

PRC REGULATION AND SUPERVISION

Overview

The commercial banking industry is highly regulated in the PRC, with the CBRC and the PBOC acting as the principal regulatory authorities. The CBRC is responsible for the supervision and regulation of banking institutions in China. The PBOC, as the central bank of the PRC, is responsible for formulating and implementing monetary policy. The applicable laws and regulations governing activities in the PRC banking industry consist principally of the PRC Banking Supervision and Regulation Law, the PRC Commercial Banking Law and the PRC People's Bank of China Law, as well as rules and regulations promulgated thereunder.

The PRC Banking Supervision and Regulation Law became effective on February 1, 2004, and defines the scope of duties of the State Council banking regulatory authority. The PRC Commercial Banking Law became effective on July 1, 1995, and was later amended on December 27, 2003. It provides the fundamental operating principles for commercial banks. The PRC People's Bank of China Law became effective on March 18, 1995 and was later amended on December 27, 2003. It defines the scope of duties and the organizational structure of the PBOC and grants the PBOC the mandate to formulate and implement monetary policy and maintain the stability of the financial markets.

Principal Regulators

Prior to April 2003, the PBOC acted both as China's central bank and as the principal regulator of the banking industry in China. In April 2003, the CBRC was established to become the primary banking industry regulator and assumed the majority of the regulatory functions from the PBOC. The PBOC retained its role as the central bank.

The CBRC

The CBRC is the primary supervisory authority and is responsible for the regulation of the banking industry in China, including commercial banks, urban credit cooperatives, rural credit cooperatives, other deposit-taking institutions and policy banks, as well as certain non-banking financial institutions such as financial asset management companies, trust and investment companies, finance companies, financial leasing companies, and other financial institutions. According to the PRC Banking Supervision and Regulation Law and related regulations, the main regulatory responsibilities of the CBRC include:

- setting rules and regulations to govern banking institutions and their activities;
- authorizing the establishment, changes, dissolution and business scope of banking institutions;
- establishing qualification requirements for the directors and senior management of banking and financial institutions;
- establishing prudent operational guidelines and standards for the risk management, internal controls, capital adequacy, asset quality, allowance for impairment losses, risk concentration, related party transaction, liquidity and other aspects of banking institutions in accordance with relevant laws and regulations;
- conducting on-site inspection and off-site monitoring of the business activities and risks of banking institutions;

- imposing corrective and punitive measures for violations of applicable banking regulations, including suspension of business operations and closure of banking and financial institutions;
- examining the qualifications of the shareholders of banking institutions; and
- compiling and publishing statistics and reports on the banking industry.

The CBRC and its local offices monitor the operations of commercial banks and their branches through on-site inspections and off-site surveillance. On-site inspections generally include visiting a bank's premises, interviewing bank employees and, for significant issues relating to a bank's operations or risk management, senior management and directors, as well as reviewing documents and materials maintained by the bank. The CBRC also conducts off-site surveillance by reviewing financial and other reports regularly submitted by banks. If a banking institution is not in compliance with a regulation, the CBRC has the power to issue corrective and punitive measures, including, but not limited to, imposing fines, ordering the suspension of certain business activities, imposing restrictions on dividends and other forms of distributions and asset transfers, and suspending the opening of new branches. In the event of a credit crisis within a banking institution, the CBRC may assume management control over, or arrange for the restructuring of, such banking institution. In extreme cases or when the commercial bank fails to take corrective actions within the time period specified by the CBRC, the CBRC may order a banking institution to suspend operations and revoke its financial operating license.

In 2006, the CBRC promulgated several rules on administrative licensing to clearly set forth and standardize the procedures and enhance the transparency and effectiveness of its banking and financial institution licensing activities in connection with, among others, the establishment of a banking institution, its organizational change, or any change or expansion in its business scope.

The PBOC

As China's central bank, the PBOC is responsible for formulating and implementing monetary policy and maintaining the stability of the financial markets. Under the PRC People's Bank of China Law and the relevant regulations, the primary responsibilities of the PBOC include:

- promulgating and implementing the decrees or rules necessary to perform its functions;
- formulating and implementing monetary policy by establishing benchmark interest rates and setting the reserve deposit ratios for commercial banks;
- extending loans to commercial banks, accepting discounted bills and conducting open market operations;
- regulating the domestic inter-bank lending market and the inter-bank bond market;
- holding, managing and operating China's foreign exchange reserves and gold reserves;
- regulating foreign exchange activities and the inter-bank foreign exchange market;
- organizing and supervising anti-money laundering activities in the PRC financial sector and monitoring fund transfers for compliance with anti-money laundering regulations;
- managing the state treasury;
- maintaining the normal operation of the clearing and settlement systems;

- collecting data and performing analysis and forecasts for the financial industry; and
- supervising the collection of credit information and rating industry and promoting the establishment of a nation-wide credit information database.

Other Regulatory Authorities

In addition to the CBRC and the PBOC, commercial banks are also subject to supervision and regulation by other regulatory authorities including primarily:

- SAFE, in relation to foreign exchange settlement business;
- CSRC, in relation to fund custody business and the regulation of companies listed in China; and
- CIRC, in relation to bancassurance business.

Licensing Requirements

Basic Requirements

The PRC Commercial Banking Law and the Measures of the CBRC on Implementation of Administrative Licensing Relating to Domestic Commercial Banks, which became effective on February 1, 2006, define the permitted business scope of commercial banks and establish licensing standards and other requirements. The establishment of a commercial bank requires the CBRC's approval and issuance of a financial operating license. In general, the establishment of a commercial bank is subject to the following principal conditions:

- the articles of association of the proposed commercial bank must comply with relevant requirements of the PRC Commercial Banking Law and the PRC Company Law;
- the registered capital of the proposed bank must meet the minimum requirement under the PRC Commercial Banking Law. The minimum required registered capital for a national commercial bank, city commercial bank and rural commercial bank is RMB1.0 billion, RMB100 million and RMB50 million, respectively;
- the directors and senior management of the proposed bank must possess the requisite professional skills and work experience;
- the organizational structure and management system must be well-established; and
- the business premises, safety and preventive measures and other operational facilities must comply with relevant requirements.

Approvals for Certain Activities

PRC commercial banks are required to obtain the CBRC's approval if they undergo certain changes, including principally:

- change of name;
- change of registered capital;
- change of the location of the head office or any branch;
- change of business scope;

- change of shareholders holding 5% or more of the bank's total capital or shares;
- amendment to the articles of association;
- merger or separation; and
- dissolution and liquidation.

Establishment of Branches

Domestic Branches

A commercial bank must apply to the CBRC or its local offices for approval and issuance of a financial operating license to establish a branch. In order to obtain this license, the branch must have sufficient operating funds commensurate with its scale and must meet other operating requirements. The sum of the operating funds provided to all branches of a bank may not exceed 60% of the total capital of the bank.

Overseas Branches

The establishment of overseas branches by PRC commercial banks is subject to the CBRC's approval, and to applicable regulations in the relevant foreign jurisdiction. In general, the CBRC will not approve an overseas branch application unless the applicant bank has satisfied a number of requirements, including, among others, (i) a capital adequacy ratio of not less than 8%, (ii) total equity investments not exceeding 50% of its net assets, (iii) recorded profits for the preceding three fiscal years, (iv) total assets in the immediately preceding year-end exceeding RMB100 billion, and (v) legitimate and adequate sources of foreign currency.

Regulation of Commercial Banking Activities

Lending

PRC banking regulations require commercial banks to take government macroeconomic policies into consideration in making lending decisions. Accordingly, commercial banks are encouraged to limit their lending to restricted industries in accordance with relevant government policies.

The CBRC promulgated Due Diligence Guidelines on Credit Extension by Commercial Banks, effective since July 25, 2004, which further specify rules relating to pre-lending due diligence investigations on corporate borrowers. After credit is granted, PRC commercial banks must continue to monitor factors that may affect the ability of the borrower to repay and must prepare written credit assessment reports on a regular basis.

The CBRC imposes a number of restrictions on commercial banks extending certain types of loans. Under the Guidelines on Credit Extension to Group Companies by Commercial Banks, effective since October 23, 2003, a commercial bank's total outstanding credit exposure to a group customer may not exceed 15% of its Net Capital Base.

Under the Automobile Loan Measures, effective since October 1, 2004, the amount of loans extended for automobiles for personal use may not exceed 80% of the purchase price of such automobiles, while for commercial automobiles and second-hand automobiles, the amount of loans may not exceed 70% and 50%, respectively, of the purchase price of such automobiles.

Under the Real Estate Loan Guidelines, effective since August 30, 2004, commercial banks are prohibited from making loans to real estate developers unless they have funded a minimum of 35% of the total investment of the real estate development project in the form of equity. Commercial banks are required to focus on the repayment ability of the residential mortgage loan borrower to ensure that the borrower's monthly housing expense and his total monthly debt service is no more than 50% and 55%, respectively, of his monthly income. Under the Opinion of Adjusting the Housing Supply Structure and Stabilizing Housing Prices approved by the State Council, effective since June 1, 2006, the down payment of any personal residential mortgage loan should not be less than 30% of the housing price, except that for any housing for personal use by the borrower with a gross floor area of less than 90 square meters, the down payment should not be less than 20% of the housing price.

Personal Wealth Management

The Tentative Guidelines for the Administration of the Personal Wealth Management Businesses of Commercial Banks, or the Wealth Management Guidelines, became effective on November 1, 2005. In an effort to establish standardized management systems in this area, the Wealth Management Guidelines place a number of restrictions on commercial banks offering personal wealth management products, including obtaining CBRC approval or filing with the CBRC prior to launching personal wealth management products.

In addition to the Wealth Management Guidelines, the CBRC has also issued the Guidelines for Risk Control of the Personal Wealth Management Businesses of Commercial Banks, effective since November 1, 2005, which require commercial banks to establish analysis, examination and reporting systems for personal wealth management services, and to keep the relevant authorities informed as to the risk management methods, risk assessment criteria and measures and other major risk management issues pertaining to its personal wealth management business.

In addition to permitting commercial banks to conduct domestic wealth management businesses, the PBOC, the CBRC and the SAFE jointly issued the Provisional Measures for Overseas Wealth Management by Commercial Banks, which became effective since April 17, 2006, to permit duly licensed commercial banks to make overseas investments in pre-approved financial products on behalf of domestic institutions and resident individuals.

Securities and Asset Management Businesses

Under the PRC Commercial Banking Law, commercial banks are generally prohibited from conducting securities business in China. However, commercial banks are permitted to:

- underwrite and trade bonds issued by the PRC government and PRC financial institutions and commercial paper issued by qualified non-financial institutions;
- act as agents in transactions involving securities, including bonds issued by the government and commercial paper issued by qualified non-financial institutions;
- provide institutional and individual investors with asset management advisory services;
- act as financial advisors in connection with large infrastructure projects, mergers and acquisitions, bankruptcy and reorganizations; and
- act as custodians for asset management companies and investment funds.

Under the Trial Administrative Measures on Fund Management Companies Owned by Commercial Banks, effective since May 20, 2005, state-owned commercial banks and joint-stock commercial banks are permitted to establish or acquire fund management companies with the approval of the CBRC and the CSRC. Commercial banks are required to implement detailed measures to segregate risks associated with the securities market and the banking sector.

Securitization of Credit Assets by Financial Institutions

Under the Measures for the Pilot Supervision and Management of the Securitization of Credit Assets by Financial Institutions, issued by the CBRC and effective since December 1, 2005, the CBRC is responsible for supervising the securitization of credit assets by financial institutions. Without the approval of the CBRC, a financial institution is not permitted to act as a promoter in the business of credit asset securitization in the PRC nor as a trustee for special purpose trusts created to hold securitized credit assets. Such approval is subject to meeting relevant qualification requirements, including, among others, the establishment of sound corporate governance, risk management and internal control systems, and a competent professional team.

Insurance

Commercial banks in China are not permitted to underwrite insurance policies, but are permitted to act as agents to sell insurance products through their distribution network. Commercial banks that conduct agency sales of insurance products are required to comply with applicable rules issued by the CIRC. Pursuant to the Interim Measures on the Administration of Ancillary Agency Insurance Business promulgated by the CIRC on August 4, 2000, commercial banks are required to obtain licenses from the CIRC before conducting agency insurance business. Pursuant to the Notice Regarding Standardization of Agency Insurance Business Conducted by Banks issued by the CIRC and the CBRC on June 15, 2006, such licenses are required for all tier-1 branches of commercial banks conducting such business.

Proprietary Investments

Unless otherwise provided by the relevant laws and regulations, PRC commercial banks generally are prohibited from engaging in the trust investment and securities businesses, investing in real estate other than for their own use, and making equity investments in non-bank financial institutions and other entities in China. Currently, commercial banks are allowed to make investments in debt instruments issued by the PRC government and PRC financial institutions, commercial paper issued by qualified PRC non-financial institutions, domestic corporate bonds traded in the inter-bank market, and derivative products.

Derivatives

The Provisional Administrative Measures on the Derivatives Business of Financial Institutions issued by the CBRC, which became effective on March 1, 2004, set forth, among other matters, detailed regulations on market access and risk management with respect to the derivatives business conducted by financial institutions. On March 22, 2005, the CBRC issued the Circular on Risk Alert Regarding Trading of Derivative Products by Domestic Banks to further strengthen the risk management of the derivatives businesses conducted by commercial banks.

Under the Provisional Administrative Measures on Derivative Business of Financial Institutions, commercial banks seeking to engage in the derivatives business must obtain prior approval from the CBRC. Such approval is subject to relevant qualification requirements, which include, among others, the establishment of a sound risk management and internal control system, a sophisticated business processing system and a real-time risk monitoring system. In addition, the bank must have a competent professional team to conduct its derivatives business. According to the Circular on Risk Alert Regarding Trading of Derivative Products by Domestic Banks, banks engaging in the derivatives business are required to strictly implement trading and exposure authorization limits and stop loss limits. All material derivatives trading activities and all trading activities involving new derivative products must be approved by the bank's board of directors or senior management duly authorized by the board of directors.

Pricing of Products and Services

Interest Rates for Loans and Deposits

Commercial banks are required to set interest rates on Renminbi-denominated loans and deposits within permitted bands around the benchmark rates set by the PBOC. During the three year period ended December 31, 2005 and the six-month period ended June 30, 2006, the PBOC has increased the overall benchmark rates for Renminbi-denominated loans and/or deposits on October 29, 2004 and April 28, 2006. On August 18, 2006, the PBOC further increased the benchmark rates for Renminbi-denominated loans and deposits. In addition, on March 17, 2005, the PBOC abolished the mandatory discount, from the PBOC benchmark rates for loans, on residential mortgage loans.

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The following table sets forth the applicable benchmark interest rates in effect for the periods indicated:

	PBOC benchmark interest rates for Renminbi-denominated loans and deposits				
	From 06/10/99 to 02/20/02	From 02/21/02 to 10/28/04	From 10/29/04 to 04/27/06	From 04/28/06 to 08/18/06	Since 08/19/06
	(in percentages per annum)				
Loans					
Short-term loans					
Less than six months	5.58%	5.04%	5.22%	5.40%	5.58%
Six months to one year	5.85	5.31	5.58	5.85	6.12
Medium- and long-term loans					
One to three years	5.94	5.49	5.76	6.03	6.30
Three to five years	6.03	5.58	5.85	6.12	6.48
More than five years and up to thirty years	6.21	5.76	6.12	6.39	6.84
Residential mortgage loans ⁽¹⁾ :					
Five years or less	5.31	4.77	4.95	6.12	6.48
More than five years	5.58	5.04	5.31	6.39	6.84
Entrusted provident housing fund mortgage loans:					
Five years or less	4.14	3.60	3.78 ⁽²⁾	4.14 ⁽⁴⁾	4.14
More than five years	4.59	4.05	4.23 ⁽³⁾	4.59 ⁽⁵⁾	4.59
Deposits					
Demand deposits					
	0.99	0.72	0.72	0.72	0.72
Time deposits					
Three months	1.98	1.71	1.71	1.71	1.80
Six months	2.16	1.89	2.07	2.07	2.25
One year	2.25	1.98	2.25	2.25	2.52
Two years	2.43	2.25	2.70	2.70	3.06
Three years	2.70	2.52	3.24	3.24	3.69
Five years	2.88	2.79	3.60	3.60	4.14

- (1) Effective since March 17, 2005, the PBOC benchmark mortgage rates are the same as the PBOC benchmark rates for loans with the same terms.
- (2) Increased to 3.96% per annum during the period from March 17, 2005 to May 8, 2006.
- (3) Increased to 4.41% per annum during the period from March 17, 2005 to May 8, 2006.
- (4) With the consent of the PBOC, the general office of the Ministry of Construction issued a circular on April 28, 2006, which stipulates that the interest rates of all levels of entrusted provident housing fund mortgage loans increase by 0.18%. Accordingly, the interest rate of loans with a five-year term or less increased to 4.14% from 3.96% (which was the applicable rate from March 17, 2005 to May 8, 2006).
- (5) With the consent of the PBOC, the general office of the Ministry of Construction issued a circular on April 28, 2006, which stipulates that the interest rates of all levels of entrusted provident housing fund mortgage loans increase by 0.18%. Accordingly, the interest rate of loans with a term more than five years increased to 4.59% from 4.41% (which was the applicable rate from March 17, 2005 to May 8, 2006).

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As the PRC government further liberalizes its interest rate regime, commercial banks have been given more discretion in determining the interest rates for Renminbi-denominated loans and deposits. The following table sets forth the permitted interest rate bands for Renminbi-denominated loans and deposits for the periods indicated:

	Loans			Deposits		
	Between 09/01/99 and 12/31/03 ⁽¹⁾	Between 01/01/04 and 10/28/04 ⁽²⁾	Since 10/29/04	Between 09/01/99 and 12/31/03	Between 01/01/04 and 10/28/04	Since 10/29/04
Maximum interest rates	Up to 130% of the PBOC benchmark rate for small- and medium-sized enterprises (up to 150% for rural credit cooperatives) and up to 110% for large enterprises	Up to 170% of the PBOC benchmark rate (up to 200% for rural credit cooperatives)	No cap (up to 230% for rural and urban credit cooperatives)	PBOC benchmark rate, except for negotiated deposits	PBOC benchmark rate, except for negotiated deposits	PBOC benchmark rate, except for negotiated deposits
Minimum interest rates	Not lower than 90% of the PBOC benchmark rate	Not lower than 90% of the PBOC benchmark rate	Not lower than 90% of the PBOC benchmark rate ⁽³⁾	PBOC benchmark rate, except for negotiated deposits	PBOC benchmark rate, except for negotiated deposits	0%

- (1) Interest rates for residential mortgage loans, public assistance loans, policy loans and certain other loans specified by the State Council may not exceed the PBOC benchmark rate.
- (2) Interest rates for residential mortgage loans, public assistance loans and certain other loans specified by the State Council may not exceed the PBOC benchmark rate.
- (3) Starting from August 19, 2006, the interest rates for residential mortgage loans may not be lower than 85% of the PBOC benchmark rate.

Prior to January 1, 2004, all Renminbi-denominated loans with a maturity of one year or less were required to have fixed interest rates and all Renminbi-denominated loans with a maturity longer than one year were required to have floating interest rates. When the applicable PBOC benchmark interest rates changed, the interest rates on floating rate corporate loans were generally reset on the next anniversary of the loan origination date following the date of change, while the interest rates on floating rate residential mortgage loans were generally reset on January 1 of the year following the date of change.

Since January 1, 2004, loans with a maturity longer than one year have been allowed to bear fixed interest rates. For corporate loans and personal consumption loans, commercial banks have been allowed to negotiate the terms of floating interest rates on a monthly, quarterly or annual basis. For residential mortgage loans, personal educational loans and certain other specified loans, the terms of floating interest rates are reset on January 1 of the year following the date of the change in the applicable benchmark interest rate. Since March 17, 2005, interest rates for residential mortgage loans have the same reset mechanism as other commercial loans.

Starting from October 29, 2004, commercial banks have been allowed to set their own interest rates on Renminbi deposits so long as such interest rates are not higher than the applicable PBOC benchmark rates. However, these restrictions do not apply to interest rates on negotiated deposits, which include deposits from insurance companies in amounts of RMB30 million or more, or deposits from provincial level social security fund management institutions in amounts of RMB500 million or more, both with a term greater than five years, or deposits from the postal savings bureau in amounts of RMB30 million or more with a term longer than three years.

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

Commercial banks are allowed to set interest rates for discounted bills based on the PBOC rediscount rates, provided that they do not exceed the benchmark interest rates for loans of the same maturity period. The PBOC rediscount rate was 2.16% from June 10, 1999 to September 10, 2001, 2.97% from September 11, 2001 to March 24, 2004, and has been 3.24% since March 25, 2004.

Pricing for Fee- and Commission-based Products and Services

According to the Tentative Administrative Measures on Pricing of Commercial Banking Services promulgated by the CBRC and the NDRC and effective since October 1, 2003, non-lending services which are subject to government price guidance include basic Renminbi settlement services, such as bank drafts, bank acceptance drafts, promissory notes, checks, remittances, entrusted collection, and other services specified by the CBRC and the NDRC. Fees for other fee- and commission-based products and services are determined by commercial banks based on market conditions. Commercial banks are also required to report to the CBRC at least 15 business days prior to the implementation of new fee schedules and to publish such fee schedules in their relevant business offices at least ten business days prior to their implementation.

Statutory Reserve Deposit and Surplus Reserve Deposit

Commercial banks are required to maintain a percentage of the balance of their general deposits in the form of reserves with the PBOC to ensure that they have sufficient liquidity for customer withdrawals. The required percentage, or reserve deposit ratio, for a commercial bank with respect to customer deposits denominated in Renminbi varies in accordance with its capital adequacy ratio calculated in accordance with the formula promulgated by the CBRC. The reserve deposit ratio is determined based on PRC GAAP and other factors such as asset quality. Effective since August 15, 2006, most commercial banks, including the Big Four commercial banks, are required to maintain reserves equal to at least 8.5% of their total outstanding balance of Renminbi-denominated deposits. Those commercial banks which fail to meet certain PBOC standards may be required to maintain a higher reserve deposit ratio. Commercial banks are also required to maintain reserves with the PBOC equal to at least 3% of their total foreign currency-denominated deposits. Effective since September 15, 2006, commercial banks are required to increase their foreign currency-denominated deposit reserves with the PBOC to 4% of their total foreign currency-denominated deposits. Unlike in many developed countries, such as the United States, there is no deposit insurance with respect to retail deposits in the PRC. See “Risk Factors—Risks Relating to China—China’s economic, political and social conditions, as well as government policies, could affect our business.”

In addition, PRC commercial banks and foreign banks in the PRC maintain surplus reserve deposits with the PBOC, which are deposits exceeding the statutory deposit reserve. Surplus reserve deposits are used for settlement and other routine payment purposes.

Capital Adequacy

Capital Adequacy Guidelines

According to the PRC Commercial Banking Law and the Administrative Measures on the Capital Adequacy Ratios of Commercial Banks, or the New Measures, which were promulgated by the CBRC on February 23, 2004, and implemented on March 1, 2004, PRC commercial banks are subject to a minimum capital adequacy ratio of 8% and a minimum core capital adequacy ratio of 4%.

The New Measures provide that all commercial banks are required to meet minimum capital adequacy standards by January 1, 2007. Commercial banks not immediately in compliance with the New Measures must formulate and implement a capital increase plan under the supervision of the CBRC. The CBRC monitors the progress made by such banks under their phase-in plans and may take corrective measures.

The New Measures assign risk weighting for a variety of assets and require deductions from core capital for certain kinds of assets. In addition, the New Measures require PRC commercial banks to make adequate allowances for various impairment losses, including for loans, before calculating their capital adequacy ratios. The capital adequacy ratio and core capital adequacy ratio are calculated in accordance with the New Measures as follows:

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

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

Components of Capital

Total capital consists of core capital and supplementary capital. Supplementary capital of commercial banks may not exceed 100% of core capital.

Core capital	includes paid-in capital, capital reserves, surplus reserves, retained earnings and minority interests.
Supplementary capital	includes up to 70% of the revaluation reserve, general allowance for impairment losses, preference shares, qualifying convertible bonds, and qualifying long-term subordinated debt not exceeding 50% of core capital.
Capital deductions	include goodwill, 100% of equity investments in unconsolidated financial institutions, and 100% of equity investments in non-financial institutions and capital investment in real estate not for self-use.
Core capital deductions	include goodwill, 50% of equity investments in unconsolidated financial institutions, and 50% of equity investments in non-financial institutions and capital investment in real estate not for self-use.

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Risk-weighted Assets

The New Measures provide for the calculation of risk-weighted assets net of any allowance for impairment losses by multiplying on-balance sheet items by their corresponding risk weighting, after taking into account risk mitigating factors. Off-balance sheet risk-weighted assets are calculated by multiplying the nominal principal amount by a credit conversion factor, which then converts to balance sheet credit-equivalent amounts. With respect to risk-weighted assets, such as exchange rate, interest rate and other derivative products, commercial banks are required to analyze them according to current risk exposure. In addition, loans secured by certain types of collateral or guarantees are allocated the risk weighting of the collateral or guarantors. Partially collateralized or guaranteed loans receive lower risk-weightings only on the portion of the loan that is collateralized or guaranteed. The following table sets forth risk weightings for different categories of assets:

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

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

Capital Charge for Market Risk

Commercial banks with trading books that exceed the lower of (i) 10% of the aggregate value of their on- and off-balance sheet assets and (ii) RMB8.5 billion are required to make a capital charge for market risk. Market risk refers to the risk of losses in a bank's on- and off-balance sheet positions arising from movements in market prices and includes risks related to interest-rate sensitive financial instruments and securities under trading accounts, and all of the foreign exchange risk and commodity

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risk of PRC commercial banks. If the market risk capital charge is applicable, capital must be applied against the sum of risk-weighted assets and market risk to determine capital adequacy.

CBRC Supervision of Capital Adequacy

The CBRC reviews and evaluates banking institutions' capital adequacy through both on-site examination and off-site surveillance. Commercial banks are required to report to the regulators their unconsolidated capital adequacy ratios on a quarterly basis, and their consolidated capital adequacy ratios on a semi-annual basis. Commercial banks are classified into three categories based on their capital adequacy as follows:

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

The actions that the CBRC takes to enforce the capital adequacy requirements may vary based on the classification of a bank. These actions may include, among others, issuing a supervisory notice, requiring such bank to submit and implement an acceptable capital restoration plan, restricting asset growth or reducing risk-bearing assets, restricting the purchase of fixed assets, restricting dividends and other forms of distributions, suspending all businesses except low-risk activities and suspending the establishment of new branches or restricting the launch of new services.

Significantly undercapitalized banks may be required to take further actions, including removing senior management, transferring control, restructuring organizations, or, in the most severe cases, closing in accordance with relevant laws and regulations.

Basel Accords

The Basel Capital Accord, or Basel I, was introduced by the Basel Committee on Banking Supervision, or the Basel Committee, in 1988. Basel I is a capital measurement system for banks that provides for the implementation of a credit risk measurement framework with a minimum capital standard of 8%. Since 1999, the Basel Committee has issued certain proposals for the New Basel Capital Accord, known as Basel II, to replace Basel I. Basel II retains the key elements of Basel I, including the general requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets, but seeks to improve the capital framework in various key aspects, including (i) making recommendations relating to capital requirements and credit risk measurement to improve the capital framework's sensitivity to credit risks, (ii) introducing supervision and review standards for banks to conduct internal assessments of their overall risks and (iii) enhancing the degree of transparency in banks' public reporting. Basel II is expected to be made available in its entirety at the end of 2007.

The CBRC has advised that the New Measures are based on Basel I while taking into consideration certain aspects of Basel II.

Issuance of Subordinated Bonds

The Measures on the Administration of Issuance of Subordinated Bonds by Commercial Banks became effective on June 17, 2004. Under such measures, PRC commercial banks are permitted to

issue subordinated bonds. A PRC commercial bank may, upon approval by the CBRC, include such subordinated bonds in its supplementary capital. Subordinated bonds can be issued either in a public offering in the inter-bank bond market or in a private placement. A PRC commercial bank may not hold an aggregate amount of subordinated bonds issued by other PRC commercial banks in excess of 20% of its core capital. The PBOC regulates the issuance and trading of subordinated bonds in the inter-bank bond market.

On December 12, 2005, the CBRC issued the Notice Regarding the Issuance of Hybrid Capital Bonds by Commercial Banks for the Replenishment of Supplementary Capital, permitting eligible commercial banks to issue hybrid capital bonds in the inter-bank market and include such bonds in their supplementary capital. The introduction of hybrid capital bonds in China opened a new channel for commercial banks to replenish their supplementary capital and improve their capital adequacy ratio.

Loan Classification, Provisioning and Write-offs

Loan Classification

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

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

(1) PRC commercial banks may implement more detailed guidelines consistent with these definitions.

The CBRC monitors the quality of loans extended by commercial banks through on-site inspections and/or off-site surveillance.

Provision Requirements

Under the Bank Loan Loss Provisioning Guidelines of the PBOC, or Provisioning Guidelines, which became effective on January 1, 2002, commercial banks are required to make provisions on a prudent and timely basis based on a reasonable estimate of the probability of loss. According to the Loan Classification Principles, a loan classified as substandard, doubtful or loss is considered to be non-performing. According to the Provisioning Guidelines, provisions for loan loss include general

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provisions, specific provisions, and special provisions. General provisions refer to the provisions made for all unidentified but possible losses, which are required to be not less than 1% of the year-end balance of total outstanding loans; specific provisions refer to the provisions made for each risk category under the Loan Classification Principles, by reference to the provisioning percentages, as stipulated in the table below, of the total balance of outstanding loans in each risk category.

<u>Category</u>	<u>Provisioning Ratio</u>
Normal	—
Special mention	2%
Substandard	25%
Doubtful	50%
Loss	100%

For substandard and doubtful loans, commercial banks have the discretion to maintain their specific allowances for impairment losses at levels ranging from 20% below the guidance level to 20% above the guidance level, depending on the banks' own assessment of the risks relating to the relevant loans. Special provisions refer to the provisions made for the risks related to certain countries, regions, industries, or certain types of loans. Commercial banks have the discretion to make special provisions on a quarterly basis in accordance with special risk factors (including risks in association with certain industries and countries), general loss rates and historical experience.

In addition, the MOF has also promulgated the Administrative Measures for Non-performing Loan Provisioning by Financial Institutions, which became effective on July 1, 2005. Pursuant to these measures and a subsequent notice issued by the MOF, commercial banks and certain other financial institutions in the PRC are required to maintain adequate allowance for impairment losses against their assets. These new measures are consistent with the policies for assessing allowance for impairment losses under IAS39 and, accordingly, there is no difference between IFRS and the PRC GAAP on the treatment of allowance for impairment losses. In addition, financial institutions should also set up a general reserve through appropriation of profit after tax to cover their potential losses that are not yet identified. The general reserve forms part of the equity of the financial institutions. Financial institutions are required to assess the risk profile of their assets in determining the general reserve level. The general reserve is made to cover those assets in respect of which the financial institutions bear risk of potential impairment losses, and is in principle not less than 1% of the aggregate amount of those assets before allowance for impairment losses as at the balance sheet date. Financial institutions are not allowed to make profit distributions to shareholders until adequate allowance for impairment losses and general reserve have been made. If a financial institution cannot meet the requirement of maintaining adequate general reserves as stipulated in these MOF regulations and notices as of July 1, 2005, the financial institution is required to take the necessary steps to ensure that such requirement can be met in approximately three years, but not more than five years, from the year 2005. At June 30, 2006, our balance of general reserve was RMB7.0 billion. We plan to meet the 1% requirement by the end of 2010 whereby we will be in compliance with the transition period set forth in the MOF guidelines. See "Financial Information—Dividend Policy."

Supervision of Loan Classification and Allowances

In 2003, the CBRC published a circular that reiterated the implementation of the Loan Classification Principles and provided additional guidance on loan classification criteria. Pursuant to a joint announcement made by the PBOC and the CBRC in 2004, the CBRC supervises and examines commercial banks' implementation of the PBOC's Loan Classification Principles and Loss

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

Loan Write-offs

Under the current rules issued by the MOF, including the Administrative Measures for the Provisioning for and the Write-off of Non-Performing Loans by Financial Institutions, effective since January 1, 2001, PRC commercial banks are required to establish a strict review and approval process to control the loan write-off procedures. A loan needs to meet the standards set by the MOF to be written off. According to the SAT regulations, including the Administrative Measures for Tax Deduction of Financial Companies' Bad Debt Loss, effective since October 1, 2002, certain bad loans may be deducted before taxes, but the deduction must first be reviewed and approved for compliance with the relevant standards of the tax authorities.

Liquidity and Other Operational Ratios

The following table sets forth, at the dates indicated, the required liquidity and loan-to-deposit ratios for commercial banks, as well as our liquidity and loan-to-deposit ratios as reported to the PBOC and the CBRC. Our ratios were calculated in accordance with the formula under the Examination Measures and Supervision Indicators Relating to the Administration of Assets/Liabilities Ratio of Commercial Banks issued by the PBOC in 1996, or the 1996 Ratio Rules, and were based on our balance sheet data prepared in accordance with PRC GAAP.

	<u>Requirement</u>	<u>At December 31,</u>			<u>At</u>
		<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>June 30,</u>
					<u>2006</u>
Liquidity ratios					
Renminbi current assets to Renminbi current liabilities	≥25.0%	45.5%	45.2%	48.9%	50.8%
Foreign currency current assets to foreign currency current liabilities	≥60.0%	81.8%	75.2%	83.4%	73.0%
Loan-to-deposit ratios⁽¹⁾					
Renminbi loans ⁽²⁾ to Renminbi deposits	≤75.0%	68.8%	65.1%	49.1%	48.4%
Foreign currency loans ⁽²⁾ to foreign currency deposits	≤85.0%	70.3%	72.6%	79.1%	70.5%

(1) The ratios were based on the financial data of domestic branches.

(2) Exclude discounted bills and before provisions.

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The following table sets forth, at the dates indicated, certain other operational ratios for commercial banks under the relevant PRC regulations, as well as such ratios for our banking operations as reported to the PBOC and the CBRC, which were calculated in accordance with the 1996 Ratio Rules and were based on our balance sheet data prepared in accordance with the applicable PRC GAAP. The ratios set forth in the table below were based on the financial data of domestic branches except for borrower concentration ratios (please see note (1) below).

	<u>Requirement</u>	<u>At December 31,</u>			<u>At June 30,</u>
		<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Borrower concentration ratios					
Total outstanding loans to a single borrower to					
Net Capital Base ⁽¹⁾	≤10.0%	— ⁽²⁾	— ⁽²⁾	5.2%	5.8%
Total loans granted to top ten borrowers to Net Capital Base ⁽¹⁾ . . .	≤50.0%	— ⁽²⁾	— ⁽²⁾	35.4%	31.0%
Inter-bank ratios					
Total Renminbi inter-bank borrowings from other banks and					
financial institutions to total Renminbi deposits	≤ 4.0%	0.0%	0.1%	0.0%	0.0%
Total Renminbi inter-bank lending to other banks and financial					
institutions ⁽³⁾ to total Renminbi deposits	≤ 8.0%	0.1%	0.1%	0.1%	0.1%
Reserve ratios					
Renminbi reserve deposits with the PBOC plus Renminbi cash to					
Renminbi deposits	≥ 5.0%	9.7%	9.6%	9.3%	9.3%
Foreign currency deposits with other financial institutions plus					
cash in foreign currencies to total foreign currency deposits . . .	≥ 5.0%	5.6%	5.0%	8.9%	9.5%

(1) Net Capital Base at December 31, 2005 is prepared in accordance with the statutory financial statements and do not reflect the impact of Caikuai (2005) No. 14 “Provisional Guidelines on Recognition and Measurement of Financial Instruments” issued by the MOF.

(2) We had a capital deficit for each of 2003 and 2004.

(3) Net of provisions.

On January 1, 2006, the CBRC issued the Provisional Rule on Core Indicators for Risk Supervision on Commercial Banks, which became effective on a trial basis on January 1, 2006 to replace the 1996 Ratio Rules. This Provisional Rule amends a number of existing core indicators and introduced a number of new core indicators. According to the CBRC, however, the Provisional Rule is still subject to necessary amendments and will officially come into force in 2007.

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The CBRC issued the Guidelines on Corporate Governance and other Regulatory Issues regarding State-owned Commercial Banks, effective since April 24, 2006, which evaluate and monitor the restructuring of the state-owned commercial banks by seven indicators in three categories. The table below demonstrates the core indicators set forth in these guidelines. We expect to file our first report to the CBRC under these guidelines for the year ending December 31, 2006. Our ratios will be calculated in accordance with these guidelines and based on our balance sheet data prepared in accordance with applicable PRC GAAP.

	Requirement
Return on assets $ROA = (\text{Net Profit} + \text{Minority Interest}) / \text{Average Total Assets} \times 100\%$	$\geq 0.6\%$ within one year after the completion of the financial restructuring and in line with the best international practice in three years
Return on equity $ROE = (\text{Net Profit} + \text{Minority Interest}) / \text{Average Equity} \times 100\%$	$\geq 11\%$ within one year after the completion of the financial restructuring; and $\geq 13\%$ in a number of years thereafter
Cost to income ratio $CTI = (\text{Operating Expenses} + \text{Depreciation}) / (\text{Net Interest Income} + \text{Net Non-interest Income}) \times 100\%$	$\geq 35\%$ and $\leq 45\%$ within one year after the completion of the financial restructuring
Non-performing loan ratio $NPL = (\text{Total Non-performing loans} / \text{Total Outstanding Loans}) \times 100\%$	$\leq 5\%$ after the completion of the financial restructuring
Capital adequacy ratio $CAR = (\text{Total Capital} - \text{Deductibles}) / (\text{Risk-weighted Assets} + 12.5 \times \text{Market Risk}) \times 100\%$	$\geq 8\%$ after the completion of the financial restructuring
Concentration of loans to a single borrower $\text{Concentration of Loans to a Single borrower} = (\text{Loans to a Single Borrower} / \text{Total Equity}) \times 100\%$	$\leq 10\%$
Allowance coverage ratio $\text{Allowance coverage ratio} = (\text{General Allowance} + \text{Specific Allowance} + \text{Special Allowance}) / (\text{Substandard Loans} + \text{Doubtful Loans} + \text{Loss Loans}) \times 100\%$	$\geq 60\%$ within one year after the completion of the financial restructuring and $\geq 100\%$ in five years

Corporate Governance

Corporate Governance

In accordance with the Provisional Guidelines on Due Diligence of the Board of Directors of Joint Stock Commercial Banks, which were promulgated by the CBRC and became effective on September 12, 2005, and the Guidelines on Corporate Governance of Joint Stock Commercial Banks, which were promulgated by the PBOC and became effective on June 4, 2002, or the Corporate Governance Guidelines, joint stock commercial banks are required to appoint at least two independent directors or three independent directors if the registered capital of the bank exceeds RMB1 billion. In addition, joint stock commercial banks are required to establish an audit committee, a related party transaction control committee and a risk management committee of the board of directors, and to the extent that the registered capital of such bank exceeds RMB1 billion, it is also required to establish a

nomination and compensation committee and strategy committee of the board of directors. They are also required to establish a supervisory board with at least two external supervisors.

The Provisional Measures Due Diligence of the Board of Directors of Joint-Stock Commercial Banks sets out, among other things, the rights and duties of the board of directors, the rules and procedures of the board meeting, the board committees, the obligations of the directors and supervision of the performance by the board of its duties.

The Guidelines on Corporate Governance and Other Regulatory Issues Regarding State-owned Commercial Banks provide that shareholders' general meetings are the governing bodies of state-owned commercial banks and shareholders of state-owned commercial banks shall exercise their rights through shareholders' general meetings and comply with laws, regulations and their own articles of association. In addition, these guidelines set out, among other things, relevant principles of corporate governance applicable to the Big Four commercial banks and Bank of Communications.

Internal Controls

Under the Internal Control Guidelines for Commercial Banks, issued by the PBOC on September 18, 2002, commercial banks are required to establish internal controls to ensure effective risk management for their business activities. Commercial banks are also required to establish a risk management department that formulates and implements risk management policies and procedures. In addition, commercial banks are required to establish an internal audit department that can independently supervise and evaluate all aspects of the banks' operations.

On February 1, 2005, the Provisional Measures on Evaluation of the Internal Control of Commercial Banks issued by the CBRC became effective. These provisional measures set out the principles, elements, procedures and other matters regarding the evaluation of the internal control of the commercial banks. The measures also provide for periodic evaluations to be conducted by the CBRC and its local offices and the regulatory actions they would take based on the results of their evaluations.

Transactions with Related Parties

In accordance with the Administrative Measures on Related Party Transactions Between Commercial Banks and Insiders or Shareholders, or the Related Party Transactions Measures, promulgated by the CBRC, which became effective on May 1, 2004, related parties include, among others, (i) shareholders holding 5% or more of the bank's outstanding shares; (ii) legal persons or other organizations under direct or indirect common control with the bank; (iii) such legal persons' or organizations' individual controlling shareholders, directors and executive officers; (iv) directors, senior management officers of headquarters and branches, employees with decision-making authority in bank lending and asset transfers, and their respective close relatives, and organizations over which the above persons have direct, indirect or joint control or may exert significant influence; and (v) other individuals, legal persons or other organizations that have direct, indirect or joint control over the commercial banks or that may exert significant influence over them.

Under the above measures of the CBRC, transactions with related parties include, among other transactions, credit extensions, asset transfers, and the provision of services between a commercial bank and its related parties. Commercial banks are required to adopt appropriate policies and

procedures to manage related party transactions and to establish a related party transaction control committee of the board of directors to supervise the implementation of, and compliance with, such policies and procedures and to examine proposed related party transactions.

Transactions with related parties are subject to certain limitations. For example, when the amount of any single related party transaction represents more than 1% of the bank's Net Capital Base, or if any single related party transaction causes the total outstanding value of transactions with that related party to represent more than 5% of the bank's Net Capital Base, the transaction must be examined by the related party transaction control committee of the commercial bank and submitted to the board of directors for approval. It must also be reported to the supervisory board of the bank and the CBRC within ten business days after such board approval. Any related party transaction that does not exceed the threshold level has to be examined and approved according to the internal authorization procedure of the commercial bank and submitted to the related party transactions control committee for filing or approval.

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

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

We have established the Related Party Transactions Control Sub-Committee under our Risk Management Committee of the board of directors.

Disclosure Requirements

Under the Provisional Measures on Information Disclosure of Commercial Banks issued by the PBOC which became effective on May 21, 2002, commercial banks with total assets of RMB1.0 billion or more or deposits of RMB500 million or more are required to publish financial statements audited by accounting firms in their annual reports. In addition, each such bank is required to disclose information relating to its risk management, corporate governance, ten largest shareholders, related party transactions and other significant information relating to the bank during the relevant fiscal year. The annual reports are required to be published within four months of the end of each fiscal year. The CBRC issued a circular on February 17, 2004 to set out further requirements regarding the annual report of joint-stock commercial banks.

Anti-money Laundering Regulation

Pursuant to the Anti-money Laundering Rules for Financial Institutions issued by the PBOC which became effective on March 1, 2003, commercial banks are required to establish an internal anti-money laundering procedure and file it with the PBOC. Commercial banks are also required to either establish an independent anti-money laundering department or designate a relevant department, in each case staffed with qualified personnel, to implement their anti-money laundering procedure. In addition, commercial banks are required to establish a system to record the identities of all customers and their respective deposits, settlement and other transactions with the bank. Upon the detection of any suspicious transactions or transactions involving large amounts, commercial banks are required to report the transactions to the PBOC or the SAFE, which supervises and regulates the reporting of foreign currency transactions. Where necessary and pursuant to relevant laws and regulations, commercial banks are required to cooperate with government authorities in preventing money laundering activities and in freezing assets. The PBOC supervises and conducts on-site inspections of commercial banks' compliance with the anti-money laundering regulations, and may impose penalties for any violations thereof.

Operational Risk Management

On March 22, 2005, the CBRC issued the Circular on Strengthening Control of Operational Risk in an effort to further strengthen commercial banks' ability to identify, manage and control operational risk. Under this circular, commercial banks are required to establish internal policies and procedures for the management and control of operational risk. A bank's internal audit and business operation departments are required to conduct independent and ad hoc reviews and examinations of the bank's business operations on a periodic basis. Ongoing reviews and examinations are required for previously identified deficiencies. Moreover, a commercial bank's head office is required to assess, from time to time, the implementation of and compliance with its internal policies and procedures with reference to operational risk.

In addition, the circular sets forth detailed requirements for commercial banks to follow, which include, among other things: establishing a system under which branch officers in charge of business operations are required to rotate and take compulsory leave on a regular basis; establishing a system to encourage full compliance with applicable regulations and internal rules and contributing to policies by all employees; improving the timely reconciliation of account statements between banks and their customers, between banks, and between operational departments and accounting departments within a bank; and strictly segregating persons in charge of account-keeping and persons in charge of account reconciliation.

Market Risk Management

The CBRC promulgated the Guidelines on Market Risk Management of Commercial Banks on December 29, 2004, which became effective since March 1, 2005, in an effort to strengthen the market risk management of commercial banks. These guidelines address, among other things, (i) the responsibilities of the board of directors and senior management of a bank in the effective supervision of market risk management; (ii) policies and procedures for market risk management; (iii) the detection, quantification, monitoring and control of market risk; and (iv) internal controls and external audits.

Risk Rating System

According to the Provisional Risk Rating System for Joint-Stock Commercial Banks, which was issued by the CBRC on February 5, 2004, the CBRC has implemented a provisional risk rating system regarding joint-stock commercial banks. Under this system, capital adequacy, asset security, management quality, profitability, liquidity and exposure to market risk of joint-stock commercial banks are evaluated and scored by the CBRC on a continual basis. Each joint-stock commercial bank is classified into one of five risk rating categories. The CBRC determines its supervision activities, including the frequency and scope of its on-site inspections, with respect to each bank based on its risk rating results. The risk rating also constitutes a basis for the CBRC's evaluation of a bank's applications for new business licenses. These risk ratings are currently not publicly available. The regulator will decide when to disclose them to the public.

Restrictions on Equity Investments in Commercial Banks

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

In addition, the Corporate Governance Guidelines impose certain additional requirements on shareholders of PRC joint-stock commercial banks. For example, in the event that a commercial bank encounters liquidity problems, its shareholders are required to immediately repay outstanding loans due and repay in advance outstanding loans not yet due from the bank. Furthermore, if a commercial bank fails to meet the required capital adequacy ratios required by relevant regulations, its shareholders are obligated to endorse measures determined by the bank's board of directors that are aimed at increasing the capital adequacy level. Moreover, if shareholders of a commercial bank fail to repay outstanding loans when due, their voting rights will be restricted for the period during which the relevant loan is overdue.

Under the PRC Company Law and relevant rules and regulations, a joint-stock commercial bank may not accept its own shares as collateral. Moreover, there are legal limitations on the ability of shareholders in a joint-stock commercial bank to pledge to any other party their shares in the bank. According to the Corporate Governance Guidelines, (i) any shareholder of a joint-stock commercial bank must give prior notice to the board of directors of the bank if it wishes to pledge its shares as collateral, and (ii) if the outstanding amount of the bank's loans to a shareholder exceeds the audited value of such shareholder's equity in the bank for the immediately preceding year, and such shareholder does not pledge any government bonds or bank deposit certificates as collateral, the shareholder may not pledge its shares. Under our articles of association, which have been approved by the CBRC, this restriction applies only to those shareholders that hold 5% or more of our shares. We have been advised by our PRC legal counsel, King & Wood, that this provision of our articles of association is legal and valid under PRC law.

Regulation of Foreign-invested Financial Institutions Operating in China

Foreign-invested Banks

Currently, foreign financial institutions may establish branches, joint venture banks or wholly owned banks in China, subject to minimum capital, asset value and other requirements. Foreign-invested financial institutions currently can provide services denominated in foreign currencies in the PRC without geographic and client restrictions. With respect to Renminbi business, since December 5, 2005, foreign-invested financial institutions have been permitted to provide services to PRC enterprises in 25 cities in accordance with the CBRC Notice on the Further Opening of the Banking Sector published on December 3, 2005. By December 2006, any existing non-prudential measures restricting the geographic presence, customer base and operational licenses of foreign banks operating in China, including restrictions on establishing new branches, are required to be eliminated under China's WTO commitments.

Under the Foreign-invested Financial Institutions Regulations promulgated on December 20, 2001 by the State Council, which became effective since February 1, 2002, its implementation rules issued by the CBRC and effective since September 1, 2004, and the Measures of CBRC on Implementation of Administrative Licensing relating to Foreign-Invested Financial Institutions promulgated on January 2, 2006 and effective since February 1, 2006, the establishment of foreign-invested banks in the PRC, including in the form of wholly foreign-owned banks, joint venture banks and branch offices of foreign banks, are subject to the approval from the CBRC. Wholly foreign-owned banks and joint venture banks shall have a registered capital as well as paid-in capital in convertible foreign currency equivalent to at least RMB300 million. For branch offices, foreign banks shall allocate to each of their branch offices in the PRC operating capital of no less than any convertible foreign currency equivalent of RMB100 million.

Equity Investment by Foreign Financial Institutions in Domestic Commercial Banks

Under the Administrative Measures on Equity Investments of Overseas Financial Institutions in Domestic Financial Institutions promulgated by the CBRC on December 8, 2003, which became effective on December 31, 2003, and the Measures of CBRC on Implementation of Administrative Licensing relating to Domestic Commercial Banks, certain foreign financial institutions may make equity investments in domestic commercial banks, subject to the CBRC's approval. However, no single foreign financial institution may own 20% or more of the equity of such a bank. In addition, if foreign investment in the aggregate exceeds 25% of the total equity interest in a non-listed domestic commercial bank, such bank will be regulated as a foreign-invested commercial bank. A listed domestic commercial bank will continue to be regulated as a domestic commercial bank even if foreign investment in the aggregate exceeds 25% of its total equity interest.

HONG KONG FINANCIAL DISCLOSURE REQUIREMENTS

Banking activities in Hong Kong are primarily governed by the Banking Ordinance and are regulated by Hong Kong Monetary Authority, or the HKMA. The principal function of the Hong Kong Monetary Authority is to promote the general stability and effectiveness of the banking system in Hong Kong. The Hong Kong Monetary Authority is responsible for supervising compliance with the provisions of the Banking Ordinance and also supervises compliance with the Hong Kong Monetary Authority's guidelines, and legislation promulgated by the Securities and Futures Commission. The Hong Kong Monetary Authority has responsibility for regulating banking institutions and granting

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banking licenses, and has the discretion to attach conditions to a bank's operating license. The Hong Kong Monetary Authority requires every authorized institution to implement a comprehensive risk management system to identify, measure, monitor and control the various types of risks relating to its activities and, where appropriate, to hold capital against those risks.

The Banking Ordinance requires banks to report to the Hong Kong Monetary Authority certain periodic returns and other information and establishes certain minimum standards and ratios relating to capital adequacy, liquidity, capitalization, limitations on shareholdings, exposure to any one customer, unsecured advances to persons affiliated with the bank and holdings of interests in land, with which all banks operating in Hong Kong must comply.

Pursuant to Rule 4.10 of the Hong Kong Listing Rules, the financial information to be disclosed in our Accountants' Report must be in accordance with best practice, which is the least that is required to be disclosed in respect of specific matters in the accounts of a company under the Companies Ordinance, IFRS, and the Financial Disclosure by Locally Incorporated Authorised Institutions issued by the Hong Kong Monetary Authority.

We are currently unable to provide certain disclosures described below as required by the Guidelines as such information is currently not available. We believe that the financial disclosures which we are currently unable to provide are immaterial to potential investors under the Global Offering. However, we are endeavoring to collect the relevant information so that we will be in a position to provide such required disclosures under the Guidelines within a reasonable time frame in the future.

- The Guidelines require separate disclosure of the movements in the allowance for loan impairment losses for individually assessed loans and for collectively assessed loans. We did not break down the movements in the allowance for loan impairment losses into allowances for individually assessed loans and collectively assessed loans, and, in lieu of that, we disclosed the movements on an aggregate basis in Note 16 to the financial information included in the Accountant's Report in Appendix I to this prospectus. We expect to be able to make such disclosure by December 31, 2008.
- The Guidelines require separate disclosure of the amount of new provisions charged to the income statement and the amount of provisions released back to the income statement in the movement of allowance for loan impairment losses. We did not segregate the amount of new provisions from the amount of provisions released back, and, in lieu of that, we disclosed these two amounts on a net basis in Note 16 to the financial information included in the Accountants' Report in Appendix I of this prospectus. We expect to be able to make such disclosure by December 31, 2008.

REGULATION AND SUPERVISION OF OUR HONG KONG OPERATIONS AND OVERSEAS OPERATIONS

Our branch in Hong Kong and our subsidiaries, Industrial and Commercial Bank of China (Asia) Limited, ICEA Finance Holdings Limited, and Industrial and Commercial International Capital Ltd. are subject to the regulation of the HKMA and the Securities and Futures Commission of Hong Kong. Our overseas branches in Macau, Singapore, Tokyo, Seoul, Busan, Frankfurt and Luxembourg are respectively subject to the regulation of the Monetary Authority of Macau, the Monetary Authority of Singapore, the Financial Services Agency of Japan, the Financial Supervisory

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Commission of the Republic of Korea, the German Bundesanstalt für Finanzdienstleistungsaufsicht and Commission de Surveillance du Secteur Financier (CSSF). Our overseas subsidiaries, ICBC (London) Limited and Industrial and Commercial Bank of China (Almaty) Joint Stock Company, and our representative offices in New York, Moscow and Sydney are respectively subject to the regulation of the U.K. Financial Services Authority, the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Market and Financial Organizations, Federal Reserve Bank of New York and Banking Department of State of New York, the Central Bank of the Russian Federation and the Australian Prudential Regulatory Authority.

Our overseas branches, subsidiaries and representative offices are also subject to the respective local banking regulatory requirements, including requirements with respect to internal controls, capital adequacy, and others. We have been duly licensed to operate in these jurisdictions by the respective banking regulatory authorities.