a distinguishable component of the Group that is engaged either in providing products or services ("business segment") or in providing products or services within a particular economic environment ("geographical segment"), which is subject to risks and rewards that are different from those of other segments.

(t) Fiduciary activities

The Group acts in a fiduciary capacity in entrusted loan and entrusted investment business. Assets held by the Group and the related undertakings to return such assets to customers are excluded from the balance sheets as the risks and rewards of the assets reside with the customers.

(u) Dividends or profit distributions

Dividends or profit distributions are recognised as a liability in the year in which they are approved and declared.

3 INTEREST INCOME

	2006	2005
Loans and advances (note)	**26,891**	21,058
Balances with central bank	**1,044**	836
Deposits and placements with		
– banks	**1,782**	838
– other financial institutions	**354**	164
Debt investments	**3,919**	2,981
Interest income on financial assets that are not at fair value through profit or loss	**33,990**	25,877

Note: Included in the above is interest income of RMB223 million accrued on impaired loans for the year ended 31 December 2006 (2005: RMB260 million).

(Expressed in millions of Renminbi unless otherwise stated)

4 INTEREST EXPENSE

	2006	2005
Deposits from customers	**10,449**	7,558
Deposits and placements from		
– banks	**424**	412
– other financial institutions	**1,127**	664
Issued debts	**481**	601
	12,481	9,235

5 FEE AND COMMISSION INCOME

	2006	2005
Bank card fees	**1,003**	570
Remittance and settlement fees	**607**	429
Agency services fees	**571**	315
Commissions from credit commitment and loan business	**267**	186
Trust services fees	**259**	101
Others	**281**	255
	2,988	1,856

6 OTHER NET INCOME

	2006	2005
Net gain arising from foreign currency dealing	**607**	509
Net loss on foreign exchange	**(313)**	(38)
Net gain on financial instruments at fair value through profit or loss	**357**	428
Net (loss)/gain on disposal of available-for-sale financial assets	**(22)**	5
Distributions from investment in funds	**117**	25
Net gain on disposal of fixed assets	**1**	4
Rental income	**64**	59
Others	**32**	13
	843	1,005

7 OPERATING EXPENSES

	2006	2005
Staff costs		
– salaries, bonuses and staff welfare (note (i))	**3,872**	3,335
– contributions to defined retirement contribution schemes	**500**	428
– housing allowances	**386**	250
– others	**295**	228
	5,053	4,241
Business tax and surcharges	**1,573**	1,219
Depreciation	**910**	854
Rental expenses	**831**	693
Other general and administrative expenses	**2,724**	2,108
	11,091	9,115

Notes:

(i) Included in the above salaries and bonuses is performance bonus, the details of which are disclosed in note 27(d).

(ii) Auditors' remuneration amounted to RMB5 million for 2006 (2005: RMB5 million) and non-audit service fee paid to auditors was RMB1 million for 2006 (2005: RMB1 million).

(Expressed in millions of Renminbi unless otherwise stated)

8 DIRECTORS' AND SUPERVISORS' EMOLUMENTS

The emoluments of the Directors' and Supervisors' during the year are as follows:

	2006					
	Directors' fees RMB'000	Salaries, allowances and benefits in kind RMB'000	Discretionary bonuses RMB'000	Share-based payments RMB'000	Retirement scheme contributions RMB'000	Total RMB'000
Executive directors						
Ma Wei Hua	–	4,200	3,506	–	927	8,633
Chen Wei	–	2,100	1,753	–	311	4,164
Non-executive directors						
Qin Xiao	–	–	–	–	–	–
Wei Jia Fu	–	–	–	–	–	–
Fu Yu Ning	–	–	–	–	–	–
Li Yin Quan	–	–	–	–	–	–
Huang Da Zhan	–	–	–	–	–	–
Tan Yue Heng	–	–	–	–	–	–
Sun Yue Ying	–	–	–	–	–	–
Wang Da Xiong	–	–	–	–	–	–
Fu Jun Yuan	–	–	–	–	–	–
Independent non-executive directors and supervisors						
Wu Jie Si	172	–	–	–	–	172
Lin Chu Xue	173	–	–	–	–	173
Austin Hu Chang Tau	173	–	–	–	–	173
Edward Chow Kwong Fai	138	–	–	–	–	138
Liu Yong Zhang	138	–	–	–	–	138
Liu Hong Xia	138	–	–	–	–	138
Shi Ji Liang	263	–	–	–	–	263
Zhu Gen Lin	–	–	–	–	–	–
Chen Hao Ming	–	–	–	–	–	–
Li Yi	–	–	–	–	–	–
Lu Yu Huan	–	–	–	–	–	–
Lin Rong Guang	–	896	382	–	256	1,534
Xiang You Zhi	–	558	240	–	94	892
Zhou Wen Qiong	–	319	140	–	82	541
Shao Rui Qing	138	–	–	–	–	138
Zhang Yu Qing	35	–	–	–	–	35
Yang Jun	35	–	–	–	–	35
Lu Ren Fa	35	–	–	–	–	35
Ding Hui Ping	35	–	–	–	–	35
Wang Qi Yan	35	–	–	–	–	35
	1,508	8,073	6,021	–	1,670	17,272

8 DIRECTORS' AND SUPERVISORS' EMOLUMENTS *(continued)*

The emoluments of the Directors' and Supervisors' during the year are as follows: *(continued)*

	2005					
	Directors' fees RMB'000	Salaries, allowances and benefits in kind RMB'000	Discretionary bonuses RMB'000	Share-based payments RMB'000	Retirement scheme contributions RMB'000	Total RMB'000
Executive directors						
Ma Wei Hua	–	3,187	4,820	–	260	8,267
Chen Wei	–	1,559	2,200	–	129	3,888
Non-executive directors						
Qin Xiao	–	–	–	–	–	–
Wei Jia Fu	–	–	–	–	–	–
Fu Yu Ning	–	–	–	–	–	–
Li Yin Quan	–	–	–	–	–	–
Huang Da Zhan	–	–	–	–	–	–
Tan Yue Heng	–	–	–	–	–	–
Sun Yue Ying	–	–	–	–	–	–
Wang Da Xiong	–	–	–	–	–	–
Fu Jun Yuan	–	–	–	–	–	–
Independent non-executive directors and supervisors						
Wu Jie Si	26	–	–	–	–	26
Lin Chu Xue	80	–	–	–	–	80
Austin Hu Chang Tau	–	–	–	–	–	–
Yang Jun	80	–	–	–	–	80
Lu Ren Fa	80	–	–	–	–	80
Ding Hui Ping	80	–	–	–	–	80
Wang Qi Yan	80	–	–	–	–	80
Zhu Gen Lin	–	–	–	–	–	–
Chen Hao Ming	–	–	–	–	–	–
Li Yi	–	–	–	–	–	–
Lu Yu Huan	–	–	–	–	–	–
Zhang Yu Qing	80	–	–	–	–	80
Lin Rong Guang	–	768	300	–	72	1,140
Xiang You Zhi	–	465	50	–	31	546
Zhou Wen Qiong	–	379	30	–	24	433
He Di	54	–	–	–	–	54
Hu Chang Tao	80	–	–	–	–	80
	640	6,358	7,400	–	516	14,914

(Expressed in millions of Renminbi unless otherwise stated)

8 DIRECTORS' AND SUPERVISORS' EMOLUMENTS *(continued)*

The number of the Directors and Supervisors whose emoluments are within the following bands is set out below.

RMB	**2006**	2005
Nil – 500,000	**26**	24
500,001 – 1,000,000	**2**	1
1,000,001 – 1,500,000	**–**	1
1,500,001 – 2,000,000	**1**	–
3,500,001 – 4,000,000	**–**	1
4,000,001 – 4,500,000	**1**	–
8,000,001 – 8,500,000	**–**	1
8,500,001 – 9,000,000	**1**	–
	31	28

None of the Directors and Supervisors received any inducements, or compensation for loss of office, or waived any emoluments during the year.

9 INDIVIDUALS WITH HIGHEST EMOLUMENTS

Of the five individuals with the highest emoluments for the year ended 31 December 2006, 2 (2005: 2) are Directors or Supervisors whose emoluments are included in Note 8 above. The aggregate of the emoluments in respect of the five individuals during the year is as follows:

	2006 RMB'000	2005 RMB'000
Salaries and other emoluments	**12,653**	8,794
Discretionary bonuses	**10,226**	11,960
Contributions to defined contribution retirement schemes	**2,430**	723
	25,309	21,477

9 INDIVIDUALS WITH HIGHEST EMOLUMENTS *(continued)*

The number of the five highest paid individuals whose emoluments fell within the following bands is set out below:

RMB	**2006**	2005
2,000,001 – 2,500,000	**–**	1
2,500,001 – 3,000,000	**–**	1
3,500,001 – 4,000,000	**1**	2
4,000,001 – 4,500,000	**3**	–
8,000,001 – 8,500,000	**–**	1
8,500,001 – 9,000,000	**1**	–

10 LOANS TO DIRECTORS, SUPERVISORS AND OFFICERS

Loans to Directors, Supervisors and Officers of the Bank disclosed pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

	2006	2005
Aggregate amount of relevant loans made by the Bank outstanding at year end	**7**	2

	2006	2005
Maximum aggregate amount of relevant loans made by the Bank outstanding during the year	**9**	4

11 PROVISION FOR IMPAIRMENT LOSSES

	2006	2005
Impairment losses charged/(released) on:		
– loans and advances (Note 17(c))	**3,537**	3,575
– deposits and placements with banks and other financial institutions	**(91)**	62
– other assets	**245**	–
	3,691	3,637

(Expressed in millions of Renminbi unless otherwise stated)

12 INCOME TAX

(a) Income tax in the consolidated income statement represents:

	2006	2005
Current tax	**3,347**	3,025
Deferred tax	**(57)**	(312)
	3,290	2,713

(b) A reconciliation of income tax expense in the consolidated income statement and that calculated at the applicable tax rate is as follows:

	2006	2005
Profit before tax	**10,084**	6,462
Notional tax on profit before tax, calculated at the statutory tax rate of 33%	**3,328**	2,133
Add/(less) the tax effect of the following items:		
– Non-deductible expenses	**198**	861
– Non-taxable income	**(209)**	(237)
– Different income tax rates in other areas	**(331)**	(133)
– Others	**304**	89
Income tax expense	**3,290**	2,713

Notes:

(i) Pursuant to the approval (Cai Shui 2007 No. 63) issued by the MOF and the State Administration of Taxation on 9 April 2007, the Bank's deductible salary expense for the year ended 31 December 2006 was approved to be RMB3.45 billion. The above tax concession is not applicable to the year ended 31 December 2005.

(ii) The income tax rates applicable to the Bank's operations in certain areas such as Shenzhen Special Economic Zone and Urumqi are 15% and 16.5% respectively during the year.

13 EARNINGS PER SHARE

Movements of the share capital are included in Note 28 of the financial statements.

(a) Basic earnings per share

The calculation of basic earnings per share is based on the net profit attributable to equity holders of the Bank and the weighted average number of shares in issue, calculated as follows:

	2006	2005
Net profit	**6,794**	3,749
Weighted average number of shares in issue (in million)	**12,833**	11,166
Basic earnings per share (in RMB)	**0.53**	0.34

(b) Diluted earnings per share

The calculation of diluted earnings per share is based on the diluted net profit and the weighted average number of shares in issue after adjusting for the effect of all dilutive potential shares, calculated as follows:

	2006	2005
Net profit	**6,794**	3,749
Interest expense on convertible bonds issued	**9**	282
Diluted net profit	**6,803**	4,031
Weighted average number of shares in issue (in million)	**12,833**	11,166
Effect of deemed conversion of convertible bonds (in million)	**60**	1,122
Weighted average number of shares in issue after dilution (in million)	**12,893**	12,288
Diluted earnings per share (in RMB)	**0.53**	0.33

(Expressed in millions of Renminbi unless otherwise stated)

14 CASH AND BALANCES WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	2006	2005
Cash	**4,622**	3,915
Balances with banks	**16,267**	18,603
Balances with other financial institutions	**6**	71
	20,895	22,589
Less: Impairment loss		
– banks	**(30)**	(27)
– other financial institutions	**(4)**	(71)
	(34)	(98)
	20,861	22,491

15 BALANCES WITH CENTRAL BANK

	2006	2005
Statutory deposit reserve funds	**57,364**	39,909
Surplus deposit reserve funds	**24,702**	21,966
Fiscal deposits	**306**	227
	82,372	62,102

The statutory deposit reserve funds are not available for the Group's daily operations. The statutory deposit reserve funds are calculated at 9% and 4% for eligible RMB deposits and foreign currency deposits respectively as at 31 December 2006 (2005: 7.5% and 3% for eligible RMB deposits and foreign currency deposits). Eligible deposits include deposits from government authorities and other organisations, fiscal deposits (other than budgets), retail deposits, corporate deposits, net credit balances of entrusted business and other deposits.

16 PLACEMENTS WITH BANKS AND OTHER FINANCIAL INSTITUTIONS

	2006	2005
Money market placements		
– banks	**38,843**	22,930
– other financial institutions	**10,390**	22
	49,233	22,952
Balances under resale agreements		
– banks	**17,770**	14,153
– other financial institutions	**21,294**	10,126
	39,064	24,279
	88,297	47,231
Less: Impairment loss		
– banks	**(57)**	(49)
– other financial institutions	**(69)**	(200)
	(126)	(249)
	88,171	46,982

Assets purchased under the above resale agreements are registered national bonds issued by the PRC government, bonds issued by the PBOC and policy banks and other debt securities of equivalent amounts.

(Expressed in millions of Renminbi unless otherwise stated)

17 LOANS AND ADVANCES TO CUSTOMERS

(a) Loans and advances to customers

	2006	2005
Corporate loans	**359,883**	298,622
Discounted bills	**103,836**	99,527
Retail loans	**101,983**	74,036
Gross loans and advances to customers	**565,702**	472,185
Less: Allowances for impairment losses	**(16,282)**	(13,510)
Net loans and advances to customers	**549,420**	458,675

(b) Analysis of loans and advances to customers

(i) Analysed by legal form of borrowers:

	2006	2005
Domestic enterprises:		
State-owned enterprises	**142,804**	111,779
Joint-stock enterprises	**42,642**	48,576
Other limited liability enterprises	**72,608**	47,619
Others	**44,783**	43,803
	302,837	251,777
Foreign-invested enterprises	**52,391**	43,418
Enterprises operating in the Mainland	**355,228**	295,195
Enterprises operating outside the Mainland	**4,655**	3,427
Corporate loans	**359,883**	298,622
Discounted bills	**103,836**	99,527
Retail loans	**101,983**	74,036
Gross loans and advances to customers	**565,702**	472,185

17 LOANS AND ADVANCES TO CUSTOMERS *(continued)*

(b) Analysis of loans and advances to customers *(continued)*

(ii) Analysed by borrowers' industry sector:

	2006	2005
Manufacturing	**82,527**	75,735
Transportation and telecommunications	**81,789**	66,154
Energy and resources	**62,046**	44,820
Trading	**30,983**	33,966
Property development and investment	**26,775**	20,089
Investment management	**23,840**	16,604
Hospitality	**9,514**	7,513
Infrastructure and construction	**12,562**	11,305
Others	**29,847**	22,436
Corporate loans	**359,883**	298,622
Discounted bills	**103,836**	99,527
Credit cards	**10,146**	4,550
Mortgages	**81,383**	64,609
Others	**10,454**	4,877
Retail loans	**101,983**	74,036
Gross loans and advances to customers	**565,702**	472,185

(c) Movements of allowances for impairment losses

	2006	2005
At 1 January	**13,510**	10,920
Charge for the year (Note 11)	**4,152**	4,031
Releases for the year (Note 11)	**(615)**	(456)
Unwinding of discount	**(222)**	(244)
Recoveries of loans and advances previously written off	**58**	84
Write-offs	**(328)**	(745)
Transfers out	**(188)**	(2)
Exchange differences	**(85)**	(78)
At 31 December	**16,282**	13,510

(Expressed in millions of Renminbi unless otherwise stated)

17 LOANS AND ADVANCES TO CUSTOMERS *(continued)*

(d) Loans and advances to customers and allowances for impairment losses

	2006				
	Loans and advances for which impairment losses are collectively assessed	Impaired loans and advances: for which impairment losses are collectively assessed	Impaired loans and advances: for which impairment losses are individually assessed	Total	Gross impaired loans and advances as a % of gross loans and advances
Gross loans and advances to					
– financial institutions	10,094	–	–	10,094	0.00
– non-financial institution customers	543,602	557	11,449	555,608	2.16
	553,696	557	11,449	565,702	2.12
Less:					
Allowances for impairment losses on loans and advances to					
– financial institutions	(41)	–	–	(41)	
– non-financial institution customers	(7,964)	(404)	(7,873)	(16,241)	
	(8,005)	(404)	(7,873)	(16,282)	
Net loans and advances to					
– financial institutions	10,053	–	–	10,053	
– non-financial institution customers	535,638	153	3,576	539,367	
	545,691	153	3,576	549,420	

17 LOANS AND ADVANCES TO CUSTOMERS *(continued)*

(d) Loans and advances to customers and allowances for impairment losses *(continued)*

	2005				
	Loans and advances for which impairment losses are collectively assessed	Impaired loans and advances for which impairment losses are collectively assessed	Impaired loans and advances for which impairment losses are individually assessed	Total	Gross impaired loans and advances as a % of gross loans and advances
Gross loans and advances to					
– financial institutions	2,567	–	–	2,567	0.00
– non-financial institution customers	457,451	460	11,707	469,618	2.59
	460,018	460	11,707	472,185	2.58
Less:					
Allowances for impairment losses on loans and advances to					
– financial institutions	(19)	–	–	(19)	
– non-financial institution customers	(6,116)	(315)	(7,060)	(13,491)	
	(6,135)	(315)	(7,060)	(13,510)	
Net loans and advances to					
– financial institutions	2,548	–	–	2,548	
– non-financial institution customers	451,335	145	4,647	456,127	
	453,883	145	4,647	458,675	

(Expressed in millions of Renminbi unless otherwise stated)

18 INVESTMENTS

	2006	2005
Financial assets at fair value through profit or loss (Note 18(a))	**7,960**	15,869
Available-for-sale investments (Note 18(b))	**109,476**	60,086
Held-to-maturity debt securities (Note 18(c))	**54,065**	48,711
Receivables (Note 18(d))	**7,384**	7,236
	178,885	131,902

(a) Financial assets at fair value through profit or loss

	2006	2005
(i) Trading assets		
Listed/quoted		
In the Mainland		
– PRC government bonds	**11**	275
– bonds issued by the PBOC	**1,993**	5,081
– bonds issued by policy banks	**1,512**	3,507
– other debt securities	**1,360**	1,003
– equity investments	**–**	30
Outside the Mainland		
– other debt securities	**–**	141
– equity investments	**–**	2
	4,876	10,039
Derivative financial instruments (Note 39(g))	**203**	86
	5,079	10,125

18 INVESTMENTS *(continued)*

(a) Financial assets at fair value through profit or loss *(continued)*

		2006	2005
(ii)	**Financial assets designated at fair value through profit or loss**		
	Listed/quoted		
	In the Mainland		
	– PRC government bonds	**2,441**	5,248
	– bonds issued by policy banks	**440**	496
		2,881	5,744
		7,960	15,869
	Financial assets at fair value through profit or loss (excluding derivative financial instruments)		
	Issued by:		
	Central governments	**2,452**	5,523
	Central banks	**1,993**	5,081
	Policy banks	**1,952**	4,003
	Banks and other financial institutions	**–**	141
	Corporate entities	**1,360**	1,035
		7,757	15,783

(Expressed in millions of Renminbi unless otherwise stated)

18 INVESTMENTS *(continued)*

(b) Available-for-sale investments

	2006	2005
Listed/quoted		
In the Mainland		
– PRC government bonds	**7,387**	7,891
– bonds issued by the PBOC	**38,748**	20,612
– bonds issued by policy banks	**20,950**	9,751
– other debt securities	**13,822**	6,804
Outside the Mainland		
– other debt securities	**8,879**	4,901
– investments in funds	**6,914**	1,211
	96,700	51,170
Unlisted/unquoted		
In the Mainland		
– bonds issued by the PBOC	**4,951**	6,890
– bonds issued by policy banks	**5,461**	–
– other debt securities	**401**	1
– equity investments	**38**	38
Outside the Mainland		
– other debt securities	**1,915**	1,979
– equity investments	**10**	8
	12,776	8,916
	109,476	60,086

18 INVESTMENTS *(continued)*

(b) Available-for-sale investments *(continued)*

	2006	2005
Issued by:		
Central governments	**7,387**	7,891
Central banks	**43,699**	27,502
Policy banks	**26,411**	9,751
Banks and other financial institutions	**18,922**	7,627
Public sector entities	**1,085**	611
Corporate entities	**11,972**	6,704
	109,476	60,086

(c) Held-to-maturity debt securities

	2006	2005
Listed/quoted		
In the Mainland		
– PRC government bonds	**13,773**	15,321
– bonds issued by the PBOC	**2,270**	1,137
– bonds issued by policy banks	**28,626**	23,532
– other debt securities	**3,511**	1,934
Outside the Mainland		
– other debt securities	**5,885**	6,787
	54,065	48,711
Fair value	**54,335**	48,997
Issued by:		
Central governments	**13,802**	15,765
Central banks	**2,270**	1,137
Policy banks	**28,626**	23,532
Banks and other financial institutions	**5,136**	4,932
Public sector entities	**1,435**	1,821
Corporate entities	**2,796**	1,524
	54,065	48,711

(Expressed in millions of Renminbi unless otherwise stated)

18 INVESTMENTS *(continued)*

(d) Receivables

	2006	2005
In the Mainland		
– PRC government bonds	**5,506**	5,388
Outside the Mainland		
– other debt securities	**1,878**	1,848
	7,384	7,236
Issued by:		
Central governments	**5,710**	5,596
Banks and other financial institutions	**1,362**	1,479
Corporate entities	**312**	161
	7,384	7,236

Receivables are unlisted/unquoted bearer's national bonds issued by the PRC government and other debt investments which the Group has the intention and ability to hold to maturity. These receivables are not quoted in an active market in the PRC or overseas. Accordingly, the Group is unable to disclose their market values. The Group considers the recoverable amounts from these assets upon their maturities are the same as their carrying values and no provision for impairment losses is required.

(e) Financial liabilities at fair value through profit or loss

	2006	2005
Derivative financial instruments (Note 39(g))	**106**	86

18 INVESTMENTS *(continued)*

(f) In June 2006, the Bank entered into an agreement with three independent third parties and China Merchants Securities Company, a related company of the Bank, to acquire 30% and 3.4% equity interest in China Merchants Fund Management Company ("CMFM") respectively for a total consideration of RMB197.7 million. The completion of the acquisition is subject to obtaining approvals from relevant regulatory authorities including the CSRC and the China Banking Regulatory Commission (the "CBRC"). As of 31 December 2006, the proposed acquisition had been approved by the CBRC but yet to be approved by the CSRC.

Upon completion of the transaction, the Group's investment in CMFM will be recognised as an investment in an associated company. The investment in an associated company and any goodwill arising will be accounted for in the consolidated financial statements in accordance with IFRSs.

19 FIXED ASSETS

2006

	Land and buildings	Investment properties (Note 19(b))	Construction in progress (Note 19(c))	Computer equipment	Leasehold improvements	Motor vehicles and other equipment	Total
Cost:							
At 1 January 2006	4,086	558	1,121	2,673	1,120	910	10,468
Additions	83	–	610	694	218	163	1,768
Transfers	491	26	(590)	–	73	–	–
Disposals/write-offs	(102)	–	(5)	(353)	–	(60)	(520)
At 31 December 2006	4,558	584	1,136	3,014	1,411	1,013	11,716
Accumulated depreciation:							
At 1 January 2006	986	100	–	1,423	610	572	3,691
Depreciation	195	46	–	396	151	122	910
Written back on disposals/ write-offs	(28)	–	–	(186)	–	(47)	(261)
At 31 December 2006	1,153	146	–	1,633	761	647	4,340
Net book value:							
At 31 December 2006	3,405	438	1,136	1,381	650	366	7,376

(Expressed in millions of Renminbi unless otherwise stated)

19 FIXED ASSETS *(continued)*

2005

	Land and buildings	Investment properties (Note 19(b))	Construction in progress (Note 19(c))	Computer equipment	Leasehold improvements	Motor vehicles and other equipment	Total
Cost:							
At 1 January 2005	4,160	296	810	2,311	952	839	9,368
Additions	68	–	402	497	169	120	1,256
Transfers	(100)	262	(90)	–	–	–	72
Disposals/write-offs	(42)	–	(1)	(135)	(1)	(49)	(228)
At 31 December 2005	4,086	558	1,121	2,673	1,120	910	10,468
Accumulated depreciation:							
At 1 January 2005	835	22	–	1,191	460	494	3,002
Depreciation	184	34	–	367	150	119	854
Transfers	(20)	44	–	–	–	–	24
Written back on disposals/ write-offs	(13)	–	–	(135)	–	(41)	(189)
At 31 December 2005	986	100	–	1,423	610	572	3,691
Net book value:							
At 31 December 2005	3,100	458	1,121	1,250	510	338	6,777

19 FIXED ASSETS *(continued)*

(a) Analysed by remaining terms of leases

The net book value of land and buildings, and investment properties at the balance sheet date is analysed by the remaining terms of the leases as follows:

	2006	2005
Held in the PRC		
– long term leases (over 50 years)	**467**	423
– medium term leases (10 – 50 years)	**3,309**	3,064
	3,776	3,487
Held in Hong Kong		
– medium term leases (10 – 50 years)	**67**	71
	3,843	3,558

(b) Investment properties mainly represent the portion of the Bank's headquarters in Shenzhen that has been leased out under operating leases or is available for lease. As at 31 December 2006, fair value of these properties was RMB0.75 billion (2005: RMB0.75 billion). Leases of investment properties run for periods of less than 5 years. The Group's rental income to be received over the remaining terms of the non-cancellable operating leases was RMB131 million as at 31 December 2006 (2005: RMB74 million).

(c) As at 31 December 2006 and 31 December 2005, there was cost of land use right of RMB387 million included in the construction in progress. For the year ended 31 December 2006, the amortisation of the land use right of RMB8.65 million was capitalised as the cost of the properties built on the land (2005: RMB8.65 million). Upon completion of the construction, the property will be transferred to relevant asset categories based on the intention of usage.

(d) As at the balance sheet date, the Directors considered that there was no impairment loss on fixed assets.

(e) As at 31 December 2006, ownership documentation for the Group's properties with a net carrying value of RMB539 million (2005: RMB1,218 million) was being finalised.

(Expressed in millions of Renminbi unless otherwise stated)

20 DEFERRED TAX

(a) Recognised deferred tax assets

The components of deferred tax assets/(liabilities) are as follows:

	2006	2005
Impairment losses on loans and advances to customers and other assets	**2,384**	2,292
Investment revaluation reserve	**(34)**	(71)
Others	**(90)**	(55)
	2,260	2,166

(b) Movements of deferred tax

	Impairment losses on loans and advances to customers and other assets	**Write-off of overdue interest receivable**	**Investment revaluation reserve**	**Others**	**Total**
At 1 January 2006	**2,292**	**–**	**(71)**	**(55)**	**2,166**
Credited/(charged) to consolidated income statement	**366**	**–**	**–**	**(35)**	**331**
Credited to reserves	**–**	**–**	**37**	**–**	**37**
Write-offs	**(274)**	**–**	**–**	**–**	**(274)**
At 31 December 2006	**2,384**	**–**	**(34)**	**(90)**	**2,260**
At 1 January 2005	1,884	86	12	(45)	1,937
Credited/(charged) to consolidated income statement	478	(86)	–	(10)	382
Charged to reserves	–	–	(83)	–	(83)
Write-offs	(70)	–	–	–	(70)
At 31 December 2005	2,292	–	(71)	(55)	2,166

21 OTHER ASSETS

	2006	2005
Interest receivable		
– debt securities	**1,623**	1,497
– loans and advances to customers	**952**	705
– others	**231**	62
	2,806	2,264
Amounts pending for settlement	**937**	185
Repossessed assets	**390**	579
Prepaid lease payments	**125**	89
Others	**499**	401
	4,757	3,518

22 DEPOSITS FROM BANKS AND OTHER FINANCIAL INSTITUTIONS

	2006	2005
Deposits from banks	**5,636**	8,928
Deposits from other financial institutions	**63,218**	30,745
	68,854	39,673

23 PLACEMENTS FROM BANKS AND OTHER FINANCIAL INSTITUTIONS

	2006	2005
Money market takings		
– banks	**1,512**	424
Balances under repurchase agreements		
– banks	**2,056**	1,505
– other financial institutions	**1,076**	1,537
	3,132	3,042
Rediscounted bills	**3,105**	108
	7,749	3,574

Assets sold under the above repurchase agreements are registered national bonds issued by the PRC government, bonds issued by policy banks and other debt securities of equivalent amounts.

(Expressed in millions of Renminbi unless otherwise stated)

24 DEPOSITS FROM CUSTOMERS

	2006	2005
Demand deposits		
– corporate customers	**257,235**	219,230
– retail customers	**152,449**	118,566
	409,684	337,796
Time deposits		
– corporate customers	**204,563**	159,245
– retail customers	**159,510**	137,363
	364,073	296,608
	773,757	634,404

25 ISSUED DEBT SECURITIES

(a) Certificates of deposit issued

On 21 June 2004, the Bank issued 3-year certificates of deposit at a nominal value of US$150 million with interest at LIBOR +0.35% per annum payable quarterly.

(b) Convertible bonds issued

On 10 November 2004, the Bank issued a 5-year convertible bond with a nominal value of RMB6,500 million. The interest rates are 1.0% for the first year, 1.375% for the second year, 1.75% for the third year, 2.125% for the forth year and 2.5% for the fifth year, payable on 10 November each year. The convertible bonds can be converted into the Bank's shares at the holder's option at RMB9.34 per share during the period from 10 May 2005 to 10 November 2009. Upon maturity, an additional 6% interest will be given to bond holders who have not converted the bonds into shares.

The conversion price of the bonds was revised from RMB9.34 per share to RMB6.23 per share with effect from 17 June 2005 following the issue of bonus shares by the Bank in 2005.

The conversion price of the bonds has been further revised from RMB6.23 per share to RMB5.74 per share with effect from 24 February 2006 following the issue of bonus shares by the Bank in 2006.

25 ISSUED DEBT SECURITIES *(continued)*

(b) Convertible bonds issued *(continued)*

On 25 September 2006, the convertible bonds of the Bank in circulation were less than RMB30 million. Pursuant to the relevant requirements, the convertible bonds were suspended for trading with effect from 29 September 2006. Holders of convertible bonds can convert the bonds into share anytime before the conversion period expires.

The Bank has an early redemption option which commences six months after the bonds' issue date and lapses on the maturity date. During that period, the Bank may redeem any outstanding convertible bonds at 103% of the nominal value of the convertible bonds plus the accrued interest if the closing price of the Bank's listed A-Shares is more than 125% of the then applicable conversion price for 20 consecutive business days.

During the final year before the maturity date of the convertible bonds, if the last traded price of the Bank's listed A-Shares falls below 75% of the conversion price for 20 consecutive trading days, the bond holders can exercise the put option to sell to the Bank all or a portion of the outstanding bonds at 108.5% of the nominal value of the convertible bonds plus accrued interest.

Details of the convertible bonds are as follows:

	2006	2005
Initial recognition:		
– Nominal value	**6,500**	6,500
– Issuance cost	**(65)**	(65)
– Equity component	**(918)**	(918)
Liability component at issue date	**5,517**	5,517
Accretion	**234**	227
Amounts converted to shares	**(5,729)**	(560)
Liability component as at 31 December	**22**	5,184

(Expressed in millions of Renminbi unless otherwise stated)

25 ISSUED DEBT SECURITIES *(continued)*

(c) Other debts issued

Particulars	Terms	Date of issue	Annual fixed interest rate (%)	Nominal value (in million)
Fixed term notes	36 months	From 13 October 2005 to 26 October 2005	2.13	5,000
Fixed term notes	60 months	From 13 October 2005 to 26 October 2005	2.56	5,000

The CBRC and the PBOC approved the Bank's issuance of a total of RMB15,000 million fixed term notes on 29 September 2005 (Yin Jian Fu【2005】No. 252) and 9 October 2005 (Yin Fu【2005】No. 75). The Bank issued a total of RMB10,000 million fixed rate term notes during the period from 13 October 2005 to 26 October 2005. Interest on these notes is payable annually.

(d) Subordinated notes issued

Particulars	Terms	Date of issue	Annual fixed interest rate (%)	Nominal value (in million)
Fixed rate notes	61 months	31 March 2004 and 10 June 2004	4.59 to 5.1	3,500

The CBRC approved the Bank's issuance of RMB3,500 million subordinated notes on 30 March 2004 (Yin Jian Fu【2004】No. 36), and the amount has been included as supplementary capital in calculating the Bank's capital adequacy ratio. Interest on the subordinated notes is payable annually.

26 OTHER LIABILITIES

	2006	2005
Interest payable	**3,450**	2,705
Clearing and settlement accounts	**1,873**	812
Salaries and welfare payable (Note 27)	**2,557**	2,476
Deferred interest income on discounted bills	**1,014**	583
Business tax and surcharges payable	**757**	575
Cheques and remittances returned	**123**	106
Others	**1,371**	1,029
	11,145	8,286

27 STAFF WELFARE SCHEME

(a) Welfare payable

This includes statutory welfare payable, which is accrued based on 14% (2005: 14%) of the total salaries.

(b) Retirement benefits

(i) Defined contribution schemes

In accordance with the regulations in the PRC, the Group participates in statutory retirement schemes organised by the municipal and provincial governments for its employees. The Group's contributions to the schemes are determined by local governments and vary at a range of 8% to 35% (2005: 8% to 35%) of the staff salaries.

In addition to the above statutory retirement schemes, the Group has established a supplementary defined contribution plan for its employees. The Group's annual contributions to this plan are determined based on 8.33% of the staff salaries since 1 January 2004. The Group's total contributions during the year are disclosed in Note 7.

(ii) Supplementary retirement scheme

In 2006, the Group purchased annuity contract with total premiums of RMB500 million (2005: RMB500 million) from independent life insurance companies to provide supplementary defined contribution retirement benefits to its full-time employees on payroll as of the year end date. New employees who join the Group after respective year ends are not eligible for this benefit. These were voluntary payments and the Group has no further obligations to make future contributions.

The Group has no other material obligations for the payment of other post retirement benefits other than the contributions described above.

(Expressed in millions of Renminbi unless otherwise stated)

27 STAFF WELFARE SCHEME *(continued)*

(c) Staff quarters

The Group purchases quarters by using the public welfare fund, and leases to the staff at market rates on short term basis. Rental income is recognised in the consolidated income statement as other net income.

(d) Staff incentive scheme

The Group has implemented a staff performance bonus scheme during the years ended 31 December 2006 and 2005. The performance bonus was accrued at a fixed percentage based on the growth in net profit for the year as approved by the Board of Directors.

The Board of Directors also approved a H-Share Appreciation Right Scheme for the Group's senior management during the year. This scheme was being reviewed and yet to be approved by the regulatory authorities at 31 December 2006. Accordingly, this scheme was not considered in these financial statements.

28 SHARE CAPITAL

	Registered and issued share capital	
	No. of shares (in million)	**Amount**
At 1 January 2006	**10,374**	**10,374**
Bonus shares issued	**971**	**971**
Conversion of convertible bonds	**938**	**938**
H-Shares issued	**2,420**	**2,420**
At 31 December 2006	**14,703**	**14,703**
At 1 January 2005	6,848	6,848
Bonus shares issued	3,424	3,424
Conversion of convertible bonds	102	102
At 31 December 2005	10,374	10,374

28 SHARE CAPITAL *(continued)*

By type of share:

	No. of shares (in million)	
	2006	2005
Unlisted legal person shares (note)	**–**	7,572
Listed shares		
– A-Shares – with trading moratorium	**7,331**	–
– A-Shares – without trading moratorium	**4,710**	2,802
– H-Shares	**2,662**	–
	14,703	2,802
	14,703	10,374

Note: Subsequent to the completion of the Bank's State Share Reform Plan, the unlisted legal person shares become listed shares subject to trading moratorium with effect from 27 February 2006.

On 17 June 2005, bonus shares were issued at a ratio of 5 bonus shares for every 10 A-Shares of the Bank by capitalisation of an amount of RMB3,424 million from the capital reserve. In addition, the Bank issued 102 million A-Shares upon conversion of the convertible bonds of RMB560 million during the year ended 31 December 2005, resulting in the increase in share capital and capital reserve of RMB102 million and RMB473 million respectively. As a result, the Bank's registered and issued capital increased from RMB6,848 million to RMB10,374 million.

On 24 February 2006, bonus shares were issued at a ratio of 0.8589 bonus shares for every 10 A-Shares of the Bank by capitalisation of an amount of RMB971 million from the capital reserve. In addition, the Bank issued 938 million A-Shares upon conversion of the convertible bonds of RMB5,169 million during the year ended 31 December 2006, resulting in the increase in share capital and capital reserve of RMB938 million and RMB4,327 million respectively.

On 22 September 2006, a total of 2,200 million H-Shares with a par value of RMB1 each were issued by the Bank at a subscription price of HK$8.55 per share as part of the Initial Public Offering.

On 27 September 2006, a total of 220 million H-Shares with a par value of RMB1 each were issued by the Bank at a subscription price of HK$8.55 per share as a result of the exercise of the over-allotment option.

(Expressed in millions of Renminbi unless otherwise stated)

28 SHARE CAPITAL *(continued)*

As a result of the Initial Public Offering and the exercise of the over-allotment option, a total of 242 million A-Shares, representing 10% of the number of H-Shares issued by the Bank were converted into H-Shares of equivalent value and transferred to Social Security Fund from state-owned shareholders of the Bank at no consideration. These H-Shares were eligible for trading since 5 October 2006.

As a result of the above events in 2006, the Bank's registered and issued capital increased from RMB10,374 million to RMB14,703 million.

All H-Shares are ordinary shares and rank pari passu with the A-Shares.

29 CAPITAL RESERVE

The capital reserve primarily represents share premium and equity component of the convertible bonds issued by the Bank. The capital reserve can be used to issue shares with the shareholders' approval.

The share premium arising from issuing H-Shares is as follows:

	2006
Gross proceeds upon issue of H-Shares	**21,049**
Shares at par value	**(2,420)**
Share premium before costs of issuing shares	**18,629**
Cost of issuing shares	**(544)**
Share premium recognised in capital reserve	**18,085**

30 SURPLUS RESERVE

Surplus reserve includes statutory surplus reserve and statutory public welfare fund.

Statutory surplus reserve is calculated according to the requirements of the Accounting Standards for Business Enterprises, the Accounting Regulations for Financial Enterprises (2001) and other relevant regulations issued by the Ministry of Finance of the People's Republic of China (the "MOF") and is provided at 10% of the audited profit after tax, until the reserve balance is equal to 50% of the Bank's registered share capital. Surplus reserve can be used to offset accumulated losses or capitalised as paid-up capital with the approval of shareholders.

30 SURPLUS RESERVE *(continued)*

Prior to 1 January 2006, statutory public welfare fund was calculated according to the requirements of the Accounting Standards for Business Enterprises, the Accounting Regulations for Financial Enterprises (2001) and other relevant regulations issued by the MOF and was provided at 5% to 10% of the audited profit after tax in accordance with the Company Law of the PRC. Effective from 1 January 2006, the Bank is no longer required to make further appropriation to the statutory public welfare fund following the issuance of revisions to the Company Law of the PRC on 27 October 2005.

The purpose of statutory public welfare fund is to provide staff facilities and other staff benefits. It is not distributable other than in liquidation.

31 INVESTMENT REVALUATION RESERVE

Investment revaluation reserve has been accounted for in accordance with the accounting policies adopted for the measurement of the available-for-sale financial assets at fair value, net of deferred tax.

32 REGULATORY GENERAL RESERVE

Pursuant to the "Administrative Measures on Provisioning for Doubtful Debts by Financial Institutions" (Cai Jin 2005 No. 49) issued by the MOF on 17 May 2005 and other related rules, the Group sets up a regulatory general reserve calculated as a percentage of the total risk assets at the balance sheet date, through a transfer directly from the retained profits, to cover its potential losses that are not yet incurred. The regulatory general reserve forms part of the equity of the Group.

33 PROFIT APPROPRIATIONS

(a) Dividends declared and paid

	2006	2005
Dividends in respect of the previous year, approved, declared and paid during the year of RMB0.8 (2005: RMB1.1) per every 10 shares	**983**	753
Special dividend of RMB1.8 (2005: Nil) per every 10 shares	**2,210**	–
	3,193	753

(Expressed in millions of Renminbi unless otherwise stated)

33 PROFIT APPROPRIATIONS *(continued)*

(b) Proposed profit appropriations

	2006	2005
Statutory surplus reserve	**711**	393
Statutory public welfare fund	**–**	393
Dividends of RMB1.2 (2005: RMB0.8) per every 10 shares	**1,764**	830
Total	**2,475**	1,616

Notes:

(i) 2005 profit was appropriated in accordance with the resolution passed at the twenty-fourth meeting of the sixth Board of Directors held on 10 April 2006 and as approved in the annual general meeting held on 16 May 2006. The actual amount approved increased to RMB983 million from RMB830 million (see (ii) below).

(ii) Additional dividends totalling RMB153 million in respect of the year ended 31 December 2005 were declared on new shares issued as a result of the conversion of convertible bonds exercised during the first three months of 2006. This amount together with the original dividend of RMB830 million proposed at 31 December 2005 were paid in June 2006.

(iii) In the light of the Global Offering, the Bank's Board of Directors approved on 30 June 2006, a special dividend distribution of RMB0.18 per share for the Bank's holders of A-Shares from its distributable retained profits at 31 December 2005. The special dividend of RMB2,210 million was approved by the Bank's shareholders in an extraordinary general meeting on 19 August 2006.

34 NOTES TO CONSOLIDATED CASH FLOW STATEMENTS

(a) Analysis of the balances of cash and cash equivalents

	2006	2005
Cash	**4,622**	3,915
With original maturity within 3 months:		
– balance with banks and other financial institutions	**9,701**	10,481
– balances with central bank	**82,372**	62,102
– placements with banks and other financial institutions	**71,031**	38,400
– investment securities:		
– at fair value through profit or loss	**247**	270
– available-for-sale	**7,637**	5,233
– held-to-maturity	**–**	208
	175,610	120,609

(b) Significant non-cash transactions

Apart from the non-cash transactions relating to the conversion of convertible bonds to share capital during the years ended 31 December 2006 and 2005 the details of which are included in Note 25(b), there were no other significant non-cash transactions.

35 SEGMENTAL REPORTING

The Group's principal activities are commercial lending and deposits taking. The funding of existing retail and corporate loans are mainly from customer deposits.

Segment information is presented in respect of the Group's business and geographical segments. Business segment information is chosen as the primary reporting format as it is more relevant to the Group's operating activities.

For the purposes of segmental analysis, external net interest income/expense represents the net interest income earned or expenses incurred on banking business originated by these segments. Internal net interest income/expense represents the allocation of revenue to reflect the benefits of funding sources allocated to the business segments by way of internal funds transfer pricing mechanism. The internal funds transfer pricing mechanism has taken into account the structure and market returns of the assets and liabilities portfolio. Cost allocation is based on the direct cost incurred by the respective business segments and apportionment of management overheads. Inter-segment interest income and expenses recognised through the internal funds transfer pricing mechanism are eliminated in the consolidated results of the operations.

(a) Business segments

The Group comprises the following main business segments:

– ***Corporate banking***

The provision of financial services to corporations and institutions includes lending and deposit taking activities, project and structured finance products, syndicated loans, cash management, investment advice and other investment services.

– ***Retail banking***

The provision of financial services to retail customers includes lending and deposit taking activities, credit card facilities and investment services.

– ***Treasury business***

It covers interbank and capital market activities and proprietary trading.

– ***Others and unallocated***

These represent equity investments, and assets, liabilities, income and expenses of the head office that are not directly attributable to a segment or cannot be allocated on a reasonable basis.

for the year ended 31 December 2006
(Expressed in millions of Renminbi unless otherwise stated)

35 SEGMENTAL REPORTING *(continued)*

(a) Business segments *(continued)*

	Year ended 31 December 2006				
	Corporate banking	Retail banking	Treasury business	Others and unallocated	Total
External net interest income	14,348	812	6,349	–	21,509
Internal net interest (expense)/income	(814)	4,086	(3,272)	–	–
Net interest income	13,534	4,898	3,077	–	21,509
Net fee and commission income	854	1,531	14	115	2,514
Other net income/(expense)	501	158	357	(173)	843
Operating income/(expense)	14,889	6,587	3,448	(58)	24,866
Operating expenses					
– depreciation	(502)	(378)	(30)	–	(910)
– others	(5,380)	(4,129)	(667)	(5)	(10,181)
	(5,882)	(4,507)	(697)	(5)	(11,091)
Provision for impairment losses	(3,241)	(533)	83	–	(3,691)
Total expenses	(9,123)	(5,040)	(614)	(5)	(14,782)
Profit/(loss) before tax	5,766	1,547	2,834	(63)	10,084
Capital expenditure	975	735	58	–	1,768
	31 December 2006				
Segment assets	451,882	105,045	370,578	6,597	934,102
Segment liabilities	461,797	311,960	91,399	13,786	878,942

35 SEGMENTAL REPORTING *(continued)*

(a) Business segments *(continued)*

	Year ended 31 December 2005				
	Corporate banking	Retail banking	Treasury business	Others and unallocated	Total
External net interest income	12,309	526	3,807	–	16,642
Internal net interest (expense)/income	(74)	3,488	(3,414)	–	–
Net interest income	12,235	4,014	393	–	16,642
Net fee and commission income	681	777	19	90	1,567
Other net income	379	107	418	101	1,005
Operating income	13,295	4,898	830	191	19,214
Operating expenses					
– depreciation	(470)	(350)	(34)	–	(854)
– others	(4,474)	(3,287)	(496)	(4)	(8,261)
	(4,944)	(3,637)	(530)	(4)	(9,115)
Provision for impairment losses	(3,176)	(399)	(62)	–	(3,637)
Total expenses	(8,120)	(4,036)	(592)	(4)	(12,752)
Profit before tax	5,175	862	238	187	6,462
Capital expenditure	691	515	50	–	1,256
	31 December 2005				
Segment assets	390,429	75,331	263,748	5,105	734,613
Segment liabilities	378,475	255,929	63,210	11,001	708,615

35 SEGMENTAL REPORTING *(continued)*

(b) Geographical segments

The Group operates principally in the PRC with branches located in major provinces, autonomous regions and municipalities directly under the central government.

In presenting information on the basis of geographical segments, operating income is allocated based on the location of the branches that generated the revenue. Segment assets and capital expenditure are allocated based on the geographical location of the underlying assets.

Geographical segments, as defined for management reporting purposes, are as follows:

– "Eastern China" region refers to the areas serviced by the following branches of the Group: Shanghai Municipality, Jiangsu Province, Zhejiang Province, Shandong Province, Fujian Province and Anhui Province;

– "Southern and Central China" region refers to the Head Office and the areas serviced by the following branches of the Group: Guangdong Province, Hunan Province, Jiangxi Province, Hubei Province and Henan Province;

– "Western China" region refers to the areas serviced by the following branches of the Group: Sichuan Province, Chongqing Municipality, Yunnan Province, Shaanxi Province, Gansu Province and Xinjiang Autonomous Region;

– "Northern China" region refers to the areas serviced by the following branches of the Group: Beijing Municipality, Tianjin Municipality, Liaoning Province, Heilongjiang Province and Shanxi Province; and

– "Others" refer to operations of Hong Kong branch and the subsidiary.

35 SEGMENTAL REPORTING *(continued)*

(b) Geographical segments *(continued)*

	2006											
	Eastern China		Southern and Central China		Western China		Northern China		Others		Total	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Total operating income (note (i))	**13,280**	**35**	**12,830**	**34**	**3,692**	**10**	**7,462**	**20**	**557**	**1**	**37,821**	**100**
Capital expenditure (note (ii))	**509**	**29**	**898**	**51**	**123**	**7**	**233**	**13**	**5**	**–**	**1,768**	**100**
Total assets	**234,884**	**25**	**481,722**	**52**	**68,741**	**7**	**122,700**	**13**	**26,055**	**3**	**934,102**	**100**
Gross loans and advances to customers	**212,829**	**38**	**177,092**	**31**	**63,327**	**11**	**108,986**	**19**	**3,468**	**1**	**565,702**	**100**
Total customer deposits	**249,848**	**32**	**246,712**	**32**	**84,898**	**11**	**167,831**	**22**	**24,468**	**3**	**773,757**	**100**

	2005											
	Eastern China		Southern and Central China		Western China		Northern China		Others		Total	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Total operating income (note (i))	9,573	33	9,940	35	3,124	11	5,857	20	244	1	28,738	100
Capital expenditure (note (ii))	459	37	431	34	217	17	149	12	–	–	1,256	100
Total assets	164,978	22	407,999	56	56,696	8	98,438	13	6,502	1	734,613	100
Gross loans and advances to customers	145,287	31	192,617	41	49,085	10	82,656	17	2,540	1	472,185	100
Total customer deposits	207,412	33	189,717	30	77,353	12	154,110	24	5,812	1	634,404	100

Notes:

(i) Total operating income represents the operating income gross of interest expense and fee and commission expense.

(ii) Capital expenditure represents total amount incurred for acquiring assets that are expected to be used for some periods.

(Expressed in millions of Renminbi unless otherwise stated)

36 ASSETS PLEDGED AS SECURITY

The following assets have been pledged as collateral for liabilities under repurchase arrangements:

	2006	2005
Secured liabilities	**6,237**	3,150
Assets pledged		
– Available-for-sale financial assets	**1,372**	–
– Held-to-maturity debt securities	**1,545**	2,000
– Other assets	**3,386**	763
	6,303	2,763

37 CONTINGENT LIABILITIES AND COMMITMENTS

(a) Credit commitments

At any given time the Group has outstanding commitments to extend credit. These commitments take the form of approved loans and credit card limits.

The Group provides financial guarantees and letters of credit to guarantee the performance of customers to third parties.

Acceptances comprise undertakings by the Group to pay bills of exchange drawn on customers. The Group expects most acceptances to be settled simultaneously with the reimbursement from the customers.

The contractual amounts of commitments and contingent liabilities are set out in the following table by category. The amounts reflected in the table for commitments assume that amounts are fully advanced. The amount reflected in the table for guarantees and letters of credit represents the maximum potential loss that would be recognised at the balance sheet date if counterparties failed completely to perform as contracted.

37 CONTINGENT LIABILITIES AND COMMITMENTS *(continued)*

(a) Credit commitments *(continued)*

	2006	2005
Contractual amount		
Irrevocable guarantees	**37,063**	34,691
Irrevocable letters of credit	**28,323**	22,436
Bills of acceptances	**166,513**	123,525
Loan commitments		
– with an original maturity of under one year	**1,371**	878
– with an original maturity of one year or over	**5,172**	2,455
Credit card commitments	**31,694**	19,731
Shipping guarantees	**–**	22
	270,136	203,738

Loan commitments only include credit limits granted to offshore customers, and onshore and offshore syndicated loans. The Directors are of the opinion that the Group will not assume any risks on the unused credit limits for other loan customers as such limits are revocable and subject to the loan approval process. As a result, such balances are not included in the above contingent liabilities and commitments.

These commitments and contingent liabilities have off-balance sheet credit risk. Before the commitments are fulfilled or expire, management assesses and makes allowances for any probable losses accordingly. As the facilities may expire without being drawn upon, the total of the contractual amounts is not representative of expected future cash outflows.

	2006	2005
Credit risk weighted amounts of contingent liabilities and commitments		
Contingent liabilities and commitments	**86,444**	68,095

The credit risk weighted amount refers to the amount as computed in accordance with the rules set out by the CBRC and depends on the status of the counterparty and the maturity characteristics. The risk weights used range from 0% to 100% of contingent liabilities and commitments.

(Expressed in millions of Renminbi unless otherwise stated)

37 CONTINGENT LIABILITIES AND COMMITMENTS *(continued)*

(a) Credit commitments *(continued)*

There are no relevant standards prescribed by IFRSs in calculating the above credit risk weighted amounts.

The credit risk weighted amounts stated above have taken into account the effects of bilateral netting arrangements.

(b) Capital commitments

Authorised capital commitments not provided for were as follows:

	2006	2005
For purchase of fixed assets:		
– Contracted for	**126**	335
– Not contracted for	**–**	132

(c) Operating lease commitments

Total future minimum lease payments under non-cancellable operating leases of properties are payable as follows:

	2006	2005
Within 1 year	**739**	539
After 1 year but within 5 years	**1,852**	1,387
After 5 years	**696**	425
	3,287	2,351

The Group and the Bank lease a number of properties under operating leases. The leases typically run for an initial period of 1 to 20 years. Lease payments are usually increased every 1 to 10 years to reflect market rental. None of the lease include contingent rental.

37 CONTINGENT LIABILITIES AND COMMITMENTS *(continued)*

(d) Outstanding litigations

At 31 December 2006, the Group was a defendant in certain pending litigations with gross claims of RMB118 million (2005: RMB250 million) arising from its banking activities. Many of these proceedings are in relation to steps taken by the Bank to collect delinquent loans and enforce rights in collateral securing such loans. The Directors consider that no material losses would be incurred by the Group as a result of these pending litigations and therefore no provision has been made in the financial statements.

(e) Redemption obligations

As an underwriting agent of PRC government bonds, the Group has the responsibility to buy back those bonds sold by it should the holders decide to early redeem the bonds held. The redemption price for the bonds at any time before their maturity date is based on the coupon value plus any interest unpaid and accrued up to the redemption date. Accrued interest payables to the bond holders are calculated in accordance with relevant rules of the MOF and the PBOC. The redemption price may be different from the fair value of similar instruments traded at the redemption date.

The redemption obligations below represent the nominal value of government bonds underwritten and sold by the Group, but not yet matured at the balance sheet date:

	2006	2005
Redemption obligations	**11,621**	11,604

The Group expects that the amount of redemption before the maturity date of these government bonds through the Group will not be material.

38 ENTRUSTED BUSINESS

	2006	2005
Entrusted deposits	**49,801**	28,489
Entrusted loans	**45,627**	28,489
Entrusted investments	**4,174**	–

The Group undertakes entrusted loans and entrusted investments business.

38 ENTRUSTED BUSINESS *(continued)*

Entrusted loans are funded by entrusted deposits and are granted to designated borrowers for specific purposes at terms specified by entrustors. The Group is responsible for managing entrusted loans. Entrusted investments are also funded by entrusted deposits, and investment decisions are made by the Group in accordance with the scope defined by entrustors.

The risks and gains or losses of entrusted business are borne by the entrustors and the Group only earns a commission. Therefore the Group does not recognise the entrusted businesses as its loans, investments and deposits. The above entrusted loans and investments are shown at their granted or invested amounts.

39 RISK MANAGEMENT

(a) Credit risk

Credit risk represents the potential loss that may arise from the failure of a debtor to meet its obligation or commitment to the Group. Credit risk increases when all counterparties are concentrated in a single industry or a geographical region, as different counterparties in the same region or industry may be affected by the same economic development, which may eventually affect their repayment abilities.

The Group has designed its organisation framework, credit policies and processes with an objective to identify, evaluate and manage its credit risk effectively. The Risk Management and Internal Control Committee is set up and is appointed by the Board to be responsible for supervising and evaluating the set-up, organisational structure, work process and effectiveness of various risk management functions. To mitigate risk, the Group may obtain collateral and guarantees where appropriate.

With respect to daily operations, the Risk Management Department, as directed by the Risk Management and Internal Control Committee, monitors and coordinates the work of other risk management functions, including the Corporate Banking Department and the Legal and Compliance Department.

In respect of the loan portfolio, the Group adopts a risk based loan classification methodology. Currently, the Group classifies loans into seven categories: excellent, good, general mention, special mention, substandard, doubtful and loss. The last three categories are considered as impaired loans and advances for which objective evidence of impairment exists based on a loss event or several events and which bear significant impairment losses. The allowances for impairment losses for the impaired loans and advances are assessed collectively or individually as appropriate.

Concentration of credit risk: when certain numbers of customers are in the same business, located in the same geographical region or their industries share similar economic characteristics, their ability to meet their obligations may be affected by the same economic changes. The level of concentration of credit risk reflects the sensitivity of the Group's operating result to a specific industry or geographical region.

39 RISK MANAGEMENT *(continued)*

(a) Credit risk *(continued)*

Analyses of loans and advances by industry, customer type, nature and geographical location are stated in Notes 17 and 35(b).

The Group's credit risk management policy for financial derivatives is the same as that for other transactions. In order to mitigate the credit risk arising from the financial derivatives, the Group has signed netting agreements with certain counterparties.

(b) Market risk

Market risk is the risk of loss arising from movements in observable market variables such as interest rates, exchange rates and equity markets. The Group is exposed to market risk primarily through its proprietary trading activities. The Group considers that any market risk arising from its proprietary trading book is not material.

The Asset and Liability Management Committee ("ALCO") of the Group is responsible for formulating market risk management policies, supervising implementation of the policies and performing independent assessments of the risk status. The Risk Management Department is responsible for managing the risks arising from the day to day operation of the Treasury division.

(c) Currency risk

The Group's foreign exchange exposure mainly comprises foreign exchange dealing by Treasury and is mitigated primarily by matching spot and forward foreign exchange contracts with foreign currency borrowings.

The Group's functional currency is RMB. Foreign currency transactions are mainly in US dollar and HK dollar. The Group's assets and liabilities are mainly denominated in RMB, with the rest being mainly in US dollar and HK dollar.

The Group monitors daily foreign currency transactions and positions closely. The following tables show the Group's assets and liabilities by major currencies as at each balance sheet date.

The PBOC, with the approval of State Council, has made the announcements regarding reforming the RMB exchange rate regime. Starting from 21 July 2005, China has reformed the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The Group has reviewed the exposures and has taken appropriate measures to mitigate currency risks.

(Expressed in millions of Renminbi unless otherwise stated)

39 RISK MANAGEMENT *(continued)*

(c) Currency risk *(continued)*

Assets and liabilities by original currency are shown as follows:

	2006			
		Equivalent in RMB' million		
	RMB	US dollar	Others	Total
Assets				
Cash and balances with central bank	83,768	2,317	909	86,994
Amounts due from banks and other financial institutions	51,126	33,252	20,032	104,410
Loans and advances to customers	525,464	18,899	5,057	549,420
Investments	141,264	34,272	3,349	178,885
Other assets	13,379	480	534	14,393
	815,001	89,220	29,881	934,102
Liabilities				
Amounts due to banks and other financial institutions	72,972	3,238	393	76,603
Deposits from customers	687,357	49,641	36,759	773,757
Financial liabilities at fair value through profit or loss	13	60	33	106
Certificates of deposit issued	–	1,170	–	1,170
Convertible bonds issued	22	–	–	22
Other debts issued	9,987	–	–	9,987
Subordinated notes issued	3,500	–	–	3,500
Other liabilities	11,094	1,905	798	13,797
	784,945	56,014	37,983	878,942
Net on-balance sheet position	30,056	33,206	(8,102)	55,160
Off-balance sheet position:				
Credit commitments (note)	131,590	27,083	4,020	162,693
Derivatives:				
– forward purchase	27,585	8,913	12,816	49,314
– forward sales	(7,626)	(40,801)	(1,285)	(49,712)
– net option position	–	115	(115)	–

39 RISK MANAGEMENT *(continued)*

(c) Currency risk *(continued)*

Assets and liabilities by original currency are shown as follows: *(continued)*

	2005			
		Equivalent in RMB' million		
	RMB	US dollar	Others	Total
Assets				
Cash and balances with central bank	63,561	1,567	889	66,017
Amounts due from banks and other financial institutions	43,196	8,777	13,585	65,558
Loans and advances to customers	430,037	24,733	3,905	458,675
Investments	110,449	18,057	3,396	131,902
Other assets	11,521	332	608	12,461
	658,764	53,466	22,383	734,613
Liabilities				
Amounts due to banks and other financial institutions	38,286	4,463	498	43,247
Deposits from customers	570,620	44,559	19,225	634,404
Financial liabilities at fair value through profit or loss	–	42	44	86
Certificates of deposit issued	–	1,211	–	1,211
Convertible bonds issued	5,184	–	–	5,184
Other debts issued	9,982	–	–	9,982
Subordinated notes issued	3,500	–	–	3,500
Other liabilities	7,596	609	2,796	11,001
	635,168	50,884	22,563	708,615
Net on-balance sheet position	23,596	2,582	(180)	25,998
Off-balance sheet position:				
Credit commitments (note)	111,357	26,156	4,727	142,240
Derivatives:				
– forward purchase	726	5,651	1,671	8,048
– forward sales	(1,915)	(2,439)	(3,387)	(7,741)

Note: Credit commitments generally expire before they are drawn; therefore the above net position (net of pledged deposits) does not represent the cash flows need.

39 RISK MANAGEMENT *(continued)*

(d) Interest rate risk

The Group's interest rate exposures comprise primarily those arising from mismatches in durations and structures of assets and liabilities in its banking operations and from positions undertaken for trading purposes.

Interest rate risk in banking operations is inherent in many business segments of the Group, and arises from factors such as differences in timing between contractual maturities or repricing of assets and liabilities. Similar risk in trading positions arises mainly from investment portfolio undertaken by treasury operation.

The ALCO regularly monitors such interest rate risk positions. The Group regularly performs interest rate sensitivity analysis on these interest rate positions for the purpose of measuring and managing the risk in order to limit potential adverse impacts of movements in interest rate on net interest income.

As the reference interest rates for RMB loans and deposits are determined by the PBOC, the Group follows the interest rates set by the PBOC when carrying out lending and deposit taking activities. The Group's monetary assets and liabilities are mainly in RMB.

39 RISK MANAGEMENT *(continued)*

(d) Interest rate risk *(continued)*

The following table indicates the effective interest rates and the expected next repricing dates (or maturity dates whichever are earlier) for interest bearing assets and liabilities at the balance sheet date.

	2006						
	Effective interest rate (note (i))	Total	3 months or less (include overdue)	Over 3 months to 1 year	Over 1 year to 5 years	Over 5 years	Non-interest bearing
Assets							
Cash and balances with central bank	0.00%-1.89%	86,994	82,372	–	–	–	4,622
Amounts due from banks and other financial institutions	0.41%-6.22%	104,410	97,752	5,583	1,075	–	–
Loans and advances to customers (note (ii))	0.00%-18.00%	549,420	332,397	202,096	12,559	2,368	–
Investments	1.75%-9.05%	178,885	45,668	86,730	35,008	11,228	251
Other assets	–	14,393	–	–	–	–	14,393
Total assets		934,102	558,189	294,409	48,642	13,596	19,266
Liabilities							
Amounts due to banks and other financial institutions	0.00%-6.20%	76,603	73,563	3,040	–	–	–
Deposits from customers	0.00%-7.00%	773,757	616,189	131,932	25,199	437	–
Financial liabilities at fair value through profit or loss	–	106	–	–	–	–	106
Certificates of deposit issued	5.72%	1,170	1,170	–	–	–	–
Convertible bonds issued	6.39%	22	–	–	22	–	–
Other debts issued	2.34%	9,987	–	–	9,987	–	–
Subordinated notes issued	4.74%	3,500	–	–	3,500	–	–
Other liabilities	–	13,797	–	–	–	–	13,797
Total liabilities		878,942	690,922	134,972	38,708	437	13,903
Asset-liability gap		55,160	(132,733)	159,437	9,934	13,159	5,363

(Expressed in millions of Renminbi unless otherwise stated)

39 RISK MANAGEMENT *(continued)*

(d) Interest rate risk *(continued)*

	2005						
	Effective interest rate (note (i))	Total	3 months or less (include overdue)	Over 3 months to 1 year	Over 1 year to 5 years	Over 5 years	Non-interest bearing
Assets							
Cash and balances with central bank	0.00%-1.89%	66,017	62,102	–	–	–	3,915
Amounts due from banks and other financial institutions	0.00%-5.49%	65,558	61,224	4,151	183	–	–
Loans and advances to customers (note (ii))	0.00%-18.00%	458,675	264,129	190,853	3,273	420	–
Investments	0.70%-11.83%	131,902	32,784	57,795	35,628	5,531	164
Other assets	–	12,461	–	–	–	–	12,461
Total assets		734,613	420,239	252,799	39,084	5,951	16,540
Liabilities							
Amounts due to banks and other financial institutions	0.00%-5.74%	43,247	42,612	336	299	–	–
Deposits from customers	0.00%-7.00%	634,404	498,954	116,056	19,361	33	–
Financial liabilities at fair value through profit or loss	–	86	–	–	–	–	86
Certificates of deposit issued	4.27%	1,211	1,211	–	–	–	–
Convertible bonds issued	6.39%	5,184	–	–	5,184	–	–
Other debts issued	2.34%	9,982	–	–	9,982	–	–
Subordinated notes issued	4.74%	3,500	–	–	3,500	–	–
Other liabilities	–	11,001	–	–	–	–	11,001
Total liabilities		708,615	542,777	116,392	38,326	33	11,087
Asset-liability gap		25,998	(122,538)	136,407	758	5,918	5,453

Notes:

(i) Effective interest rates are that carried by respective interest bearing assets/liabilities as at the year end.

(ii) For loans and advances to customers, the above "3 months or less" category includes overdue amounts (net of allowances for impairment losses) of RMB3,065 million as at 31 December 2006 (2005: RMB3,597 million). Overdue amounts represent loans of which the whole or part of the principals was overdue.

39 RISK MANAGEMENT *(continued)*

(e) Liquidity risk

Liquidity risk is the risk that funds will not be available to meet liabilities as they fall due, and it results from amount and maturity mismatches of assets and liabilities. The Group's liquidity is managed by the ALCO. The ALCO is responsible for managing liquidity on a prudent basis to meet regulatory requirement. The day to day monitoring of future cash flows and the maintenance of suitable levels of liquefiable assets by business units are the responsibility of the head office.

A substantial portion of the Group's assets is funded by customer deposits made up of corporate and retail savings accounts and term deposits as well as deposit of banks. These customer deposits, which have been growing in recent years, are widely diversified by type and maturity and represent a stable source of funds.

The Group's loans-to-deposits ratio is maintained within 75%. 9% of total RMB deposits (2005: 7.5%) and 4% of foreign currencies deposits (2005: 3%) are required to be deposited with the PBOC.

(Expressed in millions of Renminbi unless otherwise stated)

39 RISK MANAGEMENT *(continued)*

(e) Liquidity risk *(continued)*

Analysis of the Group's assets and liabilities by remaining maturity is as follows:

	2006								
	Repayable on demand	Within 1 month	After 1 month but within 3 months	After 3 months but within 1 year	After 1 year but within 5 years	After 5 years	Undated	Overdue	Total
Cash and balances with central bank (note (i))	29,324	–	–	–	–	–	57,670	–	86,994
Amounts due from banks and other financial institutions	13,282	58,826	15,104	15,568	1,591	39	–	–	104,410
Loans and advances to customers (note (ii))	–	49,314	93,463	228,092	66,783	108,718	–	3,050	549,420
Investments (note (iii))	6,914	10,843	12,698	59,374	69,726	19,079	251	–	178,885
– at fair value through profit or loss	–	306	741	2,939	3,176	595	203	–	7,960
– available-for-sale	6,914	10,255	10,134	48,928	26,761	6,436	48	–	109,476
– held-to-maturity	–	76	1,400	5,575	35,684	11,330	–	–	54,065
– receivables	–	206	423	1,932	4,105	718	–	–	7,384
Other assets	3,679	302	326	174	243	9	9,636	24	14,393
Total assets	53,199	119,285	121,591	303,208	138,343	127,845	67,557	3,074	934,102
Amounts due to banks and other financial institutions	53,405	4,704	4,530	7,359	6,605	–	–	–	76,603
Deposits from customers (note (iv))	489,451	46,856	66,385	141,802	27,610	1,653	–	–	773,757
Financial liabilities at fair value through profit or loss	–	–	–	–	–	–	106	–	106
Certificates of deposit issued	–	–	–	1,170	–	–	–	–	1,170
Convertible bonds issued	–	–	–	–	22	–	–	–	22
Other debts issued	–	–	–	–	9,987	–	–	–	9,987
Subordinated notes issued	–	–	–	–	3,500	–	–	–	3,500
Other liabilities	10,242	532	1,841	881	228	73	–	–	13,797
Total liabilities	553,098	52,092	72,756	151,212	47,952	1,726	106	–	878,942
Long/(short) position	(499,899)	67,193	48,835	151,996	90,391	126,119	67,451	3,074	55,160

39 RISK MANAGEMENT *(continued)*

(e) Liquidity risk *(continued)*

	2005								
	Repayable on demand	Within 1 month	After 1 month but within 3 months	After 3 months but within 1 year	After 1 year but within 5 years	After 5 years	Undated	Overdue	Total
Cash and balances with central bank (note (i))	25,881	–	–	–	–	–	40,136	–	66,017
Amounts due from banks and other financial institutions	10,615	33,975	8,145	11,197	1,480	146	–	–	65,558
Loans and advances to customers (note (ii))	–	37,891	84,094	204,031	67,524	61,538	–	3,597	458,675
Investments (note (iii))	1,133	7,456	7,641	34,739	57,129	23,640	164	–	131,902
– at fair value through profit or loss	–	371	1,160	6,655	6,560	1,005	118	–	15,869
– available-for-sale	1,133	6,704	4,629	21,063	23,085	3,426	46	–	60,086
– held-to-maturity	–	173	1,111	6,098	22,615	18,714	–	–	48,711
– receivables	–	208	741	923	4,869	495	–	–	7,236
Other assets	660	222	626	956	452	2	9,523	20	12,461
Total assets	38,289	79,544	100,506	250,923	126,585	85,326	49,823	3,617	734,613
Amounts due to banks and other financial institutions	23,336	4,207	3,313	2,550	9,441	400	–	–	43,247
Deposits from customers (note (iv))	387,152	33,716	56,124	129,347	27,104	961	–	–	634,404
Financial liabilities at fair value through profit or loss	–	–	–	–	–	–	86	–	86
Certificates of deposit issued	–	–	–	–	1,211	–	–	–	1,211
Convertible bonds issued	–	–	–	–	5,184	–	–	–	5,184
Other debts issued	–	–	–	–	9,982	–	–	–	9,982
Subordinated notes issued	–	–	–	–	3,500	–	–	–	3,500
Other liabilities	8,706	224	1,069	705	268	29	–	–	11,001
Total liabilities	419,194	38,147	60,506	132,602	56,690	1,390	86	–	708,615
Long/(short) position	(380,905)	41,397	40,000	118,321	69,895	83,936	49,737	3,617	25,998

39 RISK MANAGEMENT *(continued)*

(e) Liquidity risk *(continued)*

Notes:

(i) For balances with central bank, undated amount represents statutory deposit reserve funds and fiscal balances maintained with the PBOC.

(ii) For loans and advances to customers, overdue amounts represent loans of which the whole or part of the principals was overdue. The overdue amounts are stated net of appropriate allowances for impairment losses.

(iii) The remaining maturities of trading assets and assets designated at fair value through profit or loss included in investments do not represent the Group's intention to hold them to maturity.

(iv) Included in the deposits from customers that are repayable on demand were RMB79,767 million time deposits matured and awaiting for customers' instructions (2005: RMB49,356 million).

(f) Operational risk

Operational risk includes the risk of direct or indirect loss due to an event or action causing failure of technology, processes, infrastructure and personnel, and other risks having an operational impact.

The Group manages this risk through a controls-based environment by establishing a framework of policies and procedures to identify, assess, control, manage and report risks. The framework covers all business functions ranging from finance, credit, accounting, settlement, savings, treasury, intermediary business, computer applications and management, special assets resolution and legal affairs. This has allowed the Group to identify and address the operational risk inherent in key products, activities, processes and systems.

(g) Use of derivatives

Derivatives are off-balance sheet financial instruments which include forward, swap and option transactions undertaken by the Group in the foreign exchange and interest rate markets.

The Group enters into financial derivative transactions for treasury business and its assets and liabilities management purpose.

Treasury business includes the formation and sale of financial derivatives to enable customers to transfer, change or mitigate existing or anticipated risks.

When there are mismatches in the interest rates of assets and liabilities, the Group will use interest rate swaps to swap fixed interest rates into floating interest rates.

For assets and liabilities denominated in foreign currencies, the Group will be exposed to risks due to the fluctuations of exchange rates. The Group will use currency swaps and forward contracts to mitigate these risks.

39 RISK MANAGEMENT *(continued)*

(g) Use of derivatives *(continued)*

The following tables provide an analysis of the notional amounts of derivatives of the Group by maturity groupings based on the remaining periods to settlement and the corresponding fair values at the balance sheet date. The notional amounts of the derivatives indicate the transaction volume outstanding at the balance sheet date; they do not represent amounts at risk.

	2006						
	Notional amounts with remaining life of					Fair values	
	Less than 3 months	Between 3 months and 1 year	Between 1 year and 5 years	More than 5 years	Total	Assets	Liabilities
Interest rate derivatives							
Interest rate swaps	5,023	6,740	6,243	1,006	19,012	108	(53)
Currency derivatives							
Spot	15,717	–	–	–	15,717	10	(9)
Forwards	1,803	2,526	470	–	4,799	17	(13)
Foreign exchange swaps	11,976	17,063	156	–	29,195	41	(1)
Currency options	22,950	176	–	–	23,126	27	(30)
	52,446	19,765	626	–	72,837	95	(53)
Total						203	(106)
						(Note 18(a))	(Note 18(e))

(Expressed in millions of Renminbi unless otherwise stated)

39 RISK MANAGEMENT *(continued)*

(g) Use of derivatives *(continued)*

	2005						
	Notional amounts with remaining life of					Fair values	
	Less than 3 months	Between 3 months and 1 year	Between 1 year and 5 years	More than 5 years	Total	Assets	Liabilities
Interest rate derivatives							
Interest rate swaps	1,272	4,949	3,907	294	10,422	39	(51)
Currency derivatives							
Spot	2,826	–	–	–	2,826	1	(1)
Forwards	364	3,481	–	–	3,845	39	(34)
Foreign exchange swaps	182	726	162	–	1,070	7	–
	3,372	4,207	162	–	7,741	47	(35)
Total						86	(86)
						(Note 18(a))	(Note 18(e))

The replacement costs and credit risk weighted amounts in respect of these derivatives are as follows. These amounts take into account the effects of bilateral netting arrangements.

Replacement costs

	2006	2005
Interest rate derivatives	**108**	39
Currency derivatives	**95**	47
	203	86

Replacement cost represents the cost of replacing all contracts which have a positive value when marked to market. Replacement cost is a close approximation of the credit risk for these derivative contracts as at the balance sheet date.

39 RISK MANAGEMENT *(continued)*

(g) Use of derivatives *(continued)*

Credit risk weighted amounts

	2006	2005
Interest rate derivatives	**100**	26
Currency derivatives	**107**	25
	207	51

The credit risk weighted amount refers to the amount as computed in accordance with the rules set out by the CBRC and depends on the status of the counterparty and the maturity characteristics.

(h) Fair value information

(i) Financial assets

The Group's financial assets mainly include cash, deposits and placements with the central banks, banks and other financial institutions, loans and advances to customers and investments.

Except for loans and advances and held-to-maturity investments, most of the financial assets mature within 1 year or are already stated at fair value, and therefore their carrying values approximate their fair values.

Loans and advances are stated at amortised costs less allowances for impairment loss (Note 17). The interest rate of loans and advances will be adjusted in accordance with the PBOC rates, and impairment allowance is made to reduce the carrying amount of impaired loans to estimated recoverable amount. Accordingly, the carrying values of loans and advances are close to the fair values.

Held-to-maturity debt securities investments are stated at amortised costs less impairment, and the fair values are disclosed in Note 18(c).

(Expressed in millions of Renminbi unless otherwise stated)

39 RISK MANAGEMENT *(continued)*

(h) Fair value information *(continued)*

(ii) Financial liabilities

Financial liabilities mainly include customer deposits, deposits and placements from banks and other financial institutions, and debts issued by the Bank. The carrying values of financial liabilities approximate their fair values at the balance sheet date of the year presented, except the financial liabilities set out below:

Carrying value

	2006	2005
Convertible bonds issued	**22**	5,184
Subordinated notes issued	**3,500**	3,500
	3,522	8,684

Fair value

	2006	2005
Convertible bonds issued	**26**	5,595
Subordinated notes issued	**3,563**	3,657
	3,589	9,252

40 SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS

In determining the carrying amounts of some assets and liabilities, the Group makes assumptions for the effects of uncertain future events on those assets and liabilities at the balance sheet date. These estimates involve assumptions about such items as cash flows and discount rates used. The Group's estimates and assumptions are based on historical experience and expectations of future events and are reviewed periodically. In addition to assumptions and estimations of future events, judgements are also made during the process of applying the Group's accounting policies.

40 SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS *(continued)*

(a) Impairment losses on loans and advances

Loan portfolios are assessed periodically to assess whether impairment losses exist and if they exist, the amounts of impairment losses. Objective evidence for impairment includes observable data indicating that there is a measurable decrease in the estimated future cash flows from an individual loan. It also includes observable data indicating adverse changes in the repayment status of borrowers in the loan portfolio or national or local or economic conditions that correlate with defaults on the loans in the portfolio. The impairment loss for a loan that is individually evaluated for impairment is the decrease in the estimated future cash flow of that loan. When loans and advances are collectively evaluated for impairment, the estimate is based on historical loss experience for assets with credit risk characteristics similar to the loans and advances. Historical loss experience is adjusted on the basis of the relevant observable data that reflect current economic conditions. Management reviews the methodology and assumptions used in estimating future cash flows regularly to reduce any difference between loss estimates and actual loss experience.

(b) Impairment of available-for-sale financial assets

For available-for-sale financial assets, a significant or prolonged decline in fair value below cost is considered to be objective evidence of impairment. Judgement is required when determining whether a decline in fair value has been significant or prolonged. In making this judgement, historical data on market volatility as well as in the share price of the specific equity investment are taken into account. The Group also takes into account other factors, such as industry and sector performance and financial information regarding the investee.

(c) Fair value of financial instruments

For a number of financial instruments, no quoted prices in an active market exist. The fair values for these financial instruments are established by using valuation techniques. These techniques include using recent arm's length market transactions, reference to the current fair value of similar instruments and discounted cash flow analysis and option pricing models. The Group has established a process to ensure that valuation techniques are constructed by qualified personnel and are validated and reviewed by personnel independent of the area that constructed the valuation techniques. Valuation techniques are certified before being implemented for valuation and are calibrated to ensure that outputs reflect actual market conditions. Valuation models established by the Group make the maximum use of market inputs and rely as little as possible on the Group's specific data. However, it should be noted that some inputs, such as credit and counterparty risk and risk correlations, require management estimates. Management estimates and assumptions are reviewed periodically and are adjusted if necessary.

(Expressed in millions of Renminbi unless otherwise stated)

40 SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS *(continued)*

(d) Held-to-maturity investments

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity investments if the Group has the intention and ability to hold them until maturity. In evaluating whether the requirements to classify a financial asset as held-to-maturity are met, management makes significant judgements. Failure in correctly assessing the Group's intention and ability to hold specific investments until maturity may result in reclassification of the whole portfolio as available-for-sale.

(e) Income taxes

Determining income tax provisions involves judgement on the future tax treatment of certain transactions. The Group carefully evaluates tax implications of transactions and tax provisions are set up accordingly. The tax treatment of such transactions is reconsidered periodically to take into account all changes in tax legislations. Deferred tax assets are recognised for tax losses not yet used and temporary deductible differences. As those deferred tax assets can only be recognised to the extent that it is probable that future taxable profit will be available against which the unused tax credits can be utilised, management's judgement is required to assess the probability of future taxable profits. Management's assessment is constantly reviewed and additional deferred tax assets are recognised if it becomes probable that future taxable profits will allow the deferred tax asset to be recovered.

41 MATERIAL RELATED-PARTY TRANSACTIONS

(a) Transaction terms and conditions

During the year, the Group entered into transactions with related parties in the ordinary course of its banking business including lending, investment, deposit and off-balance sheet transactions. The Directors are of the opinion that the Group's material related-party transactions were all entered into on normal commercial terms. The banking transactions were priced at the relevant market rates prevailing at the time of each transaction. Interest rates on loans and deposits are required to be set in accordance with the following benchmark rates set by the PBOC:

	From 19 August 2006 to 31 December 2006	From 28 April 2006 to 19 August 2006	From 29 October 2004 to 28 April 2006
Short-term loans	5.58% to 6.12% p.a.	5.40% to 5.85% p.a.	5.22% to 5.58% p.a.
Medium to long-term loans	6.30% to 6.84% p.a.	6.03% to 6.39% p.a.	5.76% to 6.12% p.a.
Saving deposits	0.72% p.a.	0.72% p.a.	0.72% p.a.
Time deposits	1.80% to 4.14% p.a.	1.71% to 3.60% p.a.	1.71% to 3.60% p.a.

There were no allowances for impairment losses on an individual basis against loans and advances granted to related parties during the year.

41 MATERIAL RELATED-PARTY TRANSACTIONS *(continued)*

(b) Shareholders and their related companies

As the Bank's largest shareholder China Merchants Steam Navigation Company Limited ("CMSNCL") and its related companies hold 17.63% of the Bank's shares as at 31 December 2006 (2005: 24.15%), the Directors consider that CMSNCL is not a controlling shareholder of the Bank but can exercise significant influence over the financial and operating decisions of the Bank. The Group's transactions and balances with CMSNCL and its related companies are disclosed as follows:

	2006	2005
On balance sheet:		
Loans and advances	**2,581**	782
Investments	**156**	–
Deposits from customers	**13,196**	667
Off-balance sheet:		
Irrevocable guarantee	**357**	70
Irrevocable letters of credit	**102**	101
Bills of acceptances	**370**	328
Average balance of loans and advances	**1,613**	905
Interest income	**105**	53
Interest expense	**123**	4
Fees and commission (Note)	**174**	41

Note: Apart from the above transactions, the Bank also enters into transactions with CMSNCL and its related companies in the ordinary course of its banking activities such as remittance, securities trading etc. The activities are priced at the relevant market rates at the time of the transactions.

(Expressed in millions of Renminbi unless otherwise stated)

41 MATERIAL RELATED-PARTY TRANSACTIONS *(continued)*

(c) Companies controlled by directors other than those under Note 41(b) above

	2006	2005
On balance sheet:		
Loans and advances	**637**	458
Deposits from customers	**1,030**	445
Deposits from banks and other financial institutions	**–**	337
Average balance of loans and advances	**728**	765
Interest income	**46**	36
Interest expense	**7**	8
Fees and commission	**17**	–

(d) Key management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Group, directly or indirectly, including Directors, Supervisors and Executive Officers.

Remuneration for key management personnel, including amounts paid to the Bank's Directors and Supervisors as disclosed in Note 8 and certain highest paid employees as disclosed in Note 9 during the year is as follows:

	2006	2005
	RMB'000	RMB'000
Salaries and other emoluments	**16,796**	8,794
Discretionary bonuses	**13,499**	11,960
Contributions to defined contribution retirement schemes	**3,177**	723
	33,472	21,477

42 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE YEAR ENDED 31 DECEMBER 2006

Up to the date of issue of the financial statements, the IASB has issued the following amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2006 and which have not been adopted in the financial statements:

		Effective for accounting periods beginning on or after
IFRS 7	Financial Instruments: Disclosures	1 January 2007
Amendment to IAS 1	Presentation of Financial Statements: Capital Disclosures	1 January 2007

The Group has assessed the impact of these amendments, new standards and new interpretations and concluded that they would only affect the level of details in the disclosure of the consolidated financial statements, and would not have an impact on the Group's results or the state of affairs of the Group or the Bank.

43 EVENTS OCCURRED AFTER THE BALANCE SHEET DATE

On 16 March 2007, the Tenth National People's Congress (NPC) plenary session passed a resolution of the draft corporate income tax law submitted by the Standing Committee of the Tenth NPC. According to the income tax law that was passed at the Tenth NPC plenary session, the Group's applicable income tax rate will be changed from 33% to 25% with effective from 1 January 2008. Given the resolution of the new tax law is a non-adjusting event after the balance sheet date, the Group did not apply the new income tax rate in preparing the financial statements for the year ended 31 December 2006. The Group is in the process of making an assessment of the impact of applying the new tax law on the Group's financial position.

Except for the above, the Group had no material post balance sheet date events for disclosure.