Comparison of the median of 7 U.S. companies' net equity vs. their DAC

Company	(1) Net equity	(2) DAC & goodwill	Year	(2)/(1) %
PCI*	1,838	1,641	2000	89.28
Company A	10,690	11,395	1999	106.59
Company B	6,420	6,481	1999	100.95
Company C	4,791	3,235	1999	67.52
Company D	13,690	8,492	1999	62.03
Company E	2,487	2,556	1999	102.77
Company F	865	1,012	1999	116.99
Company G**	3,424	2,741	1999	80.05

*All figures are in US$ millions except: *Numbers are in HK$ millions; **Numbers are in £ millions.*

A growing, fledgling company will have had relatively less time to build up its net tangible assets and will have to plow back most of its earnings into new business and will therefore increase the relative size of its DAC.

2. Capital adequacy and financing

Financial institutions around the world, due to the fiduciary nature of the business, are required by regulatory authorities to maintain certain minimum capital in order to ensure their solvency. For instance, banks generally follow the 1988 Capital Accord set by the Basel Committee of Banks for International Settlements in determining their minimum capital requirement. Insurance companies in developed countries, however, do not have a uniform standard. Different countries tend to set different standards. Hong Kong follows the U.K. standard that was promulgated by the former European Community. The required capital is calculated by a formula which takes into account the kinds of risks a company is taking, including mortality, morbidity, accident and health risks.

In its formative years, the Company had the opportunity of using financial reinsurance to finance its required capital. Reinsurers only finance companies which they believe possess the financial strength and ability to generate profits to repay financing; as such, this type of financing is not reflected as a liability.

Due to the Company's rapid growth and expansion, financial reinsurance no longer meet the Company's expansion needs, thus equity was raised. In the middle of 1999, the Company raised more than HK$500 million through an IPO.

Once the Company has raised over HK$500 million, it is no longer necessary to use financial reinsurance. Consequently, it has been decided that while the Company enjoys an excess of capital, it will cease to use financial reinsurance as a financing vehicle.

During 2000, net cash generated from the Company's operating activities amounted to HK$428 million. Other investment activities required HK$3.6 billion for purchase of investments which was largely funded by a net receipts of HK$3.5 billion from disposal of investments.

As at December 31, 2000, the Company's net assets far exceeded the Insurance Authority's required capital level of HK$260 million.

3. *Risk management*

(a) Insurance risk

The Company is in the business of insuring against the risk of mortality, morbidity, disability, critical illness and other such risks. It retains a maximum of US$100,000 for each risk it insures, with the excess being reinsured through surplus treaty, coinsurance treaty, facultative reinsurance, and catastrophe treaty with reputable professional international reinsurers. As a result, total claims payable in any given year can be predicted with a high degree of precision. Over the last five years, the actual claims in any given year have been within a few percentage points of expected claims. Moreover, as part of our quality control process, the Company has regularly invited reinsurers to audit its underwriting and claim practices and procedures to ensure that they meet the highest industry standards.

(b) Investment risk

While the Company's products give it considerable latitude in asset allocation, the Company adopts a relatively conservative investment strategy. Invested assets required to support its insurance liabilities are entrusted to professional fund managers (see Section 6 – Investment below). While its investment mandate to fund managers allows them to invest up to 30% of such assets in equities, the actual proportion has been around 15%, with the balance invested in fixed interest instruments.

For fixed interest investments, it is the Company's investment policy to match the currencies of assets and liabilities. The Company does not require currency matching for equity investments because it subscribes to the view that currency fluctuation is a part of the overall investment consideration.

Recently, the Company has actively refined its investment model through the use of the Value at Risk (VaR) technique to measure portfolio risks and performance. Where appropriate, the Company also uses the Sharpe ratio to measure the investment performance of its fund managers.

(c) Business risk

The Company uses the well-known third-party actuarial software "Prophet" to perform, on a regular basis, long-term projections of the Company's profit/loss positions using a variety of business scenarios. Such long-term projections have enabled the Company to better understand the impact of the changing business environment on the Company's financial results and capital requirements and have, over the years, assisted the Company in its decision making in anticipation of such changes.

4. Rating

A.M. Best is the largest U.S. rating agency specialising in rating insurance companies. The majority of significant life insurance companies in the world have been rated by A.M. Best. Best's Report and Best's Review are recognised world-wide as the most comprehensive and authoritative reports on life insurance companies.

The Group received an "A- (Excellent)" rating from A.M. Best, the largest and oldest U.S. rating agency specialising in rating insurance companies, after an in-depth study was carried out on the Group's operations. In its rating rationale, A.M. Best cited the Group's "improving operating performance, strong risk-adjusted capitalization, a flexible and low risk liability structure and a high quality, liquid investment portfolio that allowed the Group to minimize its assets exposure during the 1997-98 Asian financial crisis."

Standard & Poor's is a large rating organisation, but they do not specialise in rating insurance companies.

On the other hand, Standard & Poor's gave the Group a "Bpi" rating. The rating is based on (i) publicly available information without the benefit of an in-depth interactive review of the Group's operation; and (ii) the citing of the excessive usage of financial reinsurance.

5. Embedded value

The Group has a regular program to calculate, in consultation with internationally well-known consulting actuaries, its embedded value. This value is often used by international insurance companies and investors to determine the fair value of a life insurance company. However, this value may or may not equate to a company's market capitalization, since market price is often subject to less quantifiable factors such as investors' sentiment.

Embedded values per share for the past five years are as follows:

	Embedded value (per share)
12/1996	$2.37
12/1997	$3.15
12/1998 (post IPO)	$3.85
12/1999	$4.01
12/2000	$3.95

Simply stated, the embedded value can be regarded as the accumulated wealth of a company.