Background

China Life prepares financial statements to public investors in accordance with Hong Kong Financial Reporting Standards and Hong Kong Accounting Standards ("HKFRS"). An alternative measure of the value and profitability of a life insurance company can be provided by the embedded value method. Embedded value is an actuarially determined estimate of the economic value of the life insurance business of an insurance company based on a particular set of assumptions about future experience, excluding the economic value of future new business. In addition, the value of one year's sales represents an actuarially determined estimate of the economic value arising from new life insurance business issued in one year.

China Life believes that reporting the Company's embedded value and value of one year's sales provides useful information to investors in two respects. First, the value of the Company's in-force business represents the total amount of distributable earnings, in present value terms, that can be expected to emerge over time, in accordance with the assumptions used. Second, the value of one year's sales provides an indication of the value created for investors by new business activity and hence the potential of the business. However, the information on embedded value and value of one year's sales should not be viewed as a substitute of financial measures under HKFRS or any other accounting basis. Investors should not make investment decisions based solely on embedded value information and the value of one year's sales.

It is important to note that actuarial standards with respect to the calculation of embedded value are still evolving. There is still no universal standard which defines the form, calculation methodology or presentation format of the embedded value of an insurance company. Hence, differences in definition, methodology, assumptions, accounting basis and disclosures may cause inconsistency when comparing the results of different companies.

Also, embedded value calculation involves substantial technical complexity and estimates can vary materially as key assumptions are changed. Therefore, special care is advised when interpreting embedded value results.

The values shown below do not consider the financial effect of the Policy Management Agreement Between CLIC and China Life, the Property Leasing Agreement Between CLIC and China Life, the Trademark License Agreement Between CLIC and China Life and the Non-competition Agreement Between CLIC and China Life, nor the impact of transactions between China Life and China Life Insurance Asset Management Company.

Definitions of Embedded Value and value of One Year's Sales

The embedded value of a life insurer is defined as the sum of the adjusted net worth and the value of in-force business allowing for the cost of capital supporting a company's desired solvency margin.

"Adjusted net worth" is equal to the sum of:

- Net assets, defined as assets less policy reserves and other liabilities, all measured on a PRC statutory basis; and

- Net-of-tax adjustments for relevant differences between the market value of assets and the value determined on a PRC statutory basis, together with relevant net-of-tax adjustments to other liabilities.

According to the PRC accounting basis, an impairment provision is not required until the market value of a long-term investment has been consistently lower than its book value for more than two years. On the other hand, when the market value of a long-term investment is higher than its book value, the excess is not reflected in the accounts. As the embedded value is based on market value, it is necessary to make adjustments to the value of net assets under the PRC accounting basis.

The market value of assets can fluctuate significantly over time due to the impact of the prevailing market environment. Hence the adjusted net worth can fluctuate significantly between valuation dates.

The "value of in-force business" and the "value of one year's sales" are defined here as the discounted value of the projected stream of future after-tax distributable profits for existing in-force business at the valuation date and for one year's sales in the 12 months immediately preceding the valuation date. Distributable profits arise after allowance for PRC statutory policy reserves and solvency margins at the required regulatory minimum level. The cost of maintaining this solvency margin considers the support provided by the Staff Welfare Fund.

The value of in-force business and the value of one year's sales have been determined using a traditional deterministic discounted cash flow methodology. This methodology makes implicit allowance for the cost of investment guarantees and policyholder options, asset/liability mismatch risk, credit risk and the economic cost of capital through the use of a risk-adjusted discount rate.

Assumptions

The calculations are based upon assumed investment returns of 4.0% in 2005, grading to 5.2% in 2013 (remaining level thereafter) for the long-term business and 0.72% for the short-term business. An average of 22% of the investment returns is assumed to be exempt from income tax, which leads to an effective tax rate of approximately 26% on the investment returns for the long-term business. These returns and tax rates are based on the Company's long term strategic asset mix and expected future returns. The risk-adjusted discount rate used is 11.5%. Other assumptions are determined by considering recent operating experience of the Company and expected future outlook.

Preparation

The embedded value and the value of one year's sales were prepared by China Life with assistance from the Tillinghast business of Towers Perrin, an international firm of consulting actuaries. Tillinghast considers that the methodology adopted to determine these values is reasonable in the context of the current environment as a commonly adopted methodology for the purpose of providing an embedded value disclosure in the normal course of financial reporting. Tillinghast also considers that the assumptions adopted to determine these values, taken as a whole, are reasonable for this purpose.

Summary of Results

The embedded value as at December 31, 2005 and the value of one year's sales for the 12 months to December 31, 2005 are shown below.

Table 1

Embedded Value as at December 31, 2005 and Value of One Year's Sales in the 12 months to December 31, 2005 (RMB million)

	Item	RMB Million
A	Adjusted Net Worth	70,143
B	Value of In-Force Business before Cost of Solvency Margin	53,081
C	Cost of Solvency Margin	(9,270)
D	Value of In-Force Business after Cost of Solvency Margin (B + C)	43,811
E	**Embedded Value (A + D)**	**113,954**
F	Value of One Year's Sales before Cost of Solvency Margin	9,324
G	Cost of Solvency Margin	(1,834)
H	**Value of One Year's Sales after Cost of Solvency Margin (F + G)**	**7,489**

Note: Numbers may not be additive due to rounding.

Movement Analysis

The following analysis tracks the movement of the embedded value from the start to the end of the reporting period.

Table 2

Analysis of Embedded Value Movement in 2005 (RMB million)

Item		RMB Million
A	Embedded Value at Start of Year	90,073
B	Expected Return on Embedded Value	6,152
C	Value of New Business in the Period	7,489
D	Operating Experience Variance	(208)
E	Investment Experience Variance	259
F	Assumption and Model Changes	(1,558)
G	Market Value Adjustment	11,692
H	Other	54
I	**Embedded Value as at 31 December 2005 (sum A through H)**	**113,954**

Notes: 1) Numbers may not be additive due to rounding.

2) Items B through H are explained below:

B Reflects 11.5% of the opening value of in-force business and value of new business sales in 2005 plus the return on investments supporting the 2005 opening adjusted net worth.

C Value of new business sales in 2005.

D Reflects the difference between actual 2005 experience (including lapse, mortality, morbidity and expense etc.) and the assumptions.

E Compares actual with expected investment returns during 2005.

F Reflects the effect of projection model enhancements and assumption revisions for selected products and a small increase in assumed investment returns.

G Change in the market value adjustment from the end of year 2004 to the end of the year 2005.

H Other miscellaneous items.

Sensitivity Testing

Sensitivity testing was performed using a range of alternative assumptions. In each of the sensitivity tests, only the assumption referred to was changed, with all other assumptions remaining unchanged. The results are summarized below.

Table 3

Sensitivity Results (RMB million)

	Value of In-force Business after Cost of Solvency Margin	Value of One Year's Sales after Cost of Solvency Margin
Base case scenario	43,811	7,489
Risk discount rate of 12.5%	39,524	6,659
Risk discount rate of 10.5%	48,716	8,446
10% increase in investment return	51,828	8,849
10% decrease in investment return	35,784	6,129
10% increase in expenses	43,100	6,967
10% decrease in expenses	44,520	8,011
10% increase in mortality rate for non-annuity products and 10% decrease in mortality rate for annuity products	43,227	7,390
10% decrease in mortality rate for non-annuity products and 10% increase in mortality rate for annuity products	44,399	7,589
10% increase in lapse rates	42,794	7,247
10% decrease in lapse rates	44,897	7,750
10% increase in morbidity rates	42,797	7,335
10% decrease in morbidity rates	44,836	7,645
Solvency margin at 150% of statutory minimum	37,734	6,279
10% increase in claim ratio of short term business	43,644	7,142
10% decrease in claim ratio of short term business	43,978	7,837