OVERVIEW

Prior to the early 1990s, our primary function was to execute policy decisions of the government by administering and disbursing government funds and, as a result, we did not focus on risk management. After we transferred our policy lending functions to the China Development Bank in 1994 and the promulgation of the Commercial Banking Law in 1995, which permitted banks to increasingly make lending decisions without government direction, we began to actively manage our risks. In addition, the PBOC and the CBRC have, over the past few years, sought to improve the risk management functions of Chinese banks by promulgating a series of rules and regulations. These rules and regulations require commercial banks to, among other things, classify loans under a five-category loan classification system, establish comprehensive internal controls designed to monitor and evaluate all aspects of their business, and maintain minimum capital adequacy levels. See "Banking Industry in China — Industry Trends — Strengthened Regulation and Supervision" and "Regulation and Supervision — PRC Regulation and Supervision — Regulations Regarding Capital Adequacy" and "Regulation and Supervision — PRC Regulation and Supervision — Loan Classification, Allowances and Write-offs."

We are primarily subject to credit risk, liquidity risk, market risk and operational risk. In managing our risks, our goals are to (i) identify, measure, assess, monitor and manage all significant risks on a timely basis; (ii) balance risk and financial returns; (iii) enhance our risk management framework to be more comprehensive and integrated; (iv) further strengthen our internal controls; and (v) increasingly apply the economic value added methodology as a financial management tool to manage our risks. In an effort to achieve these goals, we have undertaken various initiatives over the past few years based on international best practice, including:

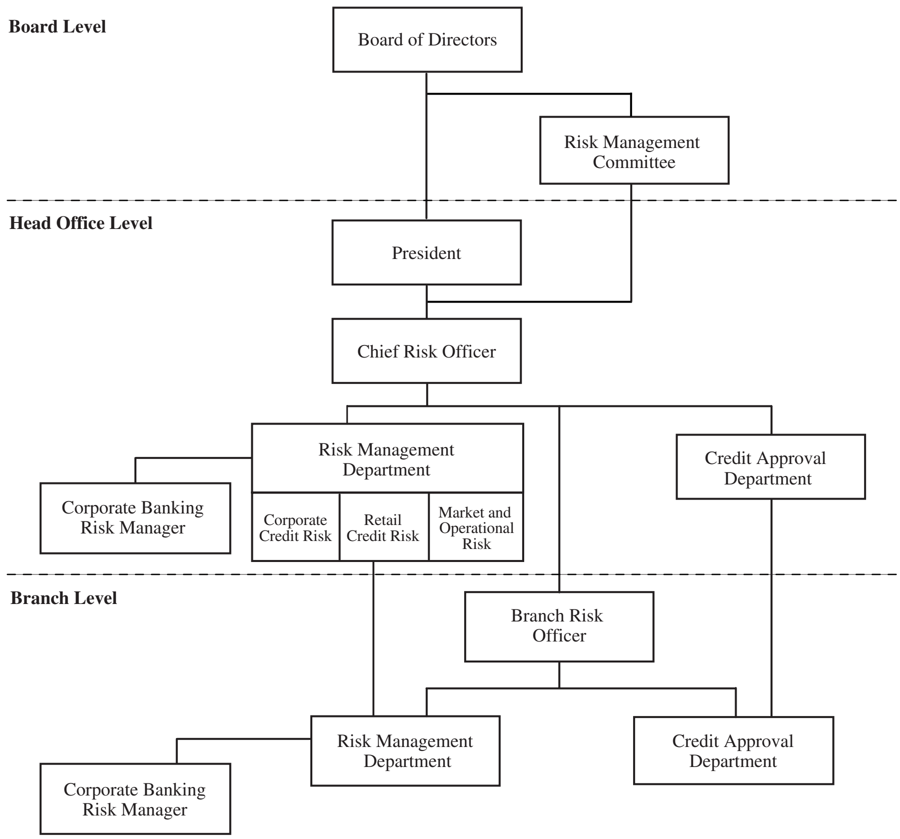
- establishing a culture that emphasizes risk management and continuously seeks to improve our risk management policies and procedures:
  - in 1999, we established limits on the amount of credit that each of our branches may approve; we further restricted these limits in 2004;
  - in 2000, we standardized credit risk management policies and procedures through the adoption of a credit manual and completed the implementation of the five-category loan classification system;
  - in 2001, we established a risk management and internal control committee responsible for risk management policies and procedures;
  - in 2002, we began to apply the economic value added methodology as a financial management tool to manage our risks;
  - in 2003, we initiated our "Risk Management Platform" project to standardize our various risk management policies and procedures across all areas of the bank; and
  - in 2003, we strengthened the application of our five-category loan classification system and began to assess loans for impairment under IFRS;
- developing more advanced information technology systems:
  - in 1998, we implemented a credit management information system, or CMIS, which collects information on our loan portfolio and supports loan monitoring, analysis and reporting;

  - in 2003, we implemented our computerized credit risk rating and early warning, or CRREW, system on a pilot basis; and
  - in 2003, we implemented our current credit approval information technology system;
- strengthening the independence of our risk management, credit approval and internal audit functions:
  - since 1999, all corporate loans have been required to be approved at a credit approval meeting by a group of credit approval officers not involved in the credit origination process;
  - in 1999 and in 2005, we underwent two phases of reorganization of our internal audit reporting structure to increase the independence of our audit department;
  - in 2005, we centralized our risk management function by establishing the position of Chief Risk Officer, or the CRO, with overall responsibility for our risk management; the risk management function, including in our tier-1 branches, reports directly to the CRO;
- increasing employee accountability for performance and compliance with our policies and procedures:
  - in 1998, we adopted a code of conduct which codified the disciplinary measures for employee misconduct; and in 2005, we adopted policies and procedures to hold management personnel accountable for the misconduct of the employees under their supervision; and
  - in 2000, we adopted policies and procedures to hold employees involved in the credit extension process more accountable for their actions.

In recent years, we have experienced an overall improvement in the asset quality of our loan portfolio. For a more detailed analysis of the changes in our asset quality, see "Assets and Liabilities — Assets — Asset Quality of Our Loan Portfolio." Although some of the risk management initiatives described above have been implemented only recently and their effectiveness has not been tested, we believe the implementation of the above initiatives over recent years has contributed to this improvement in our asset quality. For a description of certain risks relating to our risk management policies and procedures, see "Risk Factors — Risks Relating to Our Business — Some of our risk management and internal control policies and procedures are newly implemented and neither our compliance with them nor their effectiveness has been fully tested."

RISK MANAGEMENT STRUCTURE

The chart below illustrates the organizational structure of the principal elements of our risk management function that we implemented in June 2005 at both our head office and branch levels. We intend to complete the transition to vertical reporting lines for the risk management function at our branches by the end of 2005.



The new organizational structure is designed to enhance the risk management function at our bank and to increase employee accountability through clearer reporting lines and division of responsibilities.

Board of Directors and the Risk Management Committee

The risk management committee of our board of directors oversees risk management throughout our bank. The risk management committee assesses our overall risk exposure on a regular basis, provides overall guidance for the development of risk management and internal control strategies and policies and monitors their implementation. Our risk management committee consists of seven members, with Mr. Zhang Xiangdong as its chairman.

President

The president of our bank supervises the Chief Risk Officer, or the CRO. The president does not directly participate in the credit approval process, but has the power to veto loans approved by a credit approval meeting. See "— Credit Risk Management — Credit Risk Management for Corporate Loans — Credit Approval."

Chief Risk Officer

We established the CRO position in 2005 as part of our efforts to strengthen our risk management function and enhance its independence. This position represents an improvement in the definition and focus of authority and responsibility for risk management, and its independence is enhanced through the introduction of an additional, direct reporting line to the risk management committee of the board of directors.

Our CRO is our senior risk executive under our president and reports to both the risk management committee of our board of directors and the president. We are in the process of recruiting a suitable candidate, with risk management experience in financial institutions, to fill the position of CRO. Mr. Zhao Lin, our vice president primarily responsible for overseeing risk management and information technology, temporarily performs the role of CRO in his risk management responsibilities. In performing the role of CRO, Mr. Zhao is responsible for overseeing the risk management department, the credit approval department and the risk management function at each of our tier-1 branches; developing and reviewing the implementation of specific risk management and related internal control objectives, strategies, and policies and procedures, including reviewing our risk authorization and exposure limits and the application of our loan classification and provisioning guidelines; and monitoring and reviewing reports on asset quality, asset recovery, risk-related internal controls and other risk-related activities of our bank.

Risk Management Department

Our risk management department reports to the CRO and assesses, monitors and measures risk, and also develops and implements risk management tools, policies and procedures, including the classification and provisioning of our loans. In addition, the risk management department documents and evaluates internal controls within our bank. The corporate credit risk management, the personal credit risk management, and the market and operational risk management sub-departments oversee risk management activities in their specific areas of responsibility. In addition, the risk management department manages and coordinates the activities of designated risk officers associated with our corporate banking business department.

Credit Approval Department

The credit approval department operates the credit approval system within our bank and supervises our full-time credit approval officers. The credit approval department is responsible for evaluating and confirming our internal customer credit risk ratings and approving credit extensions. In addition, the department implements and monitors our credit approval procedures and criteria.

Branch-level Risk Management

The risk management department and credit approval department at each of our tier-1 and tier-2 branches are managed by a branch risk officer. The branch risk officer at a tier-1 branch reports directly to the CRO and supervises the branch risk officers of the tier-2 branches for which his tier-1 branch is responsible. The branch risk officers implement and monitor our risk management policies and procedures at branch level.

We have also implemented reporting line structures within each branch to strengthen our ability to manage risk. In order to manage risk beginning with the credit extension process, we have appointed risk managers to our corporate banking department at each branch, who work closely with our corporate relationship managers to manage credit risk in the credit origination, approval and post-disbursement stages of the credit risk management process. The risk managers report to both the branch risk management department and the branch business department. We are also in the process of establishing risk manager positions in the personal banking department.

Other Departments

In addition to the risk management department, other departments within our bank also assume risk management roles within their respective areas. In particular, our business departments are responsible for the implementation of risk management policies and procedures within their respective businesses. The assets and liabilities management, compliance, legal and information technology departments implement risk management policies and procedures within their respective areas.

CREDIT RISK MANAGEMENT

Credit risk is the risk that a bank borrower or counterparty fails to meet its obligations in accordance with agreed terms. We are exposed to credit risk primarily through our loan portfolio, investment portfolio, guarantees and commitments, and other on- and off-balance sheet credit exposures.

In order to manage our exposure to credit risk, we have adopted standardized credit extension policies and procedures which are regularly reviewed and updated by the risk management department in conjunction with other relevant departments. The credit extension process for both corporate loans and personal loans can be broadly divided into three stages: (i) credit origination and analysis, (ii) credit approval, and (iii) fund disbursement and post-disbursement management.

Credit Risk Management for Corporate Loans

Credit Origination and Analysis

Our relationship managers initiate the corporate credit extension process by either interviewing credit applicants which approach us or by proactively soliciting creditworthy prospective customers. We solicit prospective customers which we believe present low credit risk primarily based on our assessment of the economic condition and prospects of the industries or regions within which the prospective customers operate. If an applicant passes a preliminary screening by the relationship managers, it is generally required to file a formal credit application with applicable supporting documents, including organizational documents, audited financial statements for the most recent three years and material contracts. All corporate credit applications are sponsored by the relationship managers and evaluated by a team formed by the originating branch prior to being presented for credit approval. The evaluation generally consists of (i) assigning a credit risk rating to the credit applicant, (ii) evaluating the collateral, if any, securing the loan, and (iii) for fixed asset project loans, evaluating the risk, return and cash flow of the underlying project. The evaluation results become part of the application package.

Credit Risk Rating

We started to implement a manual scorecard system to generate credit risk ratings for corporate customers in 1999. In 2003, we implemented on a pilot basis a credit risk rating system which automatically generates preliminary credit risk ratings for our corporate customers. See "— Credit Risk Management for Corporate Loans — Credit Risk Management Information Technology." Beginning in 2004, we have generally required a credit risk rating for all new credit extensions, including rolled-over loans and extensions of maturity for existing credits, except for (i) low-risk loans, including loans fully secured by pledged deposits and treasury bills; and (ii) loans to newly-established companies with insufficient track records. For newly-established companies with insufficient track records, we usually evaluate the credit profiles of their controlling shareholders or sponsors to determine whether to extend credit to such customers.

In assigning a credit risk rating to an applicant, we consider a variety of quantitative and qualitative factors, including the applicant's credit history, financial condition, sources of liquidity, management skills and market competitiveness. The relationship managers will also conduct on-site visits and interview the management of the applicant to collect additional information. The applicant is evaluated and assigned a rating which is valid for one year. Prior to June 1, 2005, we used seven ratings: AAA, AA, A, BBB, BB, B and F. For loans made from June 1, 2005 onwards, we use ten ratings: AAA, AA, A, BBB, BB, B, CCC, CC, C and D. To further centralize our credit risk management, we have limited our branches' ability to assign ratings. For example, only our head office can assign an AAA rating and only our head office and tier-1 branches can assign an AA rating.

In general, we grant unsecured loans only to applicants with an AAA rating and selected applicants with an AA rating specifically approved by our head office. To other applicants, we generally only grant loans secured by properties and monetary assets or guaranteed by third parties. Our policy is to hold senior security interests and, occasionally, subordinated security interests. Furthermore, our practice is generally not to extend new loans to applicants with a credit risk rating of B or lower (BBB or lower prior to June 1, 2005) unless the loans are fully secured by pledged deposits or government bonds.

Collateral Appraisal

In general, the value of collateral is determined by an independent appraiser upon origination of newly-extended loans, and is reviewed internally on a quarterly basis for any significant changes in value. Collateralized loans are subject to loan-to-value ratio limits based on the type of collateral, as follows:

Type of Collateral	Maximum Loan-to-Value Ratio
Properties	
Real estate and movable assets	70%
Monetary assets	
Cash deposits with us	90%
Government bonds and short-term bonds	90%
Medium-to long-term bonds	80%
Non-publicly traded stocks	60% (based on net asset value)
Publicly traded stocks	60% (based on market value)

For loans guaranteed by third-party guarantors, the guarantor's financial condition, credit history and ability to meet its obligations are evaluated according to the same procedures and criteria used for the primary obligor.

Project Evaluation

Credit applications for fixed asset projects are evaluated by a team formed by the originating branch. In evaluating a project, we take into account a variety of factors, including the fundamentals of the project, the status of the project sponsors, and other sources of funding for the project.

Evaluation Report

Based on the evaluation and the applicant's credit request, the relationship manager prepares an approval application form and files an evaluation report. The evaluation report contains (i) the credit risk rating of the applicant, (ii) a maximum permitted credit exposure to the applicant, (iii) a proposed credit line, and (iv) proposed terms for the credit line. In proposing credit lines for corporate applicants which are part of a group, to the extent identifiable and practical, the relationship manager estimates our maximum permitted credit exposure to the group and propose a credit line for the entire group. The evaluation report also contains the proposed allocation of the credit line among different types of credit products.

Credit Approval

All credit extensions are required to be approved at a meeting organized by the credit approval department. For any particular loan, the credit approval meeting is organized at the corresponding branch level of our bank with the required credit authorization limit and is required to be conducted in accordance with our detailed procedures.

Credit Authorization Limits

Each branch is subject to two types of credit authorization limits: (i) the maximum total committed credit line to any single borrower and (ii) the maximum amount for any individual loan with a term of one year or more. Each credit application is required to be approved at a credit approval meeting at the branch that has the required credit authorization limits. If the proposed credit line exceeds the branch's authorization limit, the credit application is required to be submitted directly to the next higher level of branch with the required authority.

Since 1999, our head office has set and reviewed credit authorization limits of tier-1 branches based on a branch scoring system which considers, among other things, the quality of the branch's loan portfolio, its profitability and the quality of its risk management. Credit authorization limits are reviewed at least once every year. As of September 1, 2005, the credit authorization limits of tier-1 branches for total committed credit lines to any single borrower with a credit risk rating of AAA or selected customers of our head office ranged from RMB 300 million to RMB 800 million, while the limits for a borrower with a credit risk rating of AA ranged from RMB 200 million to RMB 550 million, and the limits for a borrower with a credit risk rating of A or lower ranged from RMB 150 million to RMB 450 million.

Authorization to approve corporate credit applications is primarily centralized in our head office and tier-1 branches. We have restricted the scope and level of credit approval authority of tier-2 and lower level branches. Unless otherwise authorized by tier-1 branches, tier-2 and lower-level branches generally are permitted to approve only (i) draw-downs of previously approved credit facilities and (ii) fully secured loans.

Credit Approval Meeting Procedures

Credit approval meetings are held by our head office, tier-1 branches and tier-2 branches. The following table sets forth the participants with voting power and the number of votes required to approve a credit application at each branch level.

Branch level	Participants with voting power	Votes required to approve
Head office	• One lead credit approval officer who chairs the meeting; and • at least five full-time credit approval officers.	• Lead credit approval officer must approve; and • 2/3 or more of the participants with voting power must approve.
Tier-1 branch	• One lead credit approval officer who chairs the meeting; and • at least four full-time credit approval officers.	• Lead credit approval officer must approve; and • 2/3 or more of the participants with voting power must approve.
Tier-2 branch	• One lead credit approval officer who chairs the meeting; and • at least one full-time credit approval officer.	• Unanimous approval.

Participants in the credit approval meetings with voting power include one lead credit approval officer and one or more full-time credit approval officers. In order to maintain their independence, our full-time credit approval officers do not have responsibilities within the bank other than to review credit applications. These officers are appointed internally from candidates with the required experience and qualifications. The qualifications for our full-time credit approval officers are set by our head office. The term of a full-time credit approval officer is two years and, generally, no officer is permitted to serve more than two consecutive terms. As of June 30, 2005, there were 12 full-time credit approval officers at our head office and approximately 604 full-time credit approval officers at our tier-1 branches. Our lead credit approval officers are generally (i) deputy branch general managers experienced in credit extension, (ii) general managers or deputy general managers of the credit approval department, (iii) risk management department officers, or (iv) senior full-time credit approval officers. In addition, for loans that require head office approval, our executive officers, other than our president, may participate in credit approval meetings as the lead credit approval officer.

Each credit approval meeting is attended by randomly selected, full-time credit approval officers. In addition, relationship managers are generally required to attend the meeting to answer questions from credit approval officers. If necessary, personnel from relevant departments or external experts may be invited to attend the meeting to advise credit approval officers on specific issues. However, only the lead credit approval officer and full-time credit approval officers may vote at the meeting.

In addition to new credit extensions, extensions of the terms of existing loans that are not in default must also be approved at a credit approval meeting. Any actions related to non-performing loans, however, are taken by our Special Assets Resolution department. See "— Disbursement and Post-Disbursement Management — Administration of Non-Performing Assets." Generally, the maturity on a short-term loan may be extended for a term of less than its original term; the maturity on a medium-term loan may be extended for an aggregate term of less than half of its original term; and the maturity on a long-term loan may be extended for an aggregate term of up to three years. Our maturity extension policies for personal loans are more stringent than those for corporate loans. Existing borrowers applying for additional loans are subject to the same credit approval process as new credit extensions.

Credit applications are either approved, conditionally approved, postponed for further evaluation, or rejected. If a credit application is conditionally approved, the relationship managers must ensure the conditions are satisfied. We have introduced a requirement, which is currently implemented on a pilot basis, that the satisfaction of the conditions must be reviewed by the risk managers, before the loan is extended.

Disbursement and Post-Disbursement Management

Funds Disbursement

After a credit application is approved and the relevant disbursement conditions are satisfied, authorized personnel, which typically include the branch general manager or the business department head, execute credit documents with and disburse funds to a borrower. Most of our credit documents are on standard forms prepared by our legal department. We occasionally execute credit documents that are not on our standard forms at the applicant's request, subject to review and approval of those documents by our legal department.

On-going Credit Monitoring

The relationship managers and risk managers are responsible for on-going monitoring of loans to detect any signs of potential delinquency at an early stage and to facilitate prompt remedial action. We focus on the factors that might adversely affect the borrower's ability to repay, including (i) the borrower's overall credit risk profile, including levels of the borrower's accounts receivable and inventory, changes in operating cash flow, and capital outflows not in the ordinary course of business; (ii) the status of the projects for which the proceeds from the loan are used; and (iii) the status of any security interests.

We gather information on our corporate loans primarily by collecting information from the borrowers and other sources, such as tax authorities, and conducting on-site inspections of the borrowers. Upon completion of an inspection, our relationship manager and risk manager file a report summarizing the inspection, which is reviewed by the head of the business department. In addition, the risk management department conducts an overall assessment of the quality of our loan portfolio on a monthly basis and submits a monthly report on loan quality to senior management.

Any event which could significantly affect a borrower's ability to repay is required to be reported immediately. If signs of a possible loan delinquency are detected, the relationship managers are required to conduct an immediate review of the credit quality and repayment ability of the borrower concerned and to take appropriate preventive measures, which may include on-site inspections, the enforcement of security interests or third-party guarantees, loan restructuring and loan collection, as applicable.

We implemented the CRREW system on a pilot basis for our corporate banking business in September 2003. The CRREW system assists us in monitoring loans by generating warning signals indicating risk concentration and buildup relating to particular regions, industries, products or customers. See "— Credit Risk Management for Corporate Loans — Credit Risk Management Information Technology."

Loan Classification

Prior to 1999, we classified our loans under a four-category classification system. In 1999, in accordance with PBOC requirements, we began to implement the five-category loan classification system and completed its implementation by the end of 2000. In the fourth quarter of 2003, we strengthened the application of our five-category loan classification system and began to assess loans for impairment under IFRS. See "Assets and Liabilities — Assets — Asset Quality of Our Loan Portfolio — Distribution of Loans by Loan Classification" and "Regulation and Supervision — PRC Regulation and Supervision — Loan Classification, Allowances and Write-offs — Loan Classification and Allowances."

Our relationship managers preliminarily classify loans based on the information gathered in our loan-monitoring process. The risk management department reviews, analyzes and approves the preliminary classification of each loan. Each loan classification is required to be confirmed by an inter-departmental team, with participation from the risk management department. If a loan is preliminarily classified as normal or special mention, the inter-departmental team may delegate its authority to a team chaired by the general manager of the risk management department of the branch that made the loan. The approval and confirmation of loan classifications at a branch are subject to authorization limits delegated to that branch.

Our relationship managers are required to reclassify an existing loan immediately after learning of changes in the information that may affect the loan's status. Loan classification information is reported to the head office once every ten days and the classification of each loan is reviewed and approved at least once every quarter. Our risk management department is responsible for monitoring compliance with our loan classification guidelines.

Administration of Non-Performing Assets

The special assets resolution department, or SAR department, administers most of our non-performing assets and certain other special assets. The SAR department administers corporate loans classified as sub-standard, doubtful or loss under the five-category loan classification system. For further information on the classification of our loans, see "Assets and Liabilities — Assets — Asset Quality of Our Loan Portfolio — Distribution of Loans by Loan Classification." The SAR department seeks to maximize recovery of our non-performing assets in a cost-effective manner. We have established a SAR department at our head office, our 38 tier-1 branches and certain tier-2 branches. For branches without a SAR department, we have trained personnel who specialize in the administration and recovery of non-performing assets.

Non-performing assets are transferred to our SAR department by our business departments in accordance with specific policies and procedures. After a transfer, the relevant business department continues to share information with the SAR department regarding the non-performing asset and collaborates with the SAR department to determine the best recovery solution.

To recover non-performing loans, we generally take, to the extent necessary, the following actions: (i) notification of default; (ii) restructuring; (iii) collection on collateral or guarantees; and (iv) collection through legal or arbitration proceedings. In the event we are unsuccessful in making any recovery, we generally write off the asset in accordance with the standards established by the MOF. These actions must be approved by the relevant tier-1 branch, the SAR department at our head office or an approval team at our head office, in accordance with applicable authorization limits. We may also dispose of non-performing loans to asset management companies or other third parties.

Notification of default. We notify non-performing borrowers and guarantors, if applicable, of payment default both by telephone and in writing. We may also deliver the notice in person. If we are not able to collect on the non-performing loan within a reasonable time after notice of default has been given, we may choose to restructure the loan or commence legal or arbitration collection proceedings.

Restructuring of non-performing loans. Restructurings of non-performing loans (i.e., loans classified as substandard or lower) generally involve negotiated amendments to the original loan documentation, including extending the maturity of the loan, requiring additional collateral or guarantees, or waiving overdue interest. In restructuring non-performing loans, we may also agree to substitute a new borrower or guarantor for the original borrower or guarantor, as the case may be. Once we determine to waive any overdue interest, or to extend a new loan for purposes of collecting interest or enhancing our security interest, the non-performing loan may not be upgraded into a higher loan classification category until after an observation period of six months. If the restructured principal and interest payments are current throughout the observation period, we review the loan's classification when the observation period ends and upgrade the loan if appropriate. If the borrower subsequently becomes delinquent in paying the restructured principal or interest, we downgrade the loan to its classification before the restructuring and observe the loan for an additional twelve months. If the borrower is delinquent in paying the restructured principal or interest during the original or additional observation period, we downgrade the loan to doubtful or lower. Interest accrues in the same way on restructured loans during the observation period as on other loans.

Collecting on collateral or guarantees. If we are not able to obtain repayment of the loan from the borrower, and if the borrower has ceased operations or its financial condition has deteriorated, we may choose to collect on the collateral securing the loan or make a demand for payment under the guarantee, as applicable. We obtain an independent valuation on any collateral we collect. We typically auction or otherwise sell collateral in order to maximize our cash recovery.

Collection through legal or arbitration proceedings. We typically commence legal or arbitration proceedings against the borrower if the borrower does not exhibit the intent to repay, is involved in other major legal proceedings which may threaten our ability to collect, or exhibits other characteristics or takes other actions which may compromise our ability to obtain repayment of the loan. The court judgment or arbitration ruling may take the form of an order to the borrower to make repayment. A court may also execute on the borrower's property by declaring the borrower to be bankrupt.

Write-offs. We write off a loan classified as loss once we have exhausted all means of collection and recovery and the circumstances surrounding the borrower meet the standards for write-offs established by the MOF. Loan write-offs must be approved by the relevant tier-1 branch or the head office depending on the amount of the write-off. Even after we have written off a loan, we generally continue to pursue our recovery efforts on that loan.

Credit Risk Management Information Technology

We rely on our credit management information system, or CMIS, which was implemented in 1998, as the primary data source for conducting credit asset analysis and reporting on our credit portfolio. We have also begun to operate the CRREW system on a pilot basis, which helps us determine preliminary credit risk ratings for our corporate customers and alerts us to risk concentration and build-ups in particular regions, industries, products or customers. We expect that the combination of the CMIS and CRREW systems will enable us to better assess the credit of our corporate customers based on qualitative and quantitative measures and to better monitor the quality of our credit portfolio.

The Credit Management Information System

We launched CMIS in 1998. CMIS collects and maintains information on our loans and our corporate customers and, in the case of fixed asset loans, the related projects. CMIS is our primary data source for conducting credit asset analysis and reporting on our credit portfolio. We also use CMIS as the primary tool in managing and monitoring corporate and personal loans, classifying our loans and providing information for external regulatory filings and internal research functions.

The Credit Risk Rating and Early Warning System

We implemented the CRREW system in September 2003 on a pilot basis. The CRREW system functions both as a credit risk rating system and as a credit monitoring system. It analyzes information gathered through CMIS and external information sources, including the MOF, the National Bureau of Statistics of China, the Development Research Center of the State Council and other publicly available sources containing financial or operational information on our existing or prospective borrowers.

The CRREW system is intended to supplement and eventually replace our current manual scorecard credit rating system by automating the credit risk rating process. In determining the credit risk ratings for our corporate customers, the CRREW system incorporates a range of quantitative and qualitative criteria. These criteria were developed and are regularly updated based on our historical credit experience as well as other factors, such as the borrower's geographical region, industry classification and the products and services it offers.

The CRREW system also monitors and manages our loan portfolio concentration on a geographical, industry, product and customer basis. Based on the default experience of our own credit portfolio, as well as other information we have gathered, the CRREW system generates warning signals indicating potential risk levels relating to particular regions, industries, products or customers. Our relationship managers consider these warning signals both in managing existing customers and in marketing to prospective customers.

We believe the CRREW system is among the most advanced systems of its kind used by commercial banks in China. We plan to fully implement the CRREW system by the end of 2005 for our corporate banking business. In addition, we intend to fully implement a tailored consumer credit assessment system by the end of 2006 to improve our risk assessment and management in our personal banking business.

Credit Risk Management for Personal Loans

Credit Origination and Analysis

Our personal loan officers initiate the credit extension process by interviewing credit applicants and reviewing brief questionnaires completed by the applicants. We assess applicants based on, among other things, their income, credit history and ability to repay the loan. If the applicant passes the preliminary screening conducted by our personal loan officers, he or she will file a formal credit application together with supporting documents, such as identification documents, employment letters and proof of income.

We have adopted standardized credit approval procedures for our personal loans. Our personal loan officers evaluate the application packages after they are completed and generally focus on the credit risk of the applicants and the value of collateral securing the loans. As part of the evaluation procedures, our personal loan officers normally conduct field investigations and consider information from other sources in addition to the information included in the application packages. The procedures for collateral appraisal for personal credit applications are similar to those for corporate credit applications. For collateralized loans, we generally use our approved independent valuers to determine the value of collateral as part of the loan origination process.

We primarily rely on our credit evaluations as the basis for extending personal credit. We also consider credit information on individuals provided by the national credit information system recently implemented by the PBOC. Based on such evaluations and the applicant's credit request, the personal loan officer formulates a credit recommendation and, if the recommendation is favorable, submits the application package to the credit approval officer for his review and approval.

Credit Approval

Personal loans are generally extended at our tier-2 or lower-level branches. Personal loans extended at such branches are required to be approved by a lead credit approval officer and a full-time credit approval officer. As of December 31, 2004, there were approximately 1,200 full-time credit approval officers at our tier-2 branches.

Disbursement and Post-Disbursement Management

The procedures for personal loan disbursement and post-disbursement management are similar to those for corporate loans. In monitoring personal loans, we focus on the borrower's payment status and changes in the value and status of the collateral securing a loan. After a loan becomes overdue, we actively monitor the loan and begin collection efforts, including conducting on-site inspections.

The procedures for personal loan classification are similar to those for corporate loans. In classifying our personal loans, we perform a matrix analysis generally based on the number of days by which the loans are overdue and the status and value of the collateral securing the loans. See "Assets and Liabilities — Assets — Asset Quality of Our Loan Portfolio — Distribution of Loans by Loan Classification."

Non-performing personal loans are administered by our business departments and the SAR department. The procedures for administering non-performing personal loans are similar to those for corporate loans.

Credit Risk Management for Credit Cards

We centrally manage our credit card business through our credit card center in Shanghai. We have also adopted standardized credit card approval procedures and criteria. Credit card applications are generally approved at our tier-1 branches. We monitor and analyze unusual credit card transactions to reduce the rate of fraud and intentional default. For overdue credit card balances, our collection methods include making telephone calls, mailing collection letters, visiting the borrowers and bringing legal proceedings against them.

Credit Risk Management for Treasury Operations

Our treasury operations are exposed to credit risk through our investment activities and inter-bank lending activities. Our RMB-denominated investment portfolio primarily consists of debt securities and receivables issued by the PRC government and other domestic issuers. Our foreign currency-denominated investment portfolio primarily consists of investment-grade bonds. We establish credit limits on a counterparty and geographical region basis and review them annually.

Enhancements to Credit Risk Management

We have made improvements in, and intend to continue improving, the quality of our credit risk management. We are progressively enhancing our ability to identify, review and monitor our exposure to corporate borrowers that are part of the same group and are implementing single credit limits applicable to group borrowers and their subsidiaries and affiliates, all within the constraints of the public availability of credit data and other relevant information concerning the group affiliations of individual corporate entities in China.

We are improving our analysis and assessment of our corporate and personal loans through such measures as focusing more sharply on the borrower's ability to repay; enhancing the quality of our analysis with respect to the valuation and enforceability of collateral; increasing the extent to which we monitor the value and condition of collateral after loans are made; monitoring our loan classifications more closely for consistency in the implementation of the loan classification criteria by our branches; and strengthening the supervision of our branches by our head office in the loan classification and provisioning process.

With respect to our personal loans, we have improved our ongoing risk monitoring through the introduction of an improved personal credit data information module to CMIS. We are also enhancing the quality of our controls on personal mortgage loans, particularly in connection with the review of financial information and the value of collateral, collection efforts, and the management of collateral.

We are enhancing the process for making provisions for impairment losses on loans and monitoring the quality of our credit portfolio and the amounts of our loan loss allowances on an ongoing basis. To that end, we have defined more clearly the roles and responsibilities of the risk management and other departments involved in the loan provisioning process; are improving the quality of record-keeping with respect to the computation and basis of the amounts of the loan provisions; and are strengthening the analysis and management of changes in the quality of our credit portfolio by our head office.

In addition, we are strengthening our management of non-performing loans and repossessed assets through such measures as improving the co-ordination between the SAR department and the risk management and other relevant departments; monitoring the loan classifications of restructured loans more closely for consistency; and monitoring the value of collateral and repossessed assets on a more periodic basis.

LIQUIDITY RISK MANAGEMENT

Liquidity risk is the risk of being unable to liquidate a position in a timely manner at a reasonable price to fund our obligations. We are exposed to liquidity risk primarily in the funding of our lending, trading and investment activities, as well as in the management of our liquidity positions. Our objective in liquidity management is to comply with regulatory liquidity guidelines and to be able, even under adverse conditions, to meet all our payment obligations and fund our investment and lending opportunities on a timely basis. Our asset and liability management department is responsible for the day-to-day management of our liquidity positions.

Our operations are primarily funded through our customer deposits. Therefore, our branches closely monitor their deposit levels and related liquidity requirements. When liquidity requirements arise, our branches may request additional liquidity from higher-tier branches or our head office. When any branch has deposits in excess of its liquidity requirements, it remits such funds to our head office through an internal funds transfer system. We have significant holdings in liquid assets such as PBOC bills and PRC government bonds, which we may liquidate in the market to meet potential liquidity requirements. In addition, we maintain, with the PBOC, surplus deposit reserves in addition to statutory deposit reserves in part to meet our liquidity needs.

If further liquidity requirements arise, we may borrow from the inter-bank money market, where we have historically been a net lender. For further discussion of our liquidity, see "Financial Information — Liquidity."

According to current banking regulations, we are required to comply with certain operating requirements related to liquidity, including: (i) the liquidity ratio; (ii) inter-bank lending and borrowing ratios; and (iii) the loan-to-deposit ratio. See "Regulation and Supervision — PRC Regulation and Supervision — Operating Requirements." We monitor these ratios on a quarterly basis. See "Risk Factors — Risks Relating to Our Business — We are subject to liquidity risk."

MARKET RISK MANAGEMENT

Market risk is the risk of loss in on- and off-balance sheet positions arising from movements in market prices. Such movements may arise from movements in observable market variables such as interest rates, exchange rates, equity prices and commodity prices, and other market changes that affect market risk-sensitive instruments. We are exposed to market risk primarily through the assets and liabilities on our balance sheet, as well as our off-balance sheet commitments and guarantees, comprising our proprietary investment book and our banking book. Our proprietary investment book primarily consists of securities we hold on a proprietary basis for trading and investment purposes, as well as our money market placements. Our banking book consists of our remaining balance sheet assets and liabilities. The principal risk measures and controls we employ to monitor market risk are gap analysis and stress testing for our banking book and trading portfolio. See "Financial Information — Quantitative and Qualitative Analysis of Market Risk." In addition, we apply strict authorization limits, which are determined based on factors such as product type, staff experience, and market environment. Our objective is to seek adequate financial returns while maintaining market risk within acceptable parameters.

Historically, interest rates and exchange rates were controlled and set by the PRC government and we were not exposed to significant market risk. See "Regulation and Supervision — PRC Regulation and Supervision — Pricing of Products and Services." As the government gradually liberalizes interest rates and exchange rates and the financial services sector becomes more competitive, we are increasingly subject to market risk.

Our risk management department is responsible for establishing our market risk management policies and supervising their implementation. Our asset and liability management department is responsible for implementing our market risk management policies by developing procedures to identify, assess, measure and control market risks. Our treasury department, which manages our investment portfolio both for our own account and on behalf of our customers, manages market risks on a day-to-day basis.

Interest Rate Risk Management

Interest rate risk is the exposure of a bank's financial condition to adverse movements in interest rates. The primary source of interest rate risk for us is mismatches in the maturity or repricing periods of our banking portfolio. Maturity mismatches may cause net interest income to be affected by changes in the prevailing level of interest rates.

Prior to 2004, we managed our interest rate risk exposure primarily by adjusting the maturity profile of our assets and liabilities based on our assessment of potential changes in interest rates. Since 2004, we have also begun to measure our exposure to fluctuations in interest rates using gap analysis, which provides a static view of the repricing characteristics of our assets and liabilities. We also perform stress testing and scenario analysis on both our proprietary investment book and our banking book and selected portfolios within them.

In addition, we perform duration analysis on debt instruments in our investment portfolio to assess the potential price volatility of a bond by measuring its sensitivity to interest rate fluctuations. As of June 30, 2005, the duration of our RMB-denominated bonds (other than substantially all of our receivables in our investment portfolio) and foreign currency-denominated bonds was 1.79 years and 2.54 years, respectively. We also use interest rate sensitivity analysis, VaR analysis, and stress testing to measure exposures to potential interest rate changes in our investment portfolio.

We enter into derivatives contracts, such as swaps and options, to hedge our interest rate risk exposures on our foreign currency-denominated trading and investment portfolios. We generally do not use interest rate hedging instruments to hedge our interest rate risk on RMB-denominated securities, as hedging instruments are not well developed in the domestic market.

Exchange Rate Risk Management

Exchange rate risk primarily results from mismatches in the currency denomination of our assets and liabilities and mismatches in our currency position resulting from foreign currency transactions both for own account and on behalf of customers. We are exposed to exchange rate risk because we hold loans, deposits, securities and financial derivatives that are denominated in currencies other than the Renminbi. We manage our exchange rate risk by seeking to match our lending and borrowing on a currency-by-currency basis. In addition, we hedge our open foreign currency positions from our foreign currency investments and inter-bank transactions by entering into currency spot and forward contracts. For most foreign currency transactions we execute on behalf of our customers, we generally seek to close out our open positions within the same business day to the extent permissible by the SAFE.

Enhancements to Risk Management of Treasury Operations

We have made improvements in, and intend to continue improving, the quality of controls relating to our treasury business through such measures as defining and implementing more clearly the respective roles and responsibilities of our front, middle and back office and strengthening their respective reconciliation and other control procedures; developing and implementing stronger financial management and accounting function and controls for the treasury business; developing and implementing a stronger market revaluation methodology for treasury products; and strengthening the operational risk management of the treasury business.

OPERATIONAL RISK MANAGEMENT

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Our operating units are responsible for assessing their operational risk and implementing our operational risk management policies and procedures. Our risk management department regularly conducts reviews to evaluate compliance by various departments with our policies and procedures. Our internal audit department also conducts evaluations of the effectiveness of our overall operational risk management.

Reporting and Monitoring of Non-compliance

We have established internal reporting procedures for employee misconduct that affects our business. Under our internal reporting system, statistical data relating to incidents of employee misconduct are required to be reported to our head office periodically, and significant cases are required to be reported to our head office within 24 hours of their discovery. In addition, we are required to report to the CBRC significant cases of employee misconduct.

In 2004, 63 criminal offenses committed by our employees were reported to our head office, involving a total amount of RMB 417 million. 64 criminal offenses committed by our employees were reported in 2003, involving a total amount of RMB 144 million. Of the offenses reported in 2004, 16 involved an amount of RMB 1 million or more, compared to 13 in 2003. For the six months ended June 30, 2005, 39 criminal offenses committed by our employees were reported to our head office, involving a total amount of RMB 91 million, of which nine involved an amount of RMB 1 million or more. These incidents of employee misconduct included, among other things, theft, embezzlement or misappropriation of customers' funds; mishandling of customer deposits and settlement of payment transactions; improper credit extensions; improper accounting; fraud; and acceptance of bribes. Some of these incidents implicated potential internal control weaknesses at certain of our branches. However, these incidents have not, individually or in the aggregate, had a material adverse effect on our business, financial condition or results of operations. On occasion, incidents of employee misconduct have not been reported on a timely basis, or at all, and we have imposed severe penalties for intentional failures to report misconduct, including termination of employment. For risks relating to the misconduct by our employees, see "Risk Factors — Risks Relating to Our Business — We may not be able to detect and prevent fraud or other misconduct committed by our employees or third parties."

Management of Operational Risk

We focus on enhancing our internal controls and training our employees concerning our policies and procedures, particularly those that have been recently promulgated. Since the mid-1990s, we have formulated and implemented policies and procedures for many of our principal business activities at various branch levels. The initiatives we have implemented include:

- delineating responsibilities among our departments, including the business departments, the credit approval department, the risk management department and the audit department, and segregating positions with potential conflicts of interest to establish checks and balances in our operating processes;
- implementing a centralized appointment and rotation system for key positions, particularly for key accounting and financial control positions at our branches;
- centralizing the setting of authorization limits in key operating processes, such as the credit approval process and the loan classification process;
- adopting a code of conduct which codifies the disciplinary measures for employee misconduct;
- adopting policies and procedures to hold management personnel accountable for the misconduct of employees under their supervision;
- strengthening the implementation of the rules on reporting employee misconduct and introducing more stringent penalties; and
- strengthening our anti-money laundering monitoring efforts by establishing an anti-money laundering office and implementing relevant policies and procedures in accordance with PBOC guidelines.

In addition, to reduce the operational risk caused by failures of information technology systems, we maintain backup data for our key data processing systems and are developing a disaster recovery center which will automatically back up our operational data.

In 2003, we initiated the "Risk Management Platform" project, which aims to unify our various risk management policies and procedures across all business activities and branches. The project is designed to address and improve: (i) our internal control environment; (ii) our internal control planning; (iii) our internal control implementation, operation and monitoring; (iv) the process for assessing and continuously enhancing our internal controls; and (v) information and communication relating to our internal controls. We believe that the project, upon completion, will enhance our ability to manage operational risk through improved checks and balances, efficiency and transparency. The project is expected to be fully implemented throughout the bank by the end of 2005.

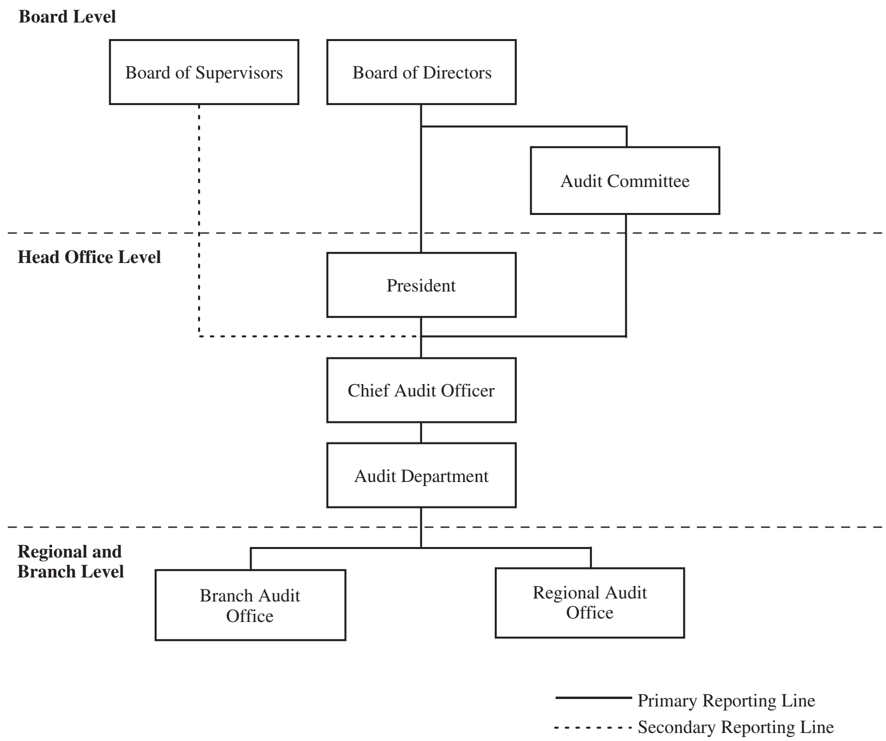
In 2005, we created a separate compliance department to monitor compliance with the laws and regulations applicable to us and our own policies and procedures. The department also focuses on strengthening employee accountability related to the credit approval process and monitors employees' compliance with relevant policies and procedures. In addition, the compliance department is also responsible for implementing our anti-money laundering policies through its anti-money laundering office.

INTERNAL AUDIT

We recognize the importance of the internal audit function at our bank. Our audit department, which has a reporting line independent from our business departments, examines and independently evaluates our risk management policies and procedures and internal controls.

In 1999, we established eight regional audit offices, which audit our tier-1 branches within their respective regions, in addition to our branch-level general audit offices. The general audit offices at tier-1 branches in turn are primarily responsible for auditing all operations within their respective geographical areas. Since May 2005, we have been implementing measures to strengthen the independence of our internal audit function through, among other things, the establishment of the general auditor position with overall responsibility for our internal audit function. Upon completion of these measures, our general audit offices at tier-1 branches and our eight regional audit offices will report directly to the audit department at the head office while notifying the general managers of their respective tier-1 branches of their audit results. The audit department at our head office will report to the chief audit officer, who in turn will report primarily to our president and to our board of directors through the audit committee of the board, and secondarily to our board of supervisors. Compensation and performance assessments of all internal audit employees of our bank will be centrally managed by our head office through the reporting line of our internal audit function. The audit committee of the board is responsible for reviewing our internal audit plans, policies and procedures, and inspecting, monitoring, reviewing and evaluating our internal audit function. In addition, the audit committee advises the board of directors on audit-related issues, as well as facilitating communication between our internal and external auditors.

The following chart illustrates the reporting structure of our internal audit function upon full implementation of the measures described above.



Our head office audit department audits our head office business departments and our regional and branch level audit departments audit our branches and branch level departments.

Our internal audit department determines the frequency and priority of our audits at each of our operations based on an assessment of the level of risk at each operation. The audit department conducts:

- on a regular basis: operation audits, internal control audits and senior management performance audits;
- from time to time: specific audits, such as audits of newly-extended loans within a specific period, residential mortgage loans, personal consumption loans, and branch assets, liabilities or income; and
- monitoring of our risk management procedures in an effort to ensure the prompt correction of any deficiencies.