FINANCIAL MANAGEMENT ASSESSMENT FOR THE FINANCIAL INTERMEDIARY

A. Introduction

1. The macroeconomic framework of the People's Republic of China (PRC) has been assessed to be satisfactory and acceptable for the involvement of the Asian Development Bank (ADB) in the PRC's financial sector through financial intermediary lending. The China Construction Bank (CCB), which was chosen through competitive selection by the China National Chemical Group (ChemChina) in February 2015 to act as (i) onlending bank, (ii) trustee of ADB loan proceeds, (iii) manager of the revolving escrow fund (REF) and the interest differential accounts, and (iv) cofinancing commercial bank for the proposed Chemical Industry Energy Efficiency and Emission Reduction Project. As financial intermediary CCB will (i) conduct financial due diligence of future subborrowers from the second batch subborrowers and make suitable recommendations to ChemChina and CHC on the basis of the creditworthiness examination; (ii) provide cofinancing for approved subprojects, if necessary; (iii) manage ADB loan disbursements for subprojects, as well as interest payments to China Haohua Chemical Group (CHC), ChemChina, CHC's energy service company (ESCO) Beijing Zhonghao Huatai Energy Technology (hereinafter referred to as Huatai or simply ESCO), and ADB, and principal payments to the REF account of CHC to be opened at CCB, and ADB; (iv) maintain the financial records for the REF, interest rate differential account and the sub-loan portfolio; (v) see to it that all relevant accounts are audited yearly; (vi) report nonperforming loans promptly to CHC; and (vii) submit necessary reports to Huatai and CHC as scheduled.

2. This financial management assessment (FMA) was conducted in accordance with ADB guidelines to assess the financial management capacity of CCB. The financial management assessment questionnaire (FMAQ) initially proposed by ADB[1] was modified where necessary to comply with the project requirements and completed by CCB with guidance from the ADB consultant.

B. Summary

3. CCB is a shareholding commercial bank listed on the stock exchanges of Shanghai and Hong Kong, China. It is the fifth-largest commercial bank in the world in market value. According to the FMA, CCB has satisfactory financial management capability to accomplish its designated tasks of (i) managing the required financial transactions and balances, (ii) providing reliable financial progress reports and monitoring reports, (iii) safeguarding financial assets, and (iv) submitting the required financial documents to auditors under arrangements acceptable to ADB.

4. CCB prepares its accounting statements under the Chinese Generally Accepted Accounting Principles (CGAAP), runs banking operations strictly in line with regulatory requirements, and is well versed in risk management with control measures such as segregation of duties, proper authorization of transactions, payroll controls, regular bank reconciliation, establishment of subsidiary accounts to hold the accumulated interest differential, and computerized transaction software.

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[1] http://www.adb.org/Documents/Others/FM-toolkit/fmaq.doc.

5. In addition to internal audit, the bank undergoes external audit each year by the world-renowned accounting firm PricewaterhouseCoopers (PwC). This practice is acceptable to the stock exchange and the government regulatory bodies. But the external auditor specifically for the project has not yet been determined; it will be chosen by the project management organization through bidding, with CCB assistance. Terms of reference must be prepared for external auditing.

6. To implement the onlending loan, CCB has formed a strong team under the general manager of the corporate banking department at the Beijing Headquarters, who will provide overall coordination within the bank. The President of the Anhui Subbranch will manage project preparation and implementation. The subbranch has formed a team of four staff members to run daily operations. The ADB loan related to the accounts of ChemChina, China Haohua Chemical Group (CHC), and Beijing Zhonghao Huatai Energy Technology (Huatai), the energy service company, or ESCO) will be set up within CCB's Anhui Subbranch, which will handle the disbursement and repayment of the ADB loan. The Anhui Subbranch has some experience in managing disbursements from foreign governments as well as projects funded by international financial institutions,[2] and has wide experience in foreign exchange risk management. However, as none of those projects were funded by ADB, the staff of Anhui Subbranch needs to be trained in ADB's financial management standards and procedures.

C. About China Construction Bank

7. Founded on 1 October 1954, CCB, with headquarters in Beijing, is one of the PRC's Big Five national commercial banks. It was listed on the stock exchange of Hong Kong on 27 December 2005, and on the Shanghai Stock Exchange on 25 September 2007. At the end of 2013, its market value of $187.8 billion made it the fifth-largest bank in the world. It also gradually set up overseas branches in Hong Kong, China, Singapore, Frankfurt, Johannesburg, Tokyo, Osaka, Seoul, New York, Ho Chi Minh, and other cities. In August 2014, CCB completed the purchase of 72% of the total stock shares of Brazil's Banco Industrial e Commercial S.A. (Bicbanco or BIC), for R$1,600 million. Thus far, it was the largest purchase by a Chinese-funded commercial bank of a controlling interest in a bank overseas, with strategic significance for the international development of CCB.

8. At the end of 2013, CCB had 368,410 employees, 57% of whom had at least a bachelor's degree. It had 14,663 branches and subbranches—14,650 in the PRC, and 13 abroad—and controlled 39 subsidiaries with 181 branches and 7,662 employees.

9. At the end of 2014, CCB ranked second among the top 1,000 banks in the world in terms of tier-1 capital, and second among Chinese banks, according to the UK magazine *The Banker*. It also ranked 38th in the Fortune Global 500. So far in 2015, CCB was ranked second in the Forbes Global 2000 and has been declared The Best Large Retail Bank in China for 2015 by The Asian Banker.[3] All these rankings and awards are indicative of CCB's success in running its large-scale banking business.

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[2] For example, in 2008, CCB on-lent €49.5 million of the third type of foreign government loan from the German development bank KfW to the Sinohydro Group. Loan implementation was smooth and no onlending issues arose.

[3] http://www.ccb.com/en/newinvestor/upload/20150330_1427710199/20150330181024641129.pdf.

1. Shareholders and Organization

10. At the end of September 2014, CCB had registered capital of CNY250.01 billion ($40.1 billion) and net equity of CNY1,208 billion ($193.6 billion). The top 10 shareholders together owned 97.46% of its shares. Table 1 gives details of CCB's top 10 shareholders.

Table 1: Top 10 Shareholders of China Construction Bank (as of 30 September 2014)

No.	Name of Shareholder	Nature of Shareholding Entity	Proportion of Shares Held
1	Central Huijin Investment	State-owned	57.26%
2	Hong Kong Securities Clearing Company Nominees	Foreign legal person	29.86%
3	Temasek Holdings of Singapore	Foreign legal person	6.39%
4	State Grid	State-owned legal person	1.08%
5	Baosteel	State-owned legal person	0.91%
6	China Ping'an Life Insurance-traditional common insurance product	Domestic non-state-owned legal person	0.86%
7	China Yangtze Power	State-owned legal person	0.41%
8	Yijia Investment Co.	Foreign legal person	0.34%
9	China Ping'an Life Insurance (traditional high-return insurance policy product)	Domestic non-state-owned legal person	0.24%
10	China Securities Finance	State-owned legal person	0.11%
	Total		97.46%

11. The CCB is committed to business integrity and international standards of modern corporate governance, and recognizes that implementing modern corporate governance practices is central to accomplishing its objective of becoming one of the most internationally competitive commercial banks. In line with this objective, CCB has been restructured as a joint-stock commercial bank with limited liability and has adopted a modern corporate governance framework, which balances authority and responsibility among the shareholders' general meeting, the board of directors (BOD), the board of supervisors, and senior management to ensure proper segregation of duties and powers among all stakeholders.

12. The BOD, consisting of 17 directors, implements the resolutions adopted during the shareholders' general meetings and has the authority to decide on important issues to protect the interests of the bank and its shareholders. Five committees were set up under the BOD: the strategy development, risk management, audit, nomination and compensation, and social responsibilities and related-party transactions committees. The last three committees are chaired by independent and non-executive directors, and more than half of their members are independent non-executive directors.

13. The board of supervisors consists of eight supervisors, three of whom represent the shareholders, three represent the employees (as required by law), and two are external supervisors. The shareholders' representatives and the external supervisors are elected during the shareholders' general meeting, and the employees' representatives are elected by the employees through their authorized proxies. The board of supervisors monitors the legitimacy and compliance of the BOD and the senior management, as well as the bank's financial status. The bank's president is reporting to the BOD and is in charge of the routine business of the

institution, with support from the senior management team.[4] There are 34 functional departments under the president, including (i) corporate banking, (ii) audit, and (iii) internal control and compliance. CCB is managed under a vertical scheme, from headquarters to the branches and then the subbranches. The headquarters oversees all operations; all branches and subbranches are dependent corporate bodies under its management. The headquarters has the final say in personnel appointments and dismissals in all branches and subbranches, as well as in service policy, rules and regulations, and foreign affairs.

14. Even though it is a state-owned bank, CCB has adequate managerial autonomy and commercially oriented governance.

2. Loan Management

15. As a government-controlled bank and listed firm, CCB complies strictly with regulatory requirements in its banking operations. It fulfills every performance indicator mandated by the People's Bank of China and the China Banking Regulatory Commission (CBRC), and has no record of ever breaching any law or regulation. CCB holds regular training to make all staff—from the top management to employees—understand the importance of complying with the law. It has also set up institutional arrangements to secure compliance. The internal control and compliance department and the legal department are the main institutional bodies safeguarding the bank's legal compliance.

16. As a commercial bank, CCB is expected to make profits for its shareholders. It is intent on maintaining a wide net interest spread, expanding its loan client base, and attracting new deposits. It is also trying to increase noninterest income, derived mainly from net fees and commissions. The bank regularly reviews its operating performance against key performance indicators, including profits and losses and nonperforming loans, at the headquarters, branch, and subbranch levels (Table 2). The finance and accounting department at each level organizes the review of profits and losses generated from operations at that level. The results in 2011–2014 were quite good—the net profit margin stayed above 40% until the third quarter of 2014.

Table 2: Performance of China Construction Bank Against Key Indicators, 2011–2014
(%)

Item	2011	2012	2013	3Q 2014
Return on equity	20.75	20.39	20.02	15.78
Return on assets	1.38	1.39	1.40	1.14
Net profit margin	42.67	42.02	42.30	44.44

Source: China Construction Bank financial statements.

17. CCB has standard procedures and an operations manual for managing the preparatory, current, and later stages of commercial loans and entrusted loans[5]. At least two client managers

[4] CCB senior management team consists of (i) six vice presidents, (ii) the chief risk officer, (iii) the chief economist, (iv) the chief audit officer, (v) the chief financial officer, (vi) the board secretary, (vii) the wholesale banking controller, (viii) the company secretary, and (ix) a qualified senior accountant.

[5] For entrusted loans, CCB is acting as a trustee and organizes loans on behalf of and between borrowers and lenders. CCB as trustee is responsible for the collection of principal and any interest, for which it charges a handling fee, but does not undertake any of the loan risk. Entrusted loans are commonly used in the PRC to enable the lending and borrowing of funds between companies since 2001 when the People's Bank of China introduced this financial instrument.

in the corporate banking department or section jointly investigate the loan applicant and collect all necessary information on the applicant, the guarantor, and the pledger, according to a checklist covering the following: legal status, license status, corporate charter, business scope, BOD authorization, identity of the legal representative and of the authorized person, operating status, sector policy, top management, financial standing, credit records, tax payment records versus financial statements, purpose of credit application, ownership and valuation of collateral (by contracted third-party evaluators), etc. The client managers verify the original documents, enter the credit investigation reports into a uniform template and the report data into the intranet credit approval system together with the scanned supporting documents, and submit an application for credit approval to the credit management department of the branch after having it reviewed by the vice president of the branch or subbranch. The credit management department assesses the application and forwards its opinion to the president or authorized representative of the branch or subbranch, and this becomes the basis for setting the maximum loan amount, the interest rate, and the security requirements, among others.

18. If the loan is approved, CCB carries out standard loan disbursement procedures to ensure consistency of disbursements with the signed agreement and its attachments. The entire disbursement process is strictly recorded. The accountant records all credit approval materials, loan agreements, transaction documents, and collateral and guarantees in a book and in the computer system, and then forwards the records to the record keeper for custody on the day after the transaction is completed. Backup computer data and records are also kept at the headquarters.

19. CCB requires regular post-investment management by client managers and staff from the credit management department involving monitoring of the flow of loan proceeds. If the proceeds go to an unknown bank account under the borrower’s name, the borrower must explain why, and provide bank statements showing the account where the loan proceeds eventually end up. The post-investment inspector from the credit granting center also inspects loan implementation. If there is any default risk, the client manager and the post-investment inspector alert the bank so it can take early action.

20. For effective portfolio management, CCB classifies loans, with CBRC guidance, into five categories according to their level of risk—normal, special attention, substandard, doubtful, and loss—and sets aside sufficient loan loss reserves, particularly for non-normal loans. All financial and accounting staff members have been trained in CCB’s operations procedures. The bank exercises financial prudence by fully considering the impact of changes in the external environment, including macroeconomic and government control policies, on asset quality, and making full provision for impairment losses on loans and advances to customers.

21. In the past few years, CCB has continually strived to optimize its credit structure and support the development of the real economy and key sectors critical to people’s livelihood (Table 3). The balance of loans granted to industries with severe excess capacity has been decreasing. CCB has responded proactively to changes in the macroeconomic environment and the government’s sectoral policy, consistently strengthened its credit systems and unified management and control over credit risk at the group level, and enforced forward-looking risk management. Its overall asset quality has remained stable over the long term.

Table 3: Loan and Advances to Customers Made by China Construction Bank to Customers, as of 31 December 2013
(CNY million)

(1) Distribution by individual and corporate customer

Item	Ending of Year	Beginning of Year
Personal loans and advances	2,464,654	2,017,826
Of which: Credit card	268,663	177,936
Housing mortgage	1,860,219	1,528,757
Others	315,772	311,133
Corporate loans and advances	5,399,631	4,963,050
Of which: short-term Loans	1,870,823	1,725,607
Medium to long term loans	3,528,808	3,237,443
Note discounting	116,962	137,558
Overseas subsidiary	608,810	393,878
Total loans and advances to customers	8,590,057	7,512,312
Minus: Loss reserve	228,696	202,433
Book value of loans and advanced to customers	8,361,361	7,309,879

(2) Distribution by industry

Item	Ending of Year (%)	Beginning of Year (%)
Manufacturing	16.67	17.50
Transportation, storage and postal services	11.56	11.76
Production and supply of electric power, gas and water	6.92	8.20
Real estate development	6.30	6.57
Leasing and commercial services	5.57	5.22
Wholesale and retail	5.47	5.32
Water, environment and public utility management	3.19	3.14
Construction	2.84	2.97
Mining	2.74	2.78
Public management, social security and social organization	1.37	1.29
Agriculture, forest, husbandry and fishing	1.22	0.98
Education	0.83	0.88
Other corporate loans	4.50	3.54
Personal loans	29.16	27.30
Discounted bills	1.66	2.55
Total loans and advances to customers	100.00	100.00

Source: CCB's Annual Report 2013

3. Financial Performance

22. CCB's banking business has been quite profitable over the assessment period, as its financial statements from 2011 to Q3 2014 (Table 4) show.

Table 4: Financial Statements of China Construction Bank, 2011–2014
(CNY million)

Balance Sheet	2011	2012	2013	2014Q3
Assets				
1 Cash on hand and due from central bank	2,379,809	2,458,069	2,475,001	2,737,700
2 Due from banks and FI	276,752	585,898	321,286	304,135
3 Noble metal	22,718	38,419	35,637	44,805
4 Lendings to banks and FI	109,040	129,653	152,065	296,200
5 Financial assets held for trading	23,096	27,572	364,050	294,545
6 Derivative financial assets	14,127	12,671	18,910	13,669
7 Reverse repurchase agreement	200,045	316,685	281,447	317,706
8 Interest receivable	56,776	68,264	80,731	93,503
9 Loans and advances to customers	6,325,194	7,309,879	8,361,361	9,102,547
10 Available-for-sale financial assets	675,058	701,041	760,292	809,711
11 Held to maturity investment	1,743,569	1,918,322	2,100,538	2,271,926
12 Investment classified as receivable	300,027	219,713	189,737	191,502
13 Long-term equity investment	2,069	2,366	2,624	2,889
14 Fixed assets	94,222	113,946	135,678	139,527
15 Land usage right	16,457	16,232	15,731	15,308
16 Intangible asset & goodwill	3,322	3,712	3,663	4,474
17 Deferred income tax asset	21,410	27,051	38,448	33,175
18 Other assets	18,143	23,335	26,011	62,541
Total assets	**12,281,834**	**13,972,828**	**15,363,210**	**16,735,863**
Liabilities				
1 Borrowing from central bank	2,220	6,281	79,157	134631
2 Due to banks and other FI	966,229	977,487	692,095	1,001,971
3 Borrowing from banks	78,725	120,256	155,917	258,928
4 Trading financial liability	33,656	37,251	380,380	339,020
5 Derivative finanical liability	13,310	11,541	19,872	12,393
6 Repurchase agreements	10,461	2,360	61,873	1,129
7 Deposits from customers	9,987,450	11,343,079	12,223,037	12,982,406
8 Salary Payable	35,931	32,772	34,080	32,210
9 Taxes payable	47,189	53,271	60,209	48,757
10 Interest payable	80,554	123,215	153,627	188,077
11 Predicted liabilities	5,180	5,058	5,014	7,139
12 Bonds payable	168,312	262,991	357,540	434,863
13 Deferred income tax liability	358	332	138	166
14 Other liabilities	35,598	47,389	65,942	85,994
Total Liabilities	11,465,173	13,023,283	14,288,881	15,527,684
Shareholders' Equity				
1 Equity capital	250,011	250,011	250,011	250,011
2 Capital reserve	135,178	135,217	135,523	135,588
3 Allowance for investment re-valuation	6,383	3,023	-19,290	-2,454
4 Surplus reserve	67,576	86,718	107,970	107,970
5 Provisions for general risks	67,342	80,483	153,835	169,064
6 Retained earnings	289,266	391,034	444,084	544,150
7 Difference due to foreign exchange	-4,615	-4,818	-6,182	-6,506
Equity to the bank's shareholders	811,141	941,668	1,065,951	1,197,823
Add: Minority	5,520	7,877	8,378	10,356
Total Equity	816,661	949,545	1,074,329	1,208,179
Total shareholder equity and liabilities	**12,281,834**	**13,972,828**	**15,363,210**	**16,735,863**

Income Statement	2011	2012	2013	2014Q3
Operating income	397,090	460,746	508,608	429,043
Operating expense	179,418	210,460	230,636	185,235
Operating profit	217,672	250,286	277,972	243,808
Plus: non-operating income	2,436	1,941	2,737	2,089
Less: non-operating expense	1,001	788	903	664
Profit before tax	219,107	251,439	279,806	245,233
Less: income tax	49,668	57,837	64,684	54,548
Net profit	**169,439**	**193,602**	**215,122**	**190,685**

Cashflow Statement	2011	2012	2013	2014Q3
Net cashflow from operating activities	125,014	368,813	45,929	463,927
Net cashflow from investment activities	152,584	-155,855	-278,182	-216,903
Net cashflow from financing activities	-15,634	-20,787	-72,541	-71,238
Influence on cash due to exchange rate change	-4,800	-1,714	-3,353	2,304
Cash increase/(decrease) for the year	**257,164**	**190,457**	**-308,147**	**178,090**
Plus: opening balance of cash & equivalent	301,299	558,463	748,920	440,773
Ending balance of cash and cash equivalents	558,463	748,920	440,773	618,863

Source: China Construction Bank's annual reports, 2011–2013, and quarterly report for the third quarter of 2014.

23. In 2011–2013, CCB's total assets, net assets, and net profit all experienced high growth. Its annual return on equity ratios during the period stayed high—above 20%. Total asset value grew at a compounded annual rate of 12% from the end of 2011 to reach CNY16.74 trillion ($2.68 trillion) by the end of September 2014. Shareholders' equity increased by 15.3% yearly from the end of 2011, to CNY1.2 trillion. Sales increased by 16% in 2012 and by 10.4% in 2013, reaching CNY509 billion ($81.57 billion) at the end of 2013. Net profit grew by 14.3% in 2012, and by 11.1% in 2013 to end the year at CNY215 billion ($34.46 billion), before increasing by a further 7.8% in the first 3 quarters of 2014, compared with the same period in 2013. These growth rates are summarized in Table 5.

Table 5: China Construction Bank Growth Rates, 2012–2014

Item	2012	2013	3Q 2014
Total assets	13.8%	10.0%	8.9%
Net assets	16.1%	13.2%	12.4%
Net profit	14.3%	11.1%	7.8%

Source: China Construction Bank audited annual financial statements for 2012 and 2013, and quarterly report for the third quarter of 2014.

24. CCB has consistently maintained a safety cushion above the regulatory requirements for all key ratios (Table 6). In September 2014, its core capital adequacy ratio reached 11.89%, a 3-year high and well above the new minimum benchmark of 6% required under Basel III. Its nonperforming loan ratio of 1.1% is still acceptable, and its loan–deposit ratio of 72.02% sits at the higher end of the permitted range, showing efficient use of deposits. At the end of 2013, the asset liquidity ratio was 46.57%, compared with the regulatory minimum of 25%. CCB's performance against these core indicators shows the bank to be in good financial health and able to run a sustainable banking business.

Table 6: Key Financial Ratios for China Construction Bank, 2011–2014
(%)

Item	Benchmark Ratio	2011	2012	2013	2014Q3
Capital adequacy ratio	⩾8	13.68	14.32	13.34	14.50
Core capital adequacy ratio	⩾6	10.97	11.32	10.75	11.89
Non-performing loan ratio	⩽5	1.09	0.99	0.99	1.10
Asset liquidity ratio	⩾25	53.70	56.73	46.57	
Deposit/loan ratio	⩽75	65.05	66.23	70.28	72.02
Top 1 loan to equity ratio	⩽10	3.30	3.86	4.51	
Top 10 loans to equity ratio	⩽50	15.18	14.76	14.80	
Provision coverage	⩾100	241.44	271.29	268.22	234.47
Cost/revenue ratio	⩽45	29.87	29.57	29.65	25.24

Source: China Construction Bank audited annual financial statements for 2011– 2013, and quarterly report for the third quarter of 2014.

25. CCB's loan portfolio has a satisfactory composition and low concentration risk. From 2011 to 2013, the largest single loan accounted for only 3.30%–4.51% of net capital, and the top 10 loans for 14.76%–15.18%, well below the regulatory limit stated in Table 7. In addition, 72.2% of CCB's loan portfolio at the end of 2013 was backed by guarantees (19.2%) or collateral (53.1%)—0.6% below the corresponding figure at the end of 2012, but still indicative of a solid position. Meanwhile, the loan loss reserve coverage was kept at a high level of 234.47–271.29 from 2011 to the third quarter of 2014. The loan portfolio is therefore well secured against possible operational risks.

26. The performance of CCB over the next 5 years is projected, with key indicators, in Table 7. The projections indicate that CCB will continue to perform well until 2019.

Table 7: Projected Performance of China Construction Bank Against Key Financial Indicators, 2013–2019
(CNY billion, except where stated otherwise)

Item	2013	2014	2015	2016	2017	2018	2019
Total assets	15,363	16,744	18,600	18,940	20,107	21,340	22,642
Loans	8,590	9,474	10,000	10,343	10,915	11,519	12,156
Total liabilities	14,289	15,492	17,160	17,300	18,257	19,266	20,332
Deposits	12,223	12,899	13,612	14,365	15,160	15,998	16,883
Equity	1,074	1,252	1,440	1,640	1,851	2,074	2,310
Profit	280	299	316	335	354	375	397
Return on assets (%)	1.47%	1.42%	1.70%	1.77%	1.76%	1.76%	1.75%
Return on equity (%)	21.23%	19.74%	21.97%	20.42%	19.14%	18.08%	17.17%
Earnings per share growth rate (%)	11.7%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%
Loan–deposit ratio	70.28%	73.45%	72%	72%	72%	72%	72%
Nonperforming loans ratio	0.99%	1.19%	<1.5%	<1.5%	<1.5%	<1.5%	<1.5%
Provision ratio	268.22%	222.23%	>200%	>200%	>200%	>200%	>200%
Capital adequacy ratio	13.34%	14.87%	>12%	>12%	>12%	>12%	>12%

Note: These projections are based on actual 2013–2014 data. The 2015–2019 estimates were prepared by the ADB consultant with China Construction Bank's 2015 operational objectives in mind.
Source: ADB PPTA.

27. CCB was rated AAA (long-term rating) for its domestic debt in August 2014 by China Lianhe Credit Rating. The latter is a joint venture of Lianhe Credit Management, a state-owned enterprise and one of the largest credit service providers in the PRC (holding 51% equity), and Fitch Ratings (49%), one of the world's top three rating agencies. CCB has also received credit ratings for its foreign debt from other world major rating agencies (Table 8). All these ratings consistently reflect the long-term stability of CCB's above-investment-grade credit position.

Table 8: China Construction Bank Ratings from International Rating Agencies

Rating Agency	Long-Term Rating	Short-Term Rating	Outlook	Date Updated
Standard & Poor's	A	A-1	Stable	Nov. 2011
Moody's	A1	P-1	Stable	Apr. 2014
Fitch	A	F1	Stable	Nov. 2007

Source: ADB PPTA

28. In summary, CCB's financial performance is sustainable, with excellent profitability and liquidity. CCB holds good-quality assets and good credit ratings, and ranks high in both loan collection performance and management quality. CCB is also sufficiently capable of carrying out subproject appraisal and monitoring subproject implementation, as well as establishing appropriate prudential policies, administrative structures, and business procedures.

4. Anti–Money Laundering Measures

29. The PRC's Anti–Money Laundering Law, passed in 2006, defines money laundering as actions intended to conceal revenues generated from drug trafficking, organized crime, smuggling, terrorism, corruption, bribery, breach of financial regulations, and financial fraud. To comply with the law, CCB has issued and continually strengthened internal anti–money laundering (AML) guidelines, such as the management rules on AML activities, the

management rules on AML reporting of large and suspicious transactions, the operations manual for the data reporting system on AML activities, and the operations manual on clients' AML risk classification. To comply with the AML rules issued by the CCB Headquarters, the Anhui Subbranch has set-up the necessary institutional arrangements, defined the roles and responsibilities of all related departments, and developed operating guidelines. By speeding up the centralized AML work, initiating an assessment of money laundering risk, and developing a new-generation AML system, CCB has effectively prevented and stopped money laundering and terrorist financing activities in its circle of operations. The AML controls adopted by CCB have been declared proper and acceptable by the CBRC.

5. Risk Management

30. CCB has accumulated extensive experience in risk management, including the identification of risk and the development of risk controls, and has adopted risk management policies and measures throughout the bank. There is no doubt, therefore, that the proposed loan assets can be safeguarded.

31. CCB has established a mutually restricted organization structure for risk management with proper division of work and clear allocation of responsibilities. The BOD carries out the risk management responsibility in accordance with the bank's articles of association and other related regulations. It has set up a risk management committee to draft risk management strategies, monitor their implementation, and regularly evaluate the overall risk profile. The senior management carries out the risk strategy adopted by the BOD and coordinates the implementation of the comprehensive risk management system for the bank group. The chief risk officer, appointed by the senior management, assists the president with the corresponding risk management work. The risk management department is specifically responsible for overall business risk management; the credit management department, for managing overall credit risk and for taking the lead in formulating credit risk management policies; and the credit approval department, for the granting of credit and the approval of the overall credit business. The internal control and compliance department is the coordinating management department responsible for internal control management, and for compliance risk and operational risk management, while the board of supervisors oversees the overall risk management system established by the BOD as well as the performance of the senior management's far-reaching risk management responsibilities. CCB has been updating its risk management policy from time to time and adapted it to market conditions, as key risk performance indicators show.

32. The credit management and credit approval departments coordinate with the corporate banking, small and medium enterprise business, institutional banking, international business, group clients, housing finance and personal lending, and legal affairs departments and the credit card center in implementing the bank's credit risk management policies and procedures. The risk management department takes the lead in developing and implementing credit risk measurement tools, including customer ratings and facility grading, and is responsible for special assets resolution. CCB manages credit risk throughout the entire credit process, from pre-lending evaluation to credit approval and post-lending monitoring. In its pre-lending evaluation, the bank assesses the credit ratings of the borrowing entity on the basis of internal rating criteria and the risks and rewards associated with the proposed project. Credit approvals are granted by designated credit approval officers. CCB continually monitors its credit business, particularly in relation to targeted industries, geographic segments, products, and clients. Adverse events that could significantly affect a borrower's repayment ability are reported promptly, and risk prevention and control measures are implemented.

33. CCB is keen to keep key risk performance indicators in line with regulatory requirements. It therefore tracks the direction of national policies, makes timely adjustments in line with potential risks in key industries and regions, and provides early warnings for the effective control of sectoral risk. It has also proactively adopted policies to prevent concentration risk resulting from large exposure, and has further tightened its lending criteria, adjusted its business structure, controlled the speed of credit approval, revitalized existing credit assets, and launched innovative products. CCB classifies credit asset risk according to the standards set by the CBRC in its Guidelines on Loan Risk Classification. Credit asset risk undergoes preliminary classification by the client manager, review by the client manager's supervisor, and review, checking, and identification by the regional credit risk management departments. CCB recognizes that repricing risk and basis risk due to a mismatch in term structure and pricing basis of assets and liabilities are the primary sources of its interest rate risk; yield curve risk and option risk have relatively less impact. It has therefore instituted measures to counter interest rate risk and keep it within a tolerable range in accordance with its risk appetite and risk management capability, while maintaining the steady growth of net interest income.

34. CCB also pays high attention to liquidity risk management. It regularly monitors the gap between its assets and liabilities for various maturities and conducts regular stress tests on its liquidity risk in order to gauge its risk tolerance in extreme scenarios of low probability and other adverse circumstances. The results show that under stress scenarios, despite increased liquidity risk, its business risks stay within a controllable range.

35. CCB further promotes market risk management by refining its market risk management policy, improving market risk monitoring and reporting, and encouraging the development of systems and tools for measuring market risk. It has clarified the orientation of its market risk policies and risk tolerance limits, optimized contingency plans and detailed rules for significant risks, and strengthened emergency management. It tracks and reports the implementation of credit approvals, as well as the authorization and risk limits of its financial market businesses, with timely warnings of possible risk. The bank has established a mechanism for evaluating key risk factors. It has also installed a transaction risk management system in all branches and performed consistency checks of transaction data to ensure the consistency and accuracy of data stored in its various offices.

36. Operational risk management is another focus of CCB's risk management system. The bank has recently strengthened its operational risk control over key areas and positions. It conducts frequent specific business inspections, auditing and monitoring to authenticate its credit granting and e-banking businesses. It continues to strengthen checks and balances across departments and positions, and dynamically adjusts incompatible positions. It constantly strengthens its operational risk management information system, assesses operational risk in various dimensions, and improves the accuracy and completeness of loss data. The bank also promotes business sustainability management and reinforces the effectiveness of its response to risks associated with huge losses and low probability.

37. In 2013, in compliance with regulatory requirements, CCB drafted a 3-year plan with the objectives, tasks, and assignments for the development of the bank's internal control systems. The implementation of this plan has greatly improved CCB's internal controls; no significant malfunction or control defects have been found so far. CCB's external auditor, PwC, was tasked with verifying the effectiveness of CCB's financial reports in relation to internal control. PwC has confirmed that, in all material respects, CCB has maintained effective internal control in accordance with the basic standards for enterprise internal control.

38. All of the above-mentioned risk management rules established by the CCB Headquarters will apply to the Anhui Subbranch under the supervision of CCB's Beijing Branch. In addition, the Beijing Branch has its own internal audit department, as does the Anhui subbranch. The general audit office at the Beijing branch has three functional divisions with a total of 73 employees. Four level-4 auditors in that office are authorized to take charge of the internal audit of the branch and its affiliated subbranches. The audit department at the Anhui subbranch, on the other hand, is staffed with three professional auditors. For the proposed ADB loan project, the internal audit will be conducted by the audit department at CCB headquarters, which will direct and supervise the auditors at the Beijing branch and the Anhui subbranch in implementing specific internal audit tasks.

D. Accounting Policies and Procedures

39. As a listed company, CCB follows the PRC's relevant accounting principles and policies issued by MOF, which are used nationwide and conform to international accounting standards in most respects. Its current accounting records and statements meet those national standards. They provide financial information in a timely manner—monthly, quarterly, and yearly. Annual financial statements audited by third-party auditors and the relevant governmental bodies are available within 4 months after the end of each year. CCB's document management system complies with the PRC's Accounting Law (1985; amended in 1993 and 1999) and Archives Law (1987; revised in 1996). In its unqualified opinion recorded in the annual reports, PwC, CCB's external auditor, has declared that the consolidated financial statements give a true and fair picture of the bank's state of affairs, financial performance, and cash flows in accordance with both the CGAAP and International Financial Reporting Standards (IFRS). The auditor has also noted the fact that the consolidated financial statements were prepared properly according to the disclosure requirements of both Shanghai and Hong Kong, China, where CCB is listed on the stock exchanges.

40. **Segregation of duties.** As one of the five largest national commercial banks, CCB has adopted the due diligence–driven segregation of operational duties among staff members and departments. All transactions under the project will be approved by the president, the accounting vice-president, or the operations office manager, depending on the amount involved. The transactions will be recorded by the general accountant. Supporting documents can therefore be reviewed and the transactions verified. If financial assets, such as guarantees, are involved, they will be kept in custody by the credit approval department at the Beijing Branch. Bank reconciliation will be prepared by an accountant and approved by the operations office manager. All transaction data will be stored in computer files and can be easily examined by clients and supervisors at the bank.

41. **Budgeting system.** The investment budget will be developed by the PIU with support from CCB. CCB will provide the necessary financial summary information, such as the following: (i) periodic transaction details and remaining balance in each account, including the CHC's revolving account and the project accounts of the sub-loan borrowers with CCB; (ii) progress made in sub-loan withdrawals; (iii) interest rate differential report; and (iv) computer-generated plan for future sub-loan disbursements, in accordance with the related contracts provided to CCB.

42. **Payments.** All payments will be made through bank transfers. CCB will check for consistency between invoices, procurement contracts, and subsidiary loan agreements (SLA3). CCB can provide internet banking services to subloan borrowers with the appropriate authorization settings, if allowed to do so by CHC. Through internet banking, borrowers can

conveniently make payments and transfers with prior approval from CHC or check their accounts with CCB. All transactions will be recorded automatically in the transaction system and reviewed by the general accountant.

43. With regard to the points mentioned above, CCB has prepared a clearly worded financial management manual for its employees, who must have obtained the necessary professional qualifications before taking up their posts. The bank also conducts regular on-the-job training for its employees in the bank's current policies and procedures, and each department can develop its own training program to suit changes in business operations and risk management. These financial management procedures and training programs are generally deemed consistent with ADB's requirements.

E. Internal Audit

44. CCB has an internal audit department (IAD), based at the head office. The IAD is in charge of inspecting and supervising the bank's overall internal controls, works largely independently, and is vertically managed. It reports to the BOD and the audit committee under the BOD. Its emphasis may change from time to time, as required by the BOD. Under the IAD at the headquarters, 39 audit offices in tier-one branches manage and conduct audit programs. In 2013, the bank's IAD adopted a risk-oriented philosophy, clarified audit priorities, and optimized audit methods to improve the quality of audits and strengthen the implementation of their recommendations. The IAD intends to focus on CCB's core tasks, pay close attention to the operational environment, and place more emphasis on the audit of key areas and businesses. It carried out 28 systemic audits in 2013, including a dynamic audit investigation of the credit business; audits of CCB's entrusted loans, centralized procurement management, anti–money laundering activities, trade in precious metals, information technology (IT) operations in some branches, and main business operations and management of some overseas institutions and subsidiaries; and an audit of the managing director's economic responsibilities. Meanwhile, the IAD has reinforced its follow-up audits. In the branches, the audit offices undertake designated audit programs given the specific operations and management and risk characteristics of the various branches, further supplementing the coverage and depth of the audits and improving the relevance of the audit programs. CCB has continued to improve audit quality by adhering to principles and focusing management and control. Through separate working mechanisms, the IAD has enhanced line management in audit offices and strengthened awareness of duties. The IAD has also fostered the creation of specialized teams trained in systems, technologies, and internal audit. The IAD consolidates the fundamentals and helps in the continual enhancement of CCB's audit capability from a long-term perspective. In addition, the BOD, the board of supervisors, and senior management all attach great importance to the audit findings, and actively ensure that their recommendations are implemented. Departments at the head office and at the branches optimize related business processes and IT systems, and reinforce risk management capability according to the audit outcomes.

F. External Audit

45. CCB has retained PwC as the bank's external auditor. PwC is a well-known accounting and auditing firm, and a world leader in its field. As the bank is a listed company, its financial statements, together with the auditor's standard opinion letter, are available to the public. CCB is also subject to regular and irregular inspections by the China Banking Regulatory Commission and People's Bank of China, and to annual audits by the government audit administration, as required by law. These audits are obviously not designed with ADB's specific requirements in mind, but they are, for the most part, consistent with those requirements.

G. Information System

46. CCB's current information system satisfies the implementation, recording, and reporting requirements for the financial intermediary loan, for the following reasons: (i) the banking software processes and records onlending transactions sufficiently well; (ii) the software conforms to the CGAAP and can provide contract-based management for each borrowing client, thus contributing greatly to the control of subloan transfers and forecast cash flows; (iii) CCB's rating system for assessing borrowers' creditworthiness will facilitate financial due diligence on subloan borrowers; and (iv) CCB has computer software that can track the post-investment implementation of sub-loans and automatically issue alerts regarding non-performing loans.

H. Capacity to Provide the Required Financial Intermediation Services

47. In relation to the funds flow arrangement,[6] CCB, as a large-scale national commercial bank with experience in onlending loans from international financial institutions (IFIs) and foreign governments, is capable of accomplishing the onlending arrangements mentioned above, as well as the following: (i) establishing, managing, and monitoring ChemChina's US dollar and yuan accounts, CHC's revolving account and interest account, Huatai's interest rate differential account and subloan account, and other subloan borrowers' accounts, as required by ADB; (ii) providing contract-based management for each subloan borrower and monitoring the use of subloan proceeds to ensure that they are used for authorized purposes; (iii) providing internet banking services to clients; and (iv) recording all required financial transactions and balances monthly, quarterly, and yearly. CCB uses standard banking software for recording transactions and has installed computerized contract management software for the timely control and monitoring of disbursements under each procurement contract with subborrowers.

48. The onlending interest rate and subloan terms will be negotiated between the subloan borrowers and CHC, which will shoulder the interest rate risk. ChemChina will be responsible for converting US dollar amounts into yuan amounts; it will also eventually bear the corresponding exchange rate risk, although it can transfer that risk to the subproject companies through contractual arrangements.

49. The scope of business of CCB's Anhui Subbranch, as approved by the CBRC, comprises the following tasks: (i) accepting deposits from the public; (ii) making short-, medium-, and long-term loans; (iii) reaching settlement of domestic and international payments; (iv) receiving and discounting financial instruments; (v) acting as agent in the issue of financial bonds; (vi) acting as agent in the issue, acceptance, and sale of government bonds; (vii) acting as agent in collections and disbursements; (viii) engaging in the business of foreign exchange deposits, foreign exchange loans, foreign exchange transfers, and foreign currency exchange; (ix) participating in foreign exchange trading on behalf of clients; (x) checking and certifying a borrower's creditworthiness; (xi) offering automobile insurance, family property insurance, health insurance, life insurance, and other insurance products; (xii) providing safe deposit box services; and (xiii) being involved in other businesses with CBRC approval. The CCB Anhui subbranch has a sufficient range of services to meet the needs of the subprojects.

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[6] The fund flow arrangements are described in detail in paragraph 45 of the Project Administration Manual.

50. CCB’s Anhui Subbranch has engaged in onlending for 11 foreign governments and an IFI, and is active in green lending. In particular, the Anhui Subbranch was the onlending bank for a KfW loan project in 2008. The borrower was Sinohydro, and the loan was for €49.5 million.

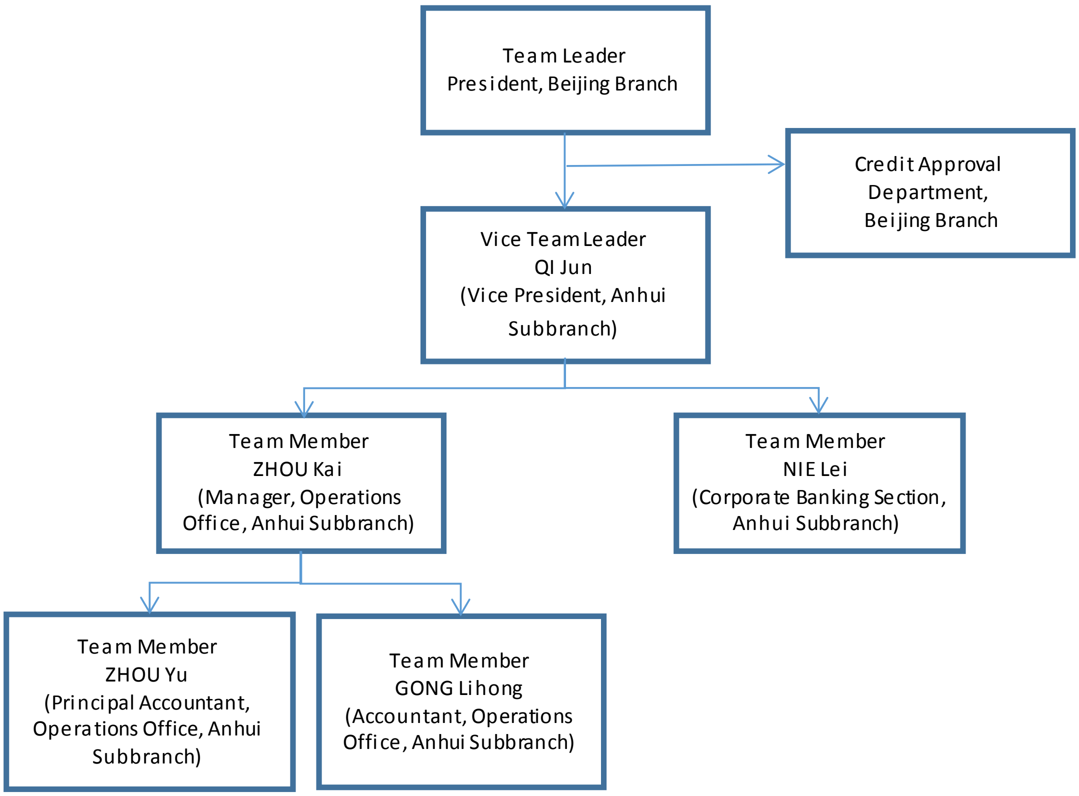
51. In view of the scope of business and overall project experience of CCB’s Anhui Subbranch, and the capacity of the designated team, the following implementation arrangements under consideration have been deemed achievable by and acceptable to CCB.

52. For the ADB loan project, CCB must build a long-term team within its Anhui Subbranch to implement the onlending operations. The team structure is shown in Figure 2. The chart shows that the designated team has the required strength to carry out ADB’s financial intermediary loan project. The team will have five staff members at the subbranch level and will be led by the president of CCB’s Beijing Branch, who will coordinate any necessary credit review of subloan borrowers by the credit approval department at the Beijing branch, to enable the branch to provide cofinancing. The branch president will also take charge of coordinating with the related departments at headquarters, if necessary, and with external government bodies, such as MOF, and will be assisted by the vice president of the Anhui Subbranch.

53. CCB’s Anhui Subbranch, which was designated the operations manager for the accounts under the ADB loan, will be fully responsible for ensuring that adequate financial and accounting capacity is available for the task. Within its accounting department, two accountants and the operations office manager will handle, record, and review routine onlending transactions, and will report to the vice president of the subbranch. For the financial due diligence on subsequent batches of subloan borrowers, the subbranch will arrange for the corporate banking section to perform the assessment. The team leader will coordinate with the related credit approval department at the Beijing Branch and, on behalf of the Anhui Subbranch, request the branch to assign the appropriate staff and to evaluate the financial due diligence reports. This type of review will always be available should the Anhui Subbranch ask for it.

54. Although sufficiently experienced and qualified to meet current financial management requirements, the financial staff of the Anhui Subbranch will need training to implement the proposed ADB project. They have not worked previously on ADB projects and they must familiarize themselves with ADB’s loan disbursement and repayment, interest differential reporting, and other procedures. Once the loan is approved, financial covenants set out in the SLA, OLAs, and subproject agreements or other official loan documents will guide the financial staff in meeting the various accounting, auditing, and internal control requirements.

Figure 2: Organization Chart for the Project



Source: China Construction Bank's Anhui Subbranch.