Management discussion and analysis of operations

2004 was the 10th Anniversary and a Year of Achievement for the Group. Life insurance business achieved a record high of HK$467.4 million in Annualised First Year Premium ("AFYP") on new business, representing an increase of 48.0% over 2003. In November, Fitch Ratings and Moody's Investors Service assigned an Insurer Financial Strength rating of "A–" and "Baa2" respectively with a stable outlook to Pacific Century Insurance Company Limited ("PCI"), reflecting its sound capitalisation, high quality management, low risk liability portfolio and improved operating performance. In the same month, PCI, together with a group of domestic companies in China, submitted an application to the China Insurance Regulatory Commission for a life insurance license in China. A formal reply is expected to be received within 6 months. In December, the Group successfully issued a 10-year bond with an aggregate principal amount of US$100 million, raising US$98.6 million, net of expenses, for future expansion in Hong Kong and China.

1. Operational Review

The Group reported a net profit from ordinary activities attributable to shareholders of HK$196.3 million for the year ended 31 December 2004, representing a decrease of 9.1% from HK$216.0 million in 2003. Basic earnings per share was HK$0.24 as compared to HK$0.26 in 2003. The decrease in earnings was mainly due to the drop in investment income, nevertheless, our investment managers still managed to achieve a return of 7.1% on the investment portfolio, compared to 9.9% in 2003.

Life insurance business achieved a record high of HK$467.4 million in AFYP on new business, an increase of 48.0% over 2003. Single and first year premium from life insurance business increased by 51.9% to HK$444.0 million, renewal premium from life insurance business increased by 7.7% to HK$1,468.4 million and total premium from life insurance business increased by 15.5% to HK$1,912.3 million. Total turnover showed an increase of 15.1% as compared to HK$1,954.4 million in 2003.

Investment income, net gains, and other income decreased by 7.5% to HK$476.2 million. Total revenue and net gains for the year was HK$2,430.6 million, compared with HK$2,212.3 million recorded in 2003, an overall increase of 9.9%.

Policyholders' benefits decreased by 3.7% to HK$642.8 million, mainly due to a lower surrender rate; agency commission and allowances increased by 5.4% to HK$292.3 million as compared to the previous year, which was attributable to the increase in new business generated during the year.

Management expenses decreased by 14.8% to HK$284.7 million and total operating expenses for the year were HK$1,326.1 million, or 4.7% below 2003. These were mainly attributable to continued stringent cost control and lower staff costs. Expense Ratio reduced from 120.2% to 105.1%, as a result of effective cost control and more new business generation.

The following is the Expense Ratio of the Group for the past five years:

Year	Expense ratio
2004	105.1%
2003	120.2%
2002	125.9%
2001	110.8%
2000	122.1%

Commissions, override and other variable expenses are assumed to be equal to 100% of the first year premiums and 10% of the renewal premiums. Administrative expenses are assumed to be equal to 25% of the first year premiums and 5% of renewal premiums. Dividing actual expenses by the summation of the four components above gives the "Expense Ratio".

(a) Agency Operations

The number of agents as at 31 December 2004 increased to 1,268 from 1,252 as at end of 2003. Individual AFYP for 2004 was HK$467.4 million, an increase of 48.0% over 2003. Agency productivity – Individual AFYP per Agent Month was HK$32,700, an increase of 64.3% compared to 2003.

As we continued our policy of terminating non-productive agents, it became more efficient and effective to manage the existing agency force leading to an increase in average productivity in 2004.

In order to strive for higher productivity, special training programs were launched to enhance agents' professionalism as well as product knowledge. Special promotional programs and incentive schemes were also introduced to reward agents with outstanding performance.

During the year, the Group has also launched several new products to ensure that the policyholders are offered with a diversified product range to accommodate their different needs.

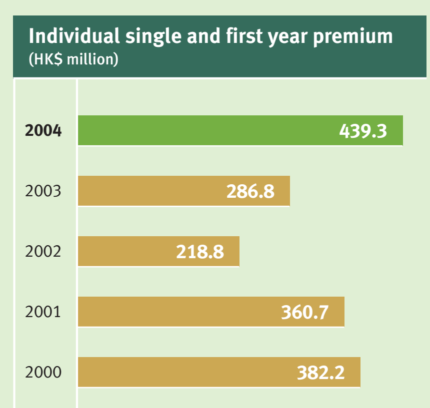
Looking ahead, we will be focusing on expanding our agency force, recruiting more new and experienced agents and improving productivity.

(b) Life Operations

As at 31 December 2004, the total number of inforce policies was 277,489 compared to 277,122 in 2003, an increase of 0.1%. Despite the small increase in the number of inforce policies, the size of new policies is relatively larger and as a result, the total premium from life insurance business increased by 15.5%.

i) Individual single and first year premium

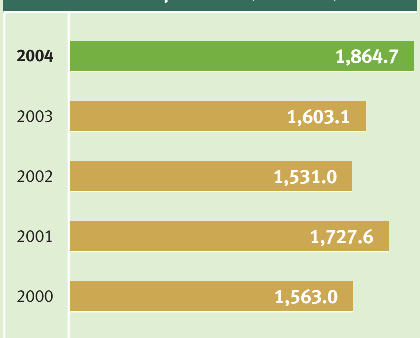
The following chart shows the Group's new sales based on individual single and first year premium over the last five years.



ii) Individual total premium

The following chart shows the Group's individual total premium over the last five years.

Individual total premium (HK$ million)



iii) Renewal ratio

The renewal ratio has improved significantly in the last two years. This was mainly due to the stability of our agency force, our improved quality services to policyholders as well as our agents' professional ethics. The following is the Renewal Ratio of the Group for the past five years:

Year	Renewal ratio
2004	98.4%
2003	94.9%
2002	85.0%
2001	98.0%
2000	97.7%

Renewal Ratio is derived by assuming that 80% of first year premium will stay on the books the following year and 93% of the renewal premium will still be on the books the year after. Adding the two together produces the expected modeled renewal premium (EMRP). To arrive at the Renewal Ratio, the actual renewal premium in the following year is then divided by EMRP; a 100% Renewal Ratio means the Group's persistency is exactly as calculated whereas an above 100% Renewal Ratio means that the Group experienced a better persistency and vice versa.

iv) Claims experience

Although there was an increase in claims ratio in 2004, the Group's claims experience is still better than the pricing assumptions. The following chart gives the Group's overall claims experience, on a claim ratio basis, over the last five years:

Year	Claims ratio
2004	99.2%
2003	91.0%
2002	95.0%
2001	97.4%
2000	93.0%

v) Products and Services

A total of ten products were introduced in 2004 to cater for different needs of our existing and potential policyholders. Out of these ten products, two products are heavily savings-oriented and are highly sought after by our policyholders.

To better serve our policyholders, the Group has enhanced its Customer Care Center. The Group also continued to increase payment channels in 2004 to facilitate premium collection. In addition, the Group set up an Agency Service Center in 2004 to provide more efficient services to our agency force. It is the Group's intention to continue to enhance services to both internal and external customers, strengthen product development, and speed up the process in product design with the aim of providing the finest customer service as well as becoming the first-mover in the insurance industry.

c) Group Insurance

For the period under review, the Group Insurance Department recorded HK$47.6 million in premiums with net income of HK$0.7 million compared to HK$52.0 million and HK$3.9 million in 2003 respectively. The drop in premium and profit was due to fierce competition in the market place.

An optional clinical benefit was introduced for our existing product "Advantage Care EB Plan" in 2004 to cater for market demands. During 2004, system was implemented to deliver claim settlement notices by electronic means to policyholders and their members for faster and efficient service. A PCI Health Care Card with co-payment arrangement was launched to facilitate clinical service and effective claim cost control.

d) Retirement Scheme Business and Mandatory Provident Fund

Since the conclusion of the Transfer Agreement with HSBC Life (International) Limited ("HSBC Life") in June 2002, the Group has successfully transferred over 12,000 members and over HK$177.9 million of assets to HSBC Life. Approximately HK$32.0 million and 3,500 members still remained to be transferred as at 31 December 2004.

e) General Insurance

Total premiums for 2004 was HK$47.1 million of which HK$38.2 million came from agency operations and HK$8.9 million from PCI Services (HK) Ltd, a broking arm set up in 2003 to supplement the PCI agency operation, representing an increase of 3.8% in total premiums as compared to 2003.

f) PCI Investment Management Limited ("PCIIM")

2004 marked another year of solid growth for PCI Investment Management Limited. Total funds under management rose by 25% to HK$11.3 billion as of the end of 2004. Two new products were introduced to the market last year. In January 2004, we launched a new subsidiary fund under our flagship umbrella investment fund — the PCIIM Emerging Markets Bond Fund. In April, we launched Eastern Explorer, a multi-strategy alternative investment fund with a focus on Asian financial markets.

While there remain a lot of uncertainties regarding market outlook in 2005, the consensus is for a general slowdown in world economic growth amidst a rising trend in global interest rates. Under this scenario, 2005 will be another challenging year for investments. As our fund size continues to grow, we will expand our investment team with an aim of achieving satisfactory return for our clients.

g) Human Resources

The Group had 288 employees as at 31 December 2004, a decrease of 14.8% over the 338 employees last year. Total remuneration (excluding directors' fees) for the year was HK$147.6 million as compared to HK$161.2 million for 2003.

In 2004, we continued our effort in promoting a stronger service excellence culture to both internal and external customers as represented by our 10th anniversary logo of "Taking an extra step". We also place high value on our employees and encourage them to enhance their knowledge in job related fields and management skills for their personal career developments. We reward our employees based on the Company's performance as well as their personal performance and capabilities.

2. China Expansion Plan

In November, PCI, together with a group of domestic companies in China, submitted an application to China Insurance Regulatory Commission for a life insurance license in China. It is expected that a formal reply will be received within 6 months. If the license is granted, the initial capital requirement will be RMB500 million, of which PCI will invest RMB100 million for a 20% equity interest. In addition, we are also exploring opportunities in investing in other established insurance companies in China for a strategic stake. We believe that our management expertise and knowledge in life insurance will be invaluable and will make a beneficial contribution to our partners.

3. Capital Adequacy and Financing

As at 31 December 2004, the Group has cash and bank balances of HK$1,072.0 million and time deposits of HK$229.5 million. During the year under review, net cash inflow from operation including investments amounted to HK$58.3 million. Invested assets increased by HK$1,891.6 million to HK$7,493.6 million, which was mainly due to premium income received and the net proceeds of US$98.6 million raised from the bond issue in December.

As at 31 December 2004, the Group's total assets were HK$9,225.1 million and net assets were HK$2,480.7 million, an increase of 24.3% and 6.2% respectively as compared to 2003.

On a statutory reporting basis, the Group's net assets far exceeded the statutory net surplus required by the Hong Kong Insurance Regulations. It is the Group's current intention to maintain its statutory surplus at or above 200% of the Hong Kong statutory solvency margin requirement. The Group performs resilience tests regularly to examine its solvency position for movements in equity markets and interest rates and any potential risks will be drawn to the attention of the management.

As at 31 December 2004, the gearing ratio of the Group was 31.0%.

Gearing ratio is the ratio of interest-bearing loans to capital and reserves.

4. Risk Management

(a) Insurance risks

The Group is in the business of insuring against the risk of mortality, morbidity, disability, critical illness, accidents, and related risks. The Group retains a maximum of US$100,000 for each risk it insures, with the excess being reinsured through surplus treaties, coinsurance treaties, facultative reinsurance, and catastrophe treaties with reputable international reinsurers. Consequently, total claims payable in any given year can be predicted with a high degree of precision. Over the last five years, the actual claims experience in any given year has been below expected claims. As part of our quality control processes, the Group has invited reinsurers to audit our underwriting and claim practices and procedures on a regular basis, to ensure that they meet the highest industry standards.

(b) Product risks

Our products are designed to meet our internal profitability requirements. Our Product Actuary and senior management sign off and approve our individual products. Profitability levels on new and existing products are reviewed from time to time to ensure that desired profit requirements can be maintained. When actual experience shows significant deviation from the pricing assumptions, the products will be revised to reflect the updated experience.

(c) Investment risks

We have always adopted a prudent and relatively conservative investment strategy. Invested assets required to support the Group's insurance liabilities are mainly managed by PCIIM. During 2004, the Group repositioned its asset allocations for General and Shareholders' funds to cater for a possible upward interest rate movement. With year-end bond holdings of 44.7% of the total portfolio, coupled with the shortened duration of approximately 4 years, the financial effect of an interest rate hike will be greatly reduced. Equity investments now made up 23.8% of our investment portfolio. The Group also invested 9.2% of its portfolio in hedge funds, which performed well in 2004.

It is the Group's investment policy to invest in investment grade bonds to limit our exposure to credit risk. The Group allows a maximum of 5% of invested assets to be invested in non-investment grade bonds.

The Group 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 Group also uses the Sharpe ratio to measure the investment performance of its fund managers.

(d) Currency risks

It is the Group's policy to match its assets and liabilities by currency to minimise its exposure to currency risks.

The Group sells policies denominated in Hong Kong dollars and US dollars and its assets are quite well matched with the liabilities. As at 31 December 2004, the Group had 0.3% cash in Asian currencies (other than Hong Kong and China) and 16.1% investments in Asian equities (other than Hong Kong and China). We believe that the currency risks in equities are reflected in their share price and therefore exposure to such Asian currencies were not hedged.

(e) Business risks

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

5. Rating

PCI was once again in 2004 reaffirmed with an "A– (Excellent)" rating from The A.M. Best Company, the largest and oldest US rating agency specialising in rating insurance companies. The rating reflects PCI's prudent capitalisation, improvement in operating performance and cautious expense control.

In November, PCI was assigned an Insurer Financial Strength rating of "A–" and "Baa2" respectively with a stable outlook by Fitch Ratings and Moody's Investors Service, both internationally renowned rating agencies, reflecting its sound capitalisation, high quality management, low risk liability portfolio and improved operating performance.

6. Embedded Value

Basis

Embedded value is the sum of the net asset value plus the value of inforce business, adjusted for the cost of holding the required solvency margin.

The following are the key assumptions used :

Investment return :
7% per annum (2003: 7%)

Risk discount rate :
10% per annum (2003: 10%)

Embedded value

The embedded value per share for the year ended 31 December 2004 and the past four years are as follows:

Year	Embedded value per share (HK$)
2004	4.327
2003	3.940
2002	3.557
2001	3.917
2000	3.295

Value of one year's new business

The value of one year's new business is the sum of the discounted projected future after-tax statutory profits generated from the new business written during the year, adjusted for the cost of holding the required solvency margin. The assumptions used are the same as those used in the calculation of embedded value. For the year ended 31 December 2004, the value of one year's new business is HK$43,600,000.

While the Company has performed the calculations, the methodology and actuarial assumptions used in the calculation of embedded value and value of new business as at 31 December 2004 have been reviewed and considered as reasonable by Watson Wyatt, an internationally renowned actuarial consulting firm.

Sensitivity

The followings reflect our estimates of the embedded values associated with the changes in the assumptions:

	HK$
Base scenario	4.327
12% risk discount rate	4.066
90% lapse rate	4.492
90% operating expenses	4.376
90% mortality/morbidity rate	4.425
6.75% investment rate (no adjustment on dividends)	4.181

Other than the sensitivity at the 12% risk discount rate all the other sensitivity results were performed by the Company and have not been reviewed by Watson Wyatt.

7. Investment

2004 turned out to be a volatile year for all financial markets. Most markets started the year on a firm note as interest rates as well as inflation remained low. However, triggered by a stronger than expected payroll number and a pick up in inflation, both equity and bond markets experienced a sharp sell-off in April and May. In the US, the Federal Reserve started to raise interest rates at the end of June, ending the 3.5-year declining interest rate cycle. There were also concerns about the impact of higher oil prices and commodity prices on the global economy and inflation.

Subsequent data showed that growth remained solid globally while inflation was still well contained. Fears of more severe Fed tightening began to wane and the long-end of the US bond market recovered sharply in the third quarter and stabilised in the final quarter. Lower bond yield and abundant liquidity also helped most equity markets to close the year strongly.

The Group's investment committee, which includes certain directors and the management of PCIIM, meets on a weekly basis to review the current investment climate and make policy decisions where necessary. Despite a chaotic year, investment results were impressive when compared to the market norm, yielding 7.1% return per annum on a dollar-weighted basis in 2004. Although lower than 9.9% recorded in 2003, our return continued to exceed 7.0% used in the embedded value calculation.

There were no material acquisitions and disposals of subsidiaries and associated companies during the year.

		Fixed interest	Mortgage & loans	Cash	Equities	Others	Total
By currency	US$	39.8%	2.6%	9.3%	6.2%	9.3%	67.2%
	HK$	4.9%	1.0%	8.9%	2.0%	0.1%	16.9%
	Others	0.0%	0.0%	0.3%	15.6%	0.0%	15.9%
	Total	**44.7%**	**3.6%**	**18.5%**	**23.8%**	**9.4%**	**100.0%**
By geographic area	US	9.0%	0.0%	0.0%	1.0%	4.3%	14.3%
	Europe	5.6%	0.0%	0.0%	0.0%	0.0%	5.6%
	Japan	0.0%	0.0%	0.0%	0.5%	0.8%	1.3%
	HK/China	10.7%	3.6%	18.5%	6.6%	0.2%	39.6%
	Other Asia	14.8%	0.0%	0.0%	15.6%	0.0%	30.4%
	Others	4.6%	0.0%	0.0%	0.1%	4.1%	8.8%
	Total	**44.7%**	**3.6%**	**18.5%**	**23.8%**	**9.4%**	**100.0%**

8. Joint Venture with The Bank of East Asia, Limited

There was a slight decrease in the number of cardholders from 12,852 to 12,175 as at 31 December 2004.

9. Policyholder Dividend

With investment return close to pricing expectation, the Group maintained the existing dividend scale and accumulation interest rate.

10. Details of Charges on Group Assets

As at 31 December 2004, there were no charges on any of the Group's assets.

11. Corporate Governance

The Audit Committee of the Company has reviewed the financial statements for the year ended 31 December 2004.

No Director is aware of any information that would reasonably indicate that the Company is not, or was not in compliance with the Code of Best Practice as set out in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited in the financial year ended 31 December 2004.

The Group aims at complying with the Corporate Governance practices being set out by the Stock Exchange from time to time. To ensure that all our stakeholders are well informed, we have adopted the practice of disclosing key information of the Group on a quarterly basis.

Committees overseeing and supervising the management of the business and affairs of the Group meet on a regular basis to ensure that the interest of the Group as well as its stakeholders are well protected.