

BANKING INDUSTRY IN CHINA

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OVERVIEW

China has experienced significant economic growth over the past two decades largely as a result of the PRC government's extensive economic reforms. These reforms were initially focused on transforming China's centrally planned economy to a more market-based economy. More recently, particularly following China's accession to the WTO in 2001, the economic reforms have also focused on, among other things, enhancing the competitiveness of Chinese enterprises. As a result of these reforms, China's GDP grew at a compound annual growth rate of 11.2% between 2000 and 2004, according to the National Bureau of Statistics of China. In addition, from 2000 to 2004, M2, which represents a broad measure of money supply, increased at a compound annual growth rate of 17.1%, and fixed asset investments increased at a compound annual growth rate of 21.0%, according to the National Bureau of Statistics of China. As of December 31, 2004, China was the seventh largest economy in the world, with a GDP of RMB 13.7 trillion.

Total RMB-denominated deposits and RMB-denominated loans of China's banking industry have increased at a compound annual growth rate of 18.1% and 15.6%, respectively, from December 31, 2000 to December 31, 2004. The following table sets forth total RMB-denominated deposits and total RMB-denominated loans for the five years ended December 31, 2004 and the respective compound annual growth rates for the periods indicated for banking institutions in China.

	As of December 31,					Compound annual growth rate (2000-2004)
	2000	2001	2002	2003	2004	
	(in billions of RMB)					
Total RMB-denominated deposits ⁽¹⁾ . . .	12,380.4	14,361.7	17,091.7	20,805.6	24,052.5	18.1%
Total RMB-denominated loans ⁽¹⁾	9,937.1	11,231.5	13,129.4	15,899.6	17,736.3	15.6%

Source: PBOC Quarterly Statistical Reports.

(1) Consists, as applicable, of the deposits or loans of the PBOC, the big four commercial banks, other national commercial banks, city commercial banks, policy banks, rural commercial banks, foreign-invested commercial banks, urban credit cooperatives, rural credit cooperatives, finance companies, trust and investment companies, financial leasing companies and the postal savings bureau.

The banking industry is an important sector within China's economy. The banking industry in China continues to be the primary provider of capital in China and bank deposits remain the primary choice for domestic savings. Despite its active role in providing capital, the banking industry in China is underdeveloped in certain respects, particularly in terms of the provision of fee- and commission-based products and services and personal banking products. In 2003, the ratio of fees and commissions to total income by China's banks was less than 8%, according to the Economist Intelligence Unit, substantially lower than fee and commission income for banking industries in more developed economies. As of December 31, 2004, personal loans represented 10.6% of total loans in China and 14.6% of GDP. Although personal loans have increased at a compound annual growth rate of 46.9% between December 31, 2000 and December 31, 2004, the proportion

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of personal loans to total loans in China is lower than that in other more developed economies. See “— Industry Trends — Increasing Demand for Personal Banking Products and Services.” We expect that continued economic growth and rising income levels in China will lead to increasing demand for more sophisticated financial products and services by corporate and retail customers, creating significant growth potential for China’s banking industry.

HISTORY AND DEVELOPMENT

From the establishment of the PRC in 1949 to the late 1970s, China’s banking industry operated primarily as a monobank system under a centrally planned economy. During this period, the PBOC served as China’s central bank as well as the primary deposit-taking and lending institution. Other banks, such as our predecessor, the People’s Construction Bank of China, the Agricultural Bank of China and the Bank of China, served as extensions of the PBOC, primarily responsible for executing policy decisions of the government by administering and disbursing government funds. Beginning in the late 1970s, as part of China’s economic reform, the banking industry underwent significant changes as some of the PBOC’s commercial banking functions were separated from its central bank function. The People’s Construction Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of China and the Bank of China became independent institutions specializing in construction and infrastructure financing, urban commercial financing, agriculture financing and foreign exchange and trade financing, respectively. These four institutions were known as the state-owned specialized banks, while the PBOC focused on acting as China’s central bank and as the principal regulator and supervisor of China’s banking system.

In the early 1980s, as part of the PRC government’s effort to introduce further competition to the banking industry, these four state-owned specialized banks were permitted to expand into new commercial banking businesses outside their specialized functions. In addition, new commercial banks and non-bank financial institutions were established. Some of these commercial banks were permitted to offer nationwide services, while others served only local markets.

In the mid-1990s, the PRC government undertook further reforms to encourage the state-owned specialized banks to operate on a more commercial basis. In 1994, the government established three policy banks, the China Development Bank, the Export-Import Bank of China and the 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 commercial banks, subsequently referred to as the “big four commercial banks.” In 1995, the Commercial Banking Law and the PBOC Law were enacted to define more clearly the permitted scope of business of commercial banks and the functions and powers of PBOC as the central bank and China’s banking regulator. In 2003, the CBRC was established to become the primary banking industry regulator and assumed the majority of the regulatory functions of the PBOC. See “Regulation and Supervision — PRC Regulation and Supervision — Principal Regulators — The CBRC.”

China’s banking industry has been historically burdened with large portfolios of non-performing loans. According to the CBRC, outstanding non-performing loans at the big four commercial banks and other national commercial banks amounted to approximately RMB 1.7 trillion as of December 31, 2004, representing a total non-performing loan ratio of 13.21% for all such banks, and non-performing loan ratios of 15.57% and 4.94% for the big four commercial banks and the other national commercial banks, respectively.

Since the late 1990s, the PRC government has taken a number of initiatives to improve the asset quality and strengthen the capital base of domestic banks. In 1998, the MOF issued special government bonds

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and contributed the proceeds of RMB 270.0 billion to the big four commercial banks as equity to improve their capital adequacy. Our predecessor, China Construction Bank, received RMB 49.2 billion of the proceeds. In 1999, the PRC government established four asset management companies primarily to acquire and manage non-performing assets of the big four commercial banks. In 2003, Huijin contributed US\$22.5 billion as equity to each of the Bank of China and our predecessor. Subsequent to these equity contributions in 2003, we and the Bank of China underwent restructurings to become joint-stock commercial banks. See “Our Restructuring and Operational Reform — Establishment of Our Bank as a Joint-stock Limited Company.”

CURRENT COMPETITIVE LANDSCAPE

China’s banking institutions are divided broadly into seven categories. The following table sets forth, as of December 31, 2004, certain information relating to the assets, deposits and loans of each category.

	As of December 31, 2004						
	Number of Institutions	Total Assets		Deposits		Loans	
		Amount	Market share	Amount	Market share	Amount	Market share
(in billions of RMB, except number of institutions and percentages)							
Big four commercial banks	4	16,998.1	53.7%	14,618.1	58.3%	10,248.1	53.7%
Other national commercial banks ⁽¹⁾ . .	12	4,827.1	15.2	4,180.1	16.7	2,931.7	15.4
City commercial banks	112	1,724.5	5.4	1,396.3	5.6	924.2	4.9
Rural credit cooperatives ⁽²⁾	32,876	3,157.8	10.0	2,784.9	11.1	2,005.8	10.5
Urban credit cooperatives	681	180.0	0.6	158.9	0.6	102.4	0.5
Foreign-invested commercial banks . . .	211	513.7	1.6	126.3	0.5	254.8	1.3
Others ⁽³⁾	149	4,276.0	13.5	1,792.1	7.2	2,620.9	13.7
Total	34,045	31,677.2	100.0%	25,056.7	100.0%	19,087.9	100.0%

Source: PBOC, banks’ annual reports, 2004 Monetary Statistics of Financial Institutions.

(1) Also known as “joint-stock commercial banks.”

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

(3) Consists of policy banks, the postal savings bureau, finance companies, trust and investment companies and financial leasing companies.

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Big Four Commercial Banks

The big four commercial banks play a major role in China's banking market and, since their establishment, have been the principal source of financing in China, particularly for state-owned enterprises. As of December 31, 2004, total assets of the big four commercial banks represented 53.7% of total assets of banking institutions in China. The following table sets forth, as of December 31, 2004, the number of branches, total assets, deposits and loans of each of the big four commercial banks.

	As of December 31, 2004						
	Total assets			Deposits		Loans	
	Approximate number of branches	Amount	% of total	Amount	% of total	Amount	% of total
	(in billions of RMB, except number of branches and percentages)						
Industrial and Commercial Bank of							
China	21,223	5,589.9	32.9%	5,000.0	34.2%	3,635.3	35.5%
Agricultural Bank of China ⁽¹⁾	31,004	4,013.8	23.6	3,491.5	23.9	2,590.1	25.3
China Construction Bank	14,458	3,904.8	23.0	3,489.4	23.9	2,225.6	21.7
Bank of China ⁽²⁾	<u>11,307</u>	<u>3,489.6</u>	<u>20.5</u>	<u>2,637.2</u>	<u>18.0</u>	<u>1,797.1</u>	<u>17.5</u>
Total	<u>77,992</u>	<u>16,998.1</u>	<u>100.0%</u>	<u>14,618.1</u>	<u>100.0%</u>	<u>10,248.1</u>	<u>100.0%</u>

Sources: Banks' annual reports.

(1) Calculated on a consolidated basis.

(2) If calculated on a consolidated basis, Bank of China ranks second based on total assets among the big four commercial banks as of December 31, 2004.

Other National Commercial Banks

As of December 31, 2004, there were 12 other national commercial banks in China, of which five are listed on a domestic stock exchange. These national commercial banks are licensed to engage in commercial banking activities nationwide, and provincial and local governments and state-owned enterprises are their principal shareholders. Total assets of these national commercial banks represented 15.2% of total assets of banking institutions in China as of December 31, 2004.

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The following table sets forth, as of December 31, 2004, the number of branches, total assets, deposits and loans of the other national commercial banks.

	As of December 31, 2004			
	Approximate number of branches	Total assets	Deposits	Loans
	(in billions of RMB, except number of branches)			
Bank of Communications	2,413	1,138.6	1,011.9	638.1
China Merchants Bank	410	602.8	512.6	375.9
CITIC Industrial Bank	392	514.8	451.4	306.4
Shanghai Pudong Development Bank	328	455.5	395.4	310.9
China Minsheng Bank	216	445.4	380.0	288.4
China Everbright Bank	374	438.9	385.3	268.0
Guangdong Development Bank	489	344.5	300.5	215.7
Industrial Bank Co., Ltd.	292	340.5	283.2	203.0
Huaxia Bank	243	304.3	267.8	181.1
Shenzhen Development Bank	234	204.3	167.3	126.2
Evergrowing Bank Co., Ltd.	74	27.2	17.0	12.9
China Zheshang Bank	2	10.3	7.7	5.1
Total	5,467	4,827.1	4,180.1	2,931.7

Sources: PBOC, banks' annual reports.

City Commercial Banks

City commercial banks are permitted to engage in commercial banking activities, generally within specific geographic areas. As of December 31, 2004, total assets of the city commercial banks represented 5.4% of total assets of banking institutions in China.

Rural and Urban Credit Cooperatives

Rural and urban credit cooperatives provide a limited range of banking products and services, including personal deposit-taking, lending and settlement services, for small enterprises and local residents. Rural credit cooperatives are typically formed by local rural residents. The PRC government implemented a pilot ownership reform program to broaden the ownership base of rural credit cooperatives and encourage consolidation among the smaller entities. Historically, urban credit cooperatives were primarily administered by the Industrial and Commercial Bank of China, but currently exist as independently operated banking institutions. As of December 31, 2004, total assets of the rural credit cooperatives (including rural commercial banks) and urban credit cooperatives represented 10.0% and 0.6%, respectively, of total assets of banking institutions in China.

Foreign-invested Commercial Banks

Foreign-invested commercial banks are subject to certain restrictions on their operations. See "Regulation and Supervision — PRC Regulation and Supervision — Regulation of Foreign-invested Commercial Banks Operating in China." Similarly to the other types of banking institutions in China, these entities are subject to supervision and regulation by the CBRC. Recently, pursuant to its WTO accession commitments, China has progressively opened RMB-denominated banking activities to foreign-invested commercial banks, and by the end of 2006, all restrictions on the geographic presence, customer base and

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operational licenses of foreign-invested commercial banks are expected to be lifted. See “— Industry Trends — Greater Foreign Participation.” As of December 31, 2004, there were 211 operations of 67 foreign banks in China, consisting of 186 branches, nine wholly-owned banks, 13 joint-venture banks and three finance companies. As of December 31, 2004, total assets of the foreign-invested commercial banks represented 1.6% of total assets of banking institutions in China.

Other Banking Institutions

Other banking institutions include policy banks, the postal savings bureau, trust and investment companies, finance companies, financial leasing companies and automobile finance companies. As of December 31, 2004, the three policy banks, the China Development Bank, the Export-Import Bank of China and the Agricultural Development Bank of China, represented 7.6% of total assets of banking institutions in China. China’s postal savings bureau operates through the nationwide network of post offices and offers savings deposits and remittance and a limited number of other banking services to individuals and non-profit institutions. As of December 31, 2004, the postal savings bureau had deposits of RMB 1,085.0 billion, representing 4.3% of total deposits of banking institutions in China.

INDUSTRY TRENDS

Strengthened Regulation and Supervision

In April 2003, the CBRC was established to assume the PBOC’s functions as the principal regulator and supervisor of China’s banking industry. Since its inception, the CBRC has promulgated a series of rules and regulations designed to enhance risk management and promote orderly market competition. Highlights of these initiatives include:

- *Enforcing implementation of the five-category loan classification system.* The CBRC has undertaken measures to more closely monitor and enforce the adoption and implementation of the five-category loan classification system by commercial banks, such as conducting on-site examinations of the appropriateness of loan classifications and monitoring changes in the level of non-performing loans;
- *Strengthening supervision over capital adequacy.* In March 2004, the CBRC implemented a set of new and more stringent capital adequacy guidelines which were based on the 1988 Basel Capital Accord and took into consideration the New Basel Capital Accord. Under these guidelines, all banks in China are required to comply with the new capital adequacy requirements by January 1, 2007. See “Regulation and Supervision — PRC Regulation and Supervision — Regulations Regarding Capital Adequacy — Capital Adequacy Guidelines;” and
- *Restructuring and enhancing corporate governance.* The CBRC has encouraged banks to establish a corporate governance structure that includes a board of directors with independent directors, audit, compensation and other board committees, and a board of supervisors. In addition, banks have been instructed to create an independent internal audit function that is supported by clearly-defined policies and procedures.

Increasing Liberalization of the Financial Services Industry

In an effort to enhance the competitiveness of domestic banks, the PBOC and the CBRC have allowed greater flexibility for banks to make independent decisions, such as those on pricing and product offerings.

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Liberalization of Interest Rates

Historically, interest rates on deposits and loans were set by and subject to other restrictions established by the PBOC. In recent years, as part of the overall reform of the banking system, the PBOC has implemented a series of initiatives designed to gradually liberalize interest rates and move towards a more market-based interest rate regime. See “Regulation and Supervision — PRC Regulation and Supervision — Pricing of Products and Services — Interest Rates for Loans and Deposits.” We expect the on-going interest rate liberalization to facilitate banks’ ability to develop and market innovative products and services and adopt risk-based pricing on credit.

Liberalization of Fee- and Commission-based Products and Services

Historically, banks in China were highly restricted in their ability to charge fees for services. It was not until 2001 that the PRC government began to promulgate comprehensive regulations permitting banks to charge for fee- and commission-based products and services. Currently, certain services remain subject to government guidance prices, including basic Renminbi settlement services specified by the CBRC and the NDRC. Fees for other products and services are determined by banks based on market conditions. See “Regulation and Supervision — PRC Regulation and Supervision — Pricing of Products and Services.” According to the Economist Intelligence Unit, the ratio of fees and commissions to total income of China’s banks was less than 8% in 2003, substantially lower than the ratio in more mature markets. This ratio is expected to increase as domestic banks continue to develop and expand these services, in response to demands for increasingly sophisticated financial products and services by corporate and retail customers.

Greater Foreign Participation

Historically, operations of foreign banks in China were subject to significant restrictions. Upon China’s accession to the WTO in December 2001, all geographic and customer restrictions on foreign currency-denominated business conducted by foreign-invested commercial banks were gradually lifted. Furthermore, foreign banks will be gradually allowed to participate in Renminbi banking activities in more cities based on a predetermined schedule until the end of 2006, when all restrictions on geographic presence, customer base and operational licenses are scheduled to be removed. See “Regulation and Supervision — PRC Regulation and Supervision — Regulation of Foreign-invested Commercial Banks Operating in China.”

Furthermore, China and Hong Kong signed the Closer Economic Partnership Arrangement, or CEPA, in June 2003. CEPA has further eased restrictions on the activities of Hong Kong banks in China, permitting them to enter the mainland financial sector and conduct Renminbi banking activities earlier than other non-PRC banks under China’s WTO commitments. For example, under CEPA, commercial banks incorporated in Hong Kong with US\$6 billion or more in total assets are qualified to apply for the establishment of branches in the PRC. By comparison, under the PBOC and CBRC regulations, commercial banks incorporated in other jurisdictions must have US\$20 billion or more in total assets to be qualified to apply for the establishment of branches.

Recently, a series of initiatives designed to further open China’s banking industry to foreign participation have been implemented by the PRC government. The key features of these initiatives include:

- allowing foreign participation in the automobile finance sector;
- lowering capital requirements for the establishment of branches in China by foreign banks;
- streamlining the procedures for foreign financial institutions to enter the Chinese market;
- increasing the maximum percentage of ownership interests in domestic financial institutions that may be held by foreign investors; and

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- encouraging qualified overseas strategic investors to participate in the restructuring and reform of China's banking industry.

Increasing Demand for Personal Banking Products and Services

We believe that rising income levels in China will continue to foster demand for personal banking products, including both personal loan products such as residential mortgages and fee- and commission-based products and services such as the distribution of insurance products and personal wealth management. The following table sets forth 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 (2000-2004)
	2000	2001	2002	2003	2004	
	(in RMB, except percentages)					
Per capita GDP	7,086.0	7,651.0	8,214.0	9,101.0	10,561.0	10.5%
Per capita annual disposable income of urban households	6,280.0	6,859.6	7,702.8	8,472.2	9,421.6	10.7%
Per capita annual net income of rural households	2,253.4	2,366.4	2,475.6	2,622.2	2,936.4	6.8%

Sources: China Statistical Yearbook 2005.

Personal loans totaled RMB 2.0 trillion as of December 31, 2004, representing 10.6% of total loans in China and 14.6% of China's GDP, according to the National Bureau of Statistics of China. By comparison, as of December 31, 2003, personal loans as a percentage of total loans was 32.4% in the U.S. and 38.0% in Japan; and personal loans as a percentage of GDP was 84.3% in the U.S. and 52.9% in Japan. From December 31, 2000 to December 31, 2004, total personal loans in China increased at a compound annual growth rate of 46.9%.

Residential mortgage loans generally represent the majority of personal loans. The growth of residential mortgage loans has been fostered by increasing private home ownership in China as a result of the government's housing reform programs begun in the 1980s. Total residential mortgage loans have grown from RMB 331.6 billion as of December 31, 2000 to approximately RMB 1.6 trillion as of December 31, 2004, according to the National Bureau of Statistics of China. Although the PRC government has adopted measures to tighten its policies on lending to the real estate industry starting in 2003, residential mortgage loans have continued to grow at a rapid pace.

While bank card use in China remains low in comparison to developed countries, the bank card business in China has experienced rapid growth in recent years. Total cards outstanding increased from 383 million as of December 31, 2001 to 762 million as of December 31, 2004, according to the PBOC. The growth has also been accompanied by an expansion of the electronic banking terminal network. Debit cards have been the primary type of bank card in the PRC. As of December 31, 2004, there were 663 million debit cards and 98 million credit cards outstanding. The development of the credit card market has so far been limited for a variety of reasons, including strict regulation on licensing, underdevelopment of a national payment infrastructure and the absence of a nationwide consumer credit information system. However, with an increasing number of licences for banks to engage in credit card business being issued, the development of China Unionpay and the expected full implementation of a national personal credit database which is being promoted by the PBOC, China's credit card industry is expected to grow significantly in the future.