

INDUSTRY OVERVIEW

The information set forth below is mainly about the PRC banking sector. It is derived from official sources. While our Directors have exercised reasonable care in compiling and reproducing the information, it has not been independently verified by the Company, the Directors, the Underwriters or any of our or their respective affiliates or advisers. This information may not be consistent with other information compiled within or outside the PRC. In particular (but without limitation), a number of overseas market observers have estimated that the level of the non-performing loans in the PRC banking system may be considerably higher than the figures cited herein, and if such estimates are true, the level of the PRC banking system's assets and some of the other related figures included in this section may be overstated.

OVERVIEW

The PRC banking market is one of the fastest growing banking markets in the world. According to the Almanac of China's Finance and Banking, from 1999 to 2004, total Renminbi deposits received by financial institutions in the PRC increased 121.1%, from RMB10,878 billion to RMB24,053 billion, and total Renminbi loans provided by financial institutions in the PRC increased 89.2%, from RMB9,373 billion to RMB17,736 billion. The following table sets forth the total Renminbi loans, total Renminbi deposits and individual savings deposits in the PRC from 1999 to 2004:

	1999	2000	2001	2002	2003	2004
	(in billions of RMB)					
Total Renminbi loans	9,373	9,937	11,231	13,129	15,900	17,736
Total Renminbi deposits	10,878	12,380	14,362	17,092	20,806	24,053
Individual savings deposits	5,962	6,433	7,376	8,691	10,362	11,956

Source: The People's Bank of China

The expansion of the PRC banking market has benefited primarily from the underlying economic growth and the resulting wealth creation and accumulation since the start of the PRC's economic modernization in 1978. The following table sets forth GDP and GDP per capita in the PRC from 1999 to 2003:

	1999	2000	2001	2002	2003
GDP (RMB billion)	8,207	8,947	9,731	10,517	11,725
GDP per capita (RMB)	6,551	7,086	7,651	8,214	9,101

Source: China Statistical Abstract 2004.

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DOMESTIC PARTICIPANTS IN THE PRC BANKING SECTOR

The PRC banking sector is comprised of wholly state-owned banks, joint stock commercial banks, policy banks, urban commercial banks, rural commercial banks, rural cooperative banks, urban credit cooperatives, rural credit cooperatives and foreign-invested financial institutions. The table below sets forth the number and market share of each type of banking institution as of December 31, 2003.

	<u>Number</u>	<u>Market share based on total assets</u>
Big Four ⁽¹⁾	4	56.8%
Joint stock commercial banks ⁽²⁾	11	14.3%
Policy banks	3	7.9%
Urban commercial banks	112	5.5%
Rural commercial banks	3	0.1%
Urban credit cooperatives	723	0.5%
Rural credit cooperatives	33,979	9.9%
China Post Savings	1	3.4%
Foreign-invested financial institutions	64	1.5%

Source: Almanac of China's Finance and Banking and the People's Bank of China.

- (1) Includes Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China and China Construction Bank.
 (2) Includes Bank of Communications, Citic Industrial Bank, China Everbright Bank, Hua Xia Bank, China Minsheng Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Industrial Bank, and Shanghai Pudong Development Bank.

Big Four

The big four commercial banks, namely, Industrial and Commercial Bank of China, or ICBC, Agricultural Bank of China, or ABC, Bank of China, or BOC, and China Construction Bank, or CCB (together, the "Big Four") have traditionally dominated the PRC banking industry. As of December 31, 2004, according to the PBOC, they accounted for 53.6% of total assets of financial institutions in the PRC.

Joint Stock Commercial Banks

According to the CBRC, as of December 31, 2004, there were 12 joint stock commercial banks in the PRC with a nationwide banking license. As of the same date, we were the largest among these banks in terms of total assets. Joint stock commercial banks generally have diversified shareholders, including, among others, local government entities and state-owned enterprises. Established mostly in the late 1980s and early 1990s, these joint stock commercial banks have gradually increased their collective market share while the market share of the Big Four has gradually decreased. As of December 31, 2004, according to the CBRC, they accounted for approximately 14.9% of total assets of financial institutions in the PRC.

Policy Banks

Three policy banks, China Development Bank, Export-Import Bank of China and Agricultural Development Bank of China, which were established to allow the Big Four to concentrate on commercial lending, are principally mandated to finance government-sponsored projects.

Other Domestic Banking Institutions

Other domestic PRC financial institutions engaged in commercial banking business include urban commercial banks, rural commercial banks, rural cooperative banks, urban credit cooperatives and rural credit cooperatives.

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PRC BANKING SECTOR REFORM

Reforming the banking sector is one of the major challenges of economic reform undertaken by the PRC government. These reforms have focused primarily on the improvement of the legal and regulatory framework; the enhancement of asset quality and the capital base; and the liberalization of interest rates.

Improvement of the legal and regulatory framework

The steps taken by the PRC government to improve the legal and regulatory framework include:

- the establishment of an independent central banking system, originally with the PBOC as both the central bank and the banking supervisory authority;
- the establishment of the CBRC in April 2003 to take over the banking supervisory and regulatory functions of the PBOC; and
- the implementation of new corporate governance and management standards across all PRC financial institutions.

See the section headed "Supervision and Regulation".

Improvement of asset quality and enhancement of capital base

The PRC banking sector has been historically burdened with large portfolios of non-performing loans. According to the CBRC, outstanding non-performing loans at the Big Four, policy banks and joint stock commercial banks amounted to approximately RMB1.7 trillion at the end of 2004, representing 13.2% of the total loans in the PRC. The following table sets forth certain information regarding the non-performing loans of state-owned and joint stock commercial banks as of the date indicated:

	As of December 31, 2004	
	Amount	% of total loan
	(in billions of RMB, except percentages)	
Non-performing loans by category:		
Substandard	308	2.4%
Doubtful	890	6.8%
Loss	520	4.0%
	1,718	13.2%
Non-performing loans by types of banks:		
Big Four	1,575	15.6%
Joint stock commercial banks ⁽¹⁾	143	4.9%

Source: China Banking Regulatory Commission

(1) Includes Bank of Communications, Citic Industrial Bank, China Everbright Bank, Hua Xia Bank, Minsheng Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Industrial Bank, Shanghai Pudong Development Bank and Evergrowing Bank.

Due to the large amount of non-performing loans in the PRC banking industry, the PRC government has taken various measures to resolve the non-performing loan problem and improve the capital adequacy levels of PRC banks. In 1999, the PRC government established four asset management companies to assume and resolve the non-performing loans transferred from the Big Four. In 1999, the Big Four transferred an aggregate of RMB1.4 trillion in assets to the four asset management companies. In 2004, CCB, BOC and our Company similarly transferred over RMB330 billion of non-performing loans to Cinda. In an effort to allow banks as well as regulators to better monitor bank asset quality in accordance with international practice, a five-category classification system was formally implemented in 2002.

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In conjunction with the transfer of these non-performing loans, regulators also employed capital injection measures to enhance the capital base of commercial banks. In 1998, a total of RMB270 billion was injected into the Big Four. In 2004, another US\$45 billion was injected into BOC and CCB for their recapitalization. In 2004, our Company was the recipient of a RMB18 billion capital injection. For details, see the section headed “Our Reorganization and Restructuring – Financial Restructuring”.

Interest Rate Reform

PRC commercial banks set the interest rates of their Renminbi deposits and loans in accordance with the benchmark rates published and modified by the PBOC from time to time. However, the PRC government has taken gradual measures to liberalize interest rates by widening the band within which commercial banks may set their Renminbi lending rates around the benchmark rates.

In January 1987, the PBOC for the first time allowed PRC commercial banks to set the interest rates for Renminbi-denominated lending within a range that is 10% lower to 20% higher than the PBOC benchmark rate. After incremental changes in the intervening years, on January 1, 2004, the PBOC further extended the upper limit of Renminbi-denominated lending rates, except for mortgages and policy loans, to no higher than 70% of the benchmark rate. Subsequently, on October 29, 2004, the PBOC removed the upper limit for Renminbi-denominated lending rates while retaining the lower limit for such rates. Effective on the same date, all deposit-taking institutions are now allowed to decrease (but not increase) Renminbi-denominated deposit rates to below the corresponding PBOC benchmark rates. See the section headed “Supervision and Regulation” for further details.

FOREIGN COMPETITION IN THE PRC BANKING SECTOR

Foreign financial institutions can conduct banking business in the PRC by establishing branches in the PRC, forming joint venture financial institutions with PRC financial institutions, or establishing wholly foreign-owned financial institutions. According to the Almanac of China’s Finance and Banking, as of December 31, 2003, the PRC government had given its approval to 64 foreign banks to open 169 branches and sub-branches and to set up 15 wholly foreign-owned commercial banks, joint venture commercial banks and finance companies in the PRC. As of December 31, 2003, according to the PBOC, foreign-invested financial institutions accounted for 1.5% of the total assets of financial institutions in the PRC.

PRC laws and regulations also permit foreign financial institutions to purchase or subscribe for limited equity interests in PRC banks. Currently, a foreign financial institution can purchase or subscribe for up to 20% of the equity interest in a PRC bank. HSBC, for example, purchased a 19.90% stake in our Company in August 2004.

Although the scale of foreign banks’ activities in the PRC remains limited by regulatory constraints, the PRC banking sector has been gradually opening to foreign entities. Upon the PRC’s entry into the WTO, foreign banks were permitted to offer foreign currency-denominated products and services in the PRC without any geographic or client restrictions. Starting December 11, 2004, foreign banks have been permitted to offer Renminbi-denominated services and products to PRC enterprises in 18 major cities including, among others, Beijing and Shanghai. At the end of 2006, the PRC banking sector will be fully opened to foreign banks without any restrictions on business scope or geography. As a result, competition in the PRC banking sector from foreign banks is expected to intensify.

In addition, the Mainland and Hong Kong Closer Economic Partnership Arrangement, a free trade agreement commonly known as the CEPA, became effective on January 1, 2004. The CEPA enables smaller Hong Kong banks to enter the PRC banking sector, which we expect will increase the competition in the PRC banking industry. For example, under the CEPA, commercial banks incorporated in Hong Kong with US\$6 billion or more in total assets are qualified to apply for the establishment of branches in the PRC. By comparison, under the relevant PBOC and CBRC regulations, commercial banks incorporated in other jurisdictions must have US\$20 billion or more in total assets to be qualified to apply for the establishment of branches.

GROWTH IN RETAIL BANKING

Although corporate banking continues to be the main business for most PRC commercial banks, retail banking products and services have also grown significantly. For example, according to the PBOC, consumer loans outstanding rose from RMB17.2 billion at the end of 1998 to RMB1,573.3 billion at the end of 2003, representing 9.9% of total loans outstanding and 13.5% of GDP. However, the level of consumer lending in the PRC is still significantly below that in other countries.

Bank Cards

While bank card penetration in the PRC remains low in comparison to developed countries, the bank card business experienced rapid growth in recent years. The total cards outstanding increased from 383 million as of December 31, 2001 to 762 million as of December 31, 2004, according to the PBOC. The growth has also been accompanied by an expansion of the electronic banking terminal network.

Debit cards have been the primary type of bank card in the PRC. As of December 31, 2004, debit cards outstanding amounted to 663 million. As of the same date, there were 98 million credit cards issued. The development of the credit card market has so far been limited by a variety of reasons, including strict regulation on licensing, underdevelopment of a national payment infrastructure and the absence of a nationwide consumer credit information system. However, with an increasing number of licences for banks to engage in credit card business being issued, the development of China UnionPay and the establishment of a national personal credit database as promoted by the PBOC, the credit card industry is expected to grow significantly in the future.

Residential Mortgages

Demand for housing in the PRC increased significantly in the 1990s when the PRC government began its housing reform by eliminating housing benefits for employees of state-owned enterprises and civil servants. As of December 31, 2004, the total outstanding balance of residential mortgages reached RMB1.6 trillion, approximately 38 times the balance at the end of 1998. Mortgage lending accounts for a majority of consumer lending by PRC banks. The residential mortgage market has, as a result, become a significant factor for sustained economic growth in the PRC. Although the PRC government has adopted measures to tighten its policies on lending to the real estate industry starting in 2003, residential mortgage loans have continued to grow at a rapid pace.