

BANKING INDUSTRY IN CHINA

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OVERVIEW

Since the late 1970s, China's economy has grown rapidly as a result of the extensive economic reforms initiated by the PRC government. According to the National Bureau of Statistics of China, China's GDP grew at a compound annual growth rate of 13.6% between 2001 and 2005. In 2005, China's total GDP amounted to RMB18.2 trillion, making China's economy the fourth largest in the world. China is also the third largest import and export country in the world with a total import and export volume of US\$1.4 trillion in 2005. The following table sets forth the total and per capita GDP of the PRC from 2001 to 2005:

	For the year ended December 31,					Compound annual growth rate
	2001	2002	2003	2004	2005	2001-2005
GDP (in billions of RMB)	10,965.5	12,033.3	13,582.3	15,987.8	18,232.1	13.6%
GDP per capita (in RMB)	8,622	9,398	10,542	12,336	13,985	12.9%

Source: National Bureau of Statistics of China.

The following table sets forth, for the periods indicated, the annual real GDP growth of the six largest economies in the world, including China, based on 2005 GDP:

	For the year ended December 31,				
	2001	2002	2003	2004	2005
	(in percentages)				
China	8.3%	9.1%	10.0%	10.1%	9.9%
France	2.1	1.3	0.9	2.1	1.4
Germany	1.2	0.1	(0.2)	1.6	0.9
Japan	0.4	0.1	1.8	2.3	2.7
United Kingdom	2.2	2.0	2.5	3.2	1.8
United States	0.8	1.6	2.7	4.2	3.5

Source: Economist Intelligence Unit.

The financial services sector in China has grown significantly primarily as a result of the rapid development of China's economy. The banking sector has benefited from the rapid economic development in China and plays a leading role in financing activities and allocation of credit resources in China. In addition, bank deposits remain the primary vehicle for domestic savings. According to the PBOC, the amount of total Renminbi-denominated deposits and loans in China increased at a compound annual growth rate of 18.9% and 14.7%, respectively, from December 31, 2001 to December 31, 2005. At December 31, 2005, the total assets of China's banking industry amounted to RMB38.4 trillion. The following table sets forth, at the dates indicated, total Renminbi-denominated

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and foreign currency-denominated deposits and total Renminbi-denominated and foreign currency-denominated loans, and the related compound annual growth rates, for the period indicated, for banking institutions in China:

	At December 31,					Compound annual growth rate
	2001	2002	2003	2004	2005	2001-2005
Total Renminbi-denominated deposits (in billions of RMB)	14,361.7	17,091.7	20,805.6	24,142.4	28,716.9	18.9%
Total Renminbi-denominated loans (in billions of RMB)	11,231.5	13,129.4	15,899.6	17,819.8	19,469.0	14.7%
Total foreign currency-denominated deposits (in billions of U.S. dollars)	134.9	150.7	148.7	153.0	161.6	4.6%
Total foreign currency-denominated loans (in billions of U.S. dollars)	80.6	102.8	130.2	135.3	150.5	16.9%

Source: PBOC.

Note: Amounts of the total deposits and loans presented above consist, as applicable, of the deposits or loans of the PBOC, the Big Four commercial banks, other national commercial banks, city commercial banks, urban credit cooperatives, rural commercial banks, rural credit cooperatives, foreign-invested banks, policy banks, finance companies, trust and investment companies, financial leasing companies and the postal savings bureau.

The Big Four commercial banks, namely, our bank, Agricultural Bank of China, Bank of China and China Construction Bank, are the primary players in the banking industry in China. At December 31, 2005, total assets of the Big Four commercial banks represented 53.5% of the total assets of banking institutions in China.

In recent years, in addition to the traditional corporate lending business, there has been significant growth in fee- and commission-based products and services and personal loans in the PRC commercial banking industry. From December 31, 2001 to December 31, 2005, total outstanding principal amount of Renminbi-denominated personal loans in China increased at a compound annual growth rate of 33.1%. Continuing economic growth and rising income levels in China are expected to result in greater demand for sophisticated corporate and personal banking products and services, presenting further growth potential for China's banking industry.

HISTORY AND DEVELOPMENT

Pre-1984

China established a centralized national banking system in 1953. Not only did the PBOC act as China's central bank, but it also engaged in ordinary commercial banking activities, such as deposit-taking, loan extension, and clearing and settlement services. During this period, Bank of China was the international business arm of the PBOC, China Construction Bank, formerly known as the People's Construction Bank of China, which operated under the direction of the MOF, was primarily responsible for administering and disbursing government funds designated for infrastructure projects, and Agricultural Bank of China, which merged into the PBOC in 1965, was established to provide financing for China's agriculture sector. This banking system remained in place until the beginning of China's economic reforms in the late 1970s.

As part of its economic reform program, the PRC government began to implement changes to the banking system in China at the end of the 1970s. One of the significant measures taken by the PRC

government was to establish state-owned specialized banks. In early 1979, the government separated Agricultural Bank of China and Bank of China from the PBOC and placed China Construction Bank under the direct supervision of the State Council. These three banks were designated to specialize in agrarian financing; foreign exchange and trade financing; and construction and infrastructure financing, respectively. At the end of 1983, the State Council officially designated the PBOC as the central bank of China and the principal regulator and supervisor of China's banking system.

1984 - 1994

We were established as a state-owned specialized bank designated to specialize in urban commercial financing on January 1, 1984, when all of the commercial banking functions of the PBOC were transferred to our bank. The State Council allowed the four state-owned specialized banks to have limited autonomy with respect to their commercial operations and permitted them to expand into other commercial banking businesses beyond their specialized functions. Beginning from the mid-1980s, with the encouragement and support of the PRC government, a number of small- and medium-sized joint-stock commercial banks and rural and urban credit cooperatives were established. However, during this period, China's banking system continued to be tightly restricted by governmental plans and policies, and China's banks were not operated on an independent and commercial basis.

1994 - 2003

In the mid-1990s, the PRC government accelerated its financial reforms and began to encourage the state-owned specialized banks to operate on a more commercial basis. In 1994, the PRC government established three policy banks—China Development Bank, The Export-Import Bank of China and Agricultural Development Bank of China—to assume substantially all policy lending functions of the state-owned specialized banks. Accordingly, the four state-owned specialized banks were transformed into state-owned commercial banks. In 1995, China adopted the PRC Commercial Banking Law, which required that PRC commercial banks be responsible for their own business operations, risk management and financial performance. However, due to the transitional nature of the Chinese economy at that time, PRC commercial banks continued to operate under significant governmental influence.

In the late 1990s, the PRC government undertook further initiatives to improve the banking industry's risk management and asset quality, and to strengthen its capital base. In 1998, the MOF contributed RMB270.0 billion to the Big Four commercial banks as equity to improve their capital adequacy by issuing special government bonds. In 1999, the PRC government established four asset management companies—China Huarong Asset Management Corporation, China Great Wall Asset Management Corporation, China Cinda Asset Management Corporation and China Orient Asset Management Corporation—as vehicles to primarily acquire and manage non-performing assets of the Big Four commercial banks. The PBOC also required all PRC commercial banks to implement a five-category loan classification system. Furthermore, the PBOC issued directives to require that PRC commercial banks implement strict credit extension policies and authorization procedures. In 2003, the CBRC was established to assume a majority of the banking regulatory functions of the PBOC and act as the primary regulator of the banking industry in China. For a description of the CBRC and a number of initiatives undertaken by the PRC government in recent years with respect to China's banking industry, see "Regulation and Supervision—PRC Regulation and Supervision."

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2003 - Present

At the end of 2003, the PRC government commenced a major restructuring of China's banking industry. In December 2003, Huijin contributed US\$22.5 billion as equity to each of China Construction Bank and Bank of China. Subsequent to these equity contributions in 2004, China Construction Bank and Bank of China each disposed of or wrote off non-performing assets, introduced foreign and domestic strategic investors and issued subordinated debts. Our restructuring commenced in April 2005 when Huijin contributed US\$15.0 billion as equity to our bank, and the MOF retained RMB124.0 billion of our then existing capital. For a description of our restructuring, see "Our Restructuring and Operational Reform—Financial Restructuring."

INDUSTRY STRUCTURE

The following table sets forth, at December 31, 2005, certain information relating to the total assets, loans and deposits of the banking institutions in each category, which are based on PRC GAAP data.

	At December 31, 2005						
	Number of institutions	Total assets		Total loans		Total deposits	
		Amount	% of total	Amount ⁽⁶⁾	% of total	Amount	% of total
(in billions of RMB, except numbers of institutions and percentages)							
Big Four commercial banks	4	20,552.2	53.5%	10,810.2	50.5%	17,374.4	58.7%
Other national commercial banks ⁽¹⁾	13	5,897.5	15.3	3,530.6	16.5	4,570.0	15.4
City commercial banks	115	2,059.1	5.4	1,112.6	5.2	1,691.1	5.7
Urban credit cooperatives	681 ⁽⁵⁾	205.1	0.5	114.8	0.5	181.3	0.6
Rural credit cooperatives ⁽²⁾	32,876 ⁽⁵⁾	3,175.4	8.3	1,900.9	8.9	2,767.4	9.4
Foreign-invested banks ⁽³⁾	211 ⁽⁵⁾	635.3	1.6	330.1	1.6	169.5	0.6
Others ⁽⁴⁾	149 ⁽⁵⁾	5,923.5	15.4	3,603.7	16.8	2,839.8	9.6
Total		<u>38,448.1</u>	<u>100.0%</u>	<u>21,402.9</u>	<u>100.0%</u>	<u>29,593.5</u>	<u>100.0%</u>

Source: PBOC, annual reports and prospectuses of relevant banks.

(1) Amounts of total assets, loans and deposits do not include those of China Zheshang Bank and Bohai Bank.

(2) Consists of rural commercial banks and rural credit cooperatives.

(3) At December 31, 2004, there were 67 foreign-invested banks involved in 211 operations in China, consisting of 186 branches, nine wholly owned banks, 13 joint-venture banks and three finance companies.

(4) Consists of policy banks, finance companies, trust and investment companies, financial leasing companies and the postal savings bureau. Amounts of total assets, loans and deposits, however, do not include those of the postal savings bureau.

(5) At December 31, 2004.

(6) Amounts for total loans are before allowance for impairment losses.

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The Big Four Commercial Banks

Since their establishment, the Big Four commercial banks have been the principal source of financing in China, particularly for state-owned enterprises. At December 31, 2005, total assets of the Big Four commercial banks represented 53.5% of the total assets of banking institutions in China. The following table sets forth, at December 31, 2005, the total assets, loans and deposits, which are based on PRC GAAP data, and the approximate number of domestic and overseas branches, outlets and other establishments of each of the Big Four commercial banks:

At December 31, 2005							
Total assets		Total loans		Total deposits		Approximate number of branches, outlets and other establishments	
Amount	% of total	Amount ⁽¹⁾	% of total	Amount	% of total		
(in billions of RMB, except numbers of branches, outlets and other establishments and percentages)							
Industrial and Commercial Bank of							
China	6,454.1	31.4%	3,289.6	30.4%	5,660.5 ⁽²⁾	32.6%	18,870
Agricultural Bank of China	4,771.0	23.2	2,829.3	26.2	4,036.9	23.2	28,234
Bank of China	4,742.8	23.1	2,235.0	20.7	3,703.8	21.3	11,618
China Construction Bank	4,584.3	22.3	2,456.3	22.7	3,973.2	22.9	14,250
Total	20,552.2	100.0%	10,810.2	100.0%	17,374.4	100.0%	72,972

Source: Annual reports and prospectuses of relevant banks.

(1) Amounts for total loans are before allowances for impairment losses.

(2) Amounts for total deposits exclude the fiscal deposits and outward remittance.

Other National Commercial Banks

At December 31, 2005, there were 13 other national commercial banks in China. These banks are licensed to engage in commercial banking activities nation-wide. The total assets of these national commercial banks represented 15.3% of the total assets of banking institutions in China at December 31, 2005.

Other Market Participants

City commercial banks are permitted to engage in commercial banking activities within specific geographic areas. Urban and rural credit cooperatives and rural commercial banks provide a limited range of designated banking products and services for small enterprises and local residents in specific urban and rural areas.

Foreign-invested banks are currently subject to certain restrictions on their operations. See “Regulation and Supervision—PRC Regulation and Supervision—Regulation of Foreign-invested Financial Institutions Operating in China.” Pursuant to its WTO accession commitments, China has progressively permitted foreign-invested banks to conduct Renminbi-denominated banking businesses and, by the end of 2006, all restrictions on the geographic presence, customer base and operational licenses of foreign-invested banks are expected to be removed.

Other financial institutions include policy banks, finance companies, trust and investment companies, financial leasing companies and the postal savings bureau. China’s postal savings bureau operates through the nation-wide network of post offices and offers savings deposits, remittance and a limited number of other banking services.

INDUSTRY TRENDS

Strengthened Regulation and Other Banking Sector Reforms

The PBOC and, since its establishment in 2003, the CBRC have implemented a series of reform initiatives designed to strengthen the regulation and supervision of China's banking sector, liberalize the financial markets, and enhance corporate governance and risk management of PRC commercial banks. These initiatives include, among others:

- strengthening regulation and supervision with respect to issues such as capital adequacy, asset quality, liquidity, operating efficiency and profitability;
- the gradual liberalization of market entry and interest rates;
- encouraging banks to establish a corporate governance structure that includes a board of directors with independent directors and audit, risk management and other board committees, and requiring banks to create an independent internal audit function with clearly defined policies and procedures and develop an internal control system in line with international best practices;
- requiring banks to improve credit approval procedures and other lending practices, supervising the implementation of the five-category loan classification and the related loan loss provisioning practices, and strengthening the regulatory requirements for market risk and operational risk management;
- encouraging foreign investment in China's banking sector by, among other measures, raising the 15% ownership limit on individual foreign investments in PRC domestic commercial banks to 20%, with a 25% maximum limit on total foreign holdings in non-listed PRC commercial banks; and
- encouraging commercial banks to expand into new business areas and selecting certain qualified banks to adopt the universal banking model on a trial basis, including encouraging commercial banks to jointly develop businesses with insurance companies and establish fund management companies.

See "Regulation and Supervision."

Further Growth of Fee- and Commission-based Products and Services

Historically, PRC commercial banks were restricted in their ability to charge fees and commissions for banking services. Since 2001, the PRC government has begun to allow PRC commercial banks greater flexibility to charge fees and commissions for their banking services. According to the CBRC, the domestic fee and commission income of the Big Four commercial banks increased from RMB6.9 billion in 1995 to RMB38.9 billion in 2004, representing a compound annual growth rate of 21.2%. Fee- and commission-based products and services are expected to contribute increasingly to the operating income of PRC commercial banks as the PRC government continues its financial reforms and PRC commercial banks seek to meet the increasingly sophisticated demand of their corporate and personal banking customers.

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Increasing Demand for Personal Banking Products and Services

In recent years, demand for personal banking products and services in China has grown significantly. We believe that rising income levels in China will continue to foster demand for personal banking products, including consumer finance and personal wealth management products and services. The following table sets forth certain key personal income data for China and their respective compound annual growth rates for the periods indicated:

	For the year ended December 31,					Compound annual growth rate
	2001	2002	2003	2004	2005	2001-2005
	(in RMB, except percentages)					
Per capita annual disposable income of urban households	6,860	7,703	8,472	9,422	10,493	11.2%
Per capita annual net income of rural households	2,366	2,476	2,622	2,936	3,255	8.3%

Source: National Bureau of Statistics of China.

Renminbi-denominated personal loans totalled RMB2.2 trillion at December 31, 2005, representing 11.3% of total loans in China, according to the PBOC. By comparison, at December 31, 2005, outstanding personal loans as a percentage of total loans was 39.2% in the U.S. and 28.2% in Japan. Accordingly, we believe that the personal lending business in China has significant potential for growth. From December 31, 2001 to December 31, 2005, total outstanding principal amount of Renminbi-denominated personal loans in China increased at a compound annual growth rate of 33.1%.

Property mortgage loans have been the largest component of personal loans. Private home ownership has grown significantly in China primarily as a result of the housing reform programs implemented by the PRC government since the 1980s. Total personal property mortgage loans grew from RMB559.8 billion at December 31, 2001 to approximately RMB1.8 trillion at December 31, 2005, according to the PBOC. Although the PRC government has adopted various measures to tighten lending to the property sector since 2003 to address the overheating of the housing market, personal property mortgage loans have continued to grow significantly in the past few years. Since April 2006, the PRC government has introduced certain new monetary policies and other regulatory measures to contain the expansion of the real estate industry, as well as certain other industries. See “Risk Factors—Risks Relating to China—China’s Economic, Political and Social Conditions, as well as Government Policies, Could Affect Our Business.”

The bank card business in China has also expanded rapidly in recent years. The total number of bank cards in China increased from approximately 383 million at December 31, 2001 to approximately 960 million at December 31, 2005. This growth was accompanied by an expansion of the electronic banking terminal network. Debit cards have been the primary type of bank card issued in China. At December 31, 2005, there were approximately 920 million debit cards and approximately 40 million credit cards in issue. The development of the credit card market has been limited to date for a variety of reasons, including strict regulation on licensing, underdeveloped nation-wide payment infrastructure and, until recently, the absence of a nation-wide consumer credit information system. However, with the increasing number of banks being licensed to engage in credit card business, the development of a unified national inter-bank information exchange network for bank cards by China Unionpay and the development of a nation-wide personal credit information system by the PBOC, we expect China’s credit card industry to grow significantly in the future.

In addition, personal wealth management business has experienced significant growth in China in recent years. For example, the annual volume of open-end funds issued in China increased from 11.7 billion units in 2001 to 101.8 billion units in 2005, representing a compound annual growth rate of 71.7%. At December 31, 2005, the total net assets of all the open-end funds outstanding in China amounted to RMB386.9 billion. With the continued transformation of the PRC financial system and the further development of the universal banking model in the PRC banking industry, demand for personal wealth management products and services is expected to continue to grow rapidly.

Rapid Growth of Inter-bank Market

Since its establishment in the mid-1990s, the inter-bank market in China has grown significantly. The PRC inter-bank market currently consists of a number of segments, including inter-bank borrowings, discounted bills, bonds, foreign exchange, futures and gold. In addition, in recent years, there have been significant developments in new financial tools and derivative products in the PRC inter-bank market, which include, among others, non-recourse repurchase of bonds, bond forwards, interest rate swaps, foreign exchange forwards, foreign exchange swaps and commercial paper. According to the PBOC, the total amount of inter-bank borrowings increased from RMB197.8 billion in 1998 to RMB1.3 trillion in 2005, representing a compound annual growth rate of 30.9%. The total amount of bonds repurchased on a non-recourse basis increased from RMB1.4 trillion in 1998 to RMB18.2 trillion in 2005, representing a compound annual growth rate of 44.3%. The total amount of foreign exchange traded in the inter-bank market of China increased from US\$40.8 billion in 1994 to US\$209.0 billion in 2004, representing a compound annual growth rate of 17.7%.

Improvement in Asset Quality

Historically, China's banking sector was burdened with a high level of non-performing loans. Since the late 1990s, the PRC government has undertaken a series of measures designed to assist the Big Four commercial banks in improving asset quality. These measures include establishing four asset management companies as vehicles primarily to acquire and manage the non-performing loans of the Big Four commercial banks, which contributed to the decrease in their ratios of non-performance loans. According to the CBRC, the ratio of non-performing loans of the Big Four commercial banks, as calculated in accordance with PRC GAAP, decreased to 10.5% at December 31, 2005 from 20.4% at December 31, 2003. In addition, pursuant to PRC government directives and regulatory requirements, the Big Four and other PRC commercial banks have adopted various measures designed to enhance their risk management capabilities and improve their asset quality.

Development of National Credit Information System

In recent years, the PRC government has begun to develop a nation-wide credit information system in order to enable PRC commercial banks to make better-informed credit decisions. In September 2003, the PBOC established the Credit Information System Bureau, or CISB, to focus on developing nation-wide credit information systems.

In 1997, the PBOC began to develop a bank loan registration system to collect credit information on corporate borrowers. At November 30, 2005, the system had collected data on approximately 4.5 million corporate loan borrowers, and the outstanding Renminbi-denominated loans recorded in the system amounted to RMB17.4 trillion, representing approximately 90.0% of the total outstanding Renminbi-denominated loans of financial institutions in China. By the end of 2005, the

PBOC had upgraded this system into a consolidated nation-wide corporate credit information database. In December 2005, the upgraded system was introduced in selected regions on a trial basis. It is expected that, beginning from the second half of 2006, all PRC commercial banks and certain qualified rural credit cooperatives will implement this system.

In 2004, the CISB started to develop a personal credit information system to collect information on personal credit data. At December 31, 2005, the outstanding personal loans recorded in this system amounted to RMB2.2 trillion, representing 97.5% of the total outstanding personal loans in China. After implementing this system on a trial basis in selected PRC commercial banks and rural credit cooperatives, the CISB officially launched the system on a nation-wide basis in January 2006.

Greater Participation by Foreign-invested Banks

Historically, foreign-invested banks operating in China faced significant restrictions. Since China's accession to the WTO in December 2001, China has gradually lifted restrictions imposed on foreign-invested banks and, as described above, all the remaining restrictions are expected to be removed by the end of 2006. In addition, in recent years, the PRC government has adopted a series of initiatives to encourage participation in China's banking industry by foreign-invested banks, including:

- lowering capital requirements for the establishment of branches in China by foreign-invested banks;
- simplifying the procedures for foreign-invested financial institutions to enter the PRC market;
- increasing the maximum percentage of ownership interests in domestic financial institutions that may be held by foreign investors; and
- encouraging qualified overseas strategic investors to participate in the restructuring and reform of China's banking industry.

Furthermore, as a result of the CEPA, more commercial banks in Hong Kong and Macau are expected to enter the PRC banking market. Under the CEPA, commercial banks incorporated in Hong Kong or Macau with US\$6 billion or more in total assets may apply to establish branches in the PRC. This minimum asset requirement is significantly lower than the minimum requirement of US\$20 billion in total assets for banks incorporated in other jurisdictions.

The trend of greater foreign participation in China's banking industry is also reflected in the recent significant increase in investments in PRC domestic commercial banks by major international commercial banks and financial institutions. In connection with their equity investments, these international banks and financial institutions have generally entered into business cooperation arrangements with the respective PRC commercial banks to cooperate with them in developing their corporate governance and risk management capabilities. In addition, these business cooperation arrangements include plans to jointly develop products and services in credit cards, wealth management, treasury services and other areas considered to have high growth potential. As China's economy continues to grow, we expect foreign investments in China's banking industry to increase.

Increasing Direct Access of Corporations to China's Capital Markets

In May 2005, the PBOC promulgated regulations allowing qualified corporations to issue commercial paper in the domestic inter-bank market. Following this regulatory change, the domestic

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commercial paper market has grown significantly. Compared to bank loans, commercial paper currently represents a less expensive source of financing for corporations. In addition, China's capital markets continue to evolve and expand. Consequently, direct financing channels are expected to become an increasingly important source of financing for Chinese corporations.