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INTEGRITY



# Management's Discussion and Analysis of Financial Condition and Results of Operations



<p><b>Mr Tang Yunxiang</b> Chairman</p>	<p><b>Mr Wang Yi</b> Vice Chairman, Executive Director, President and Chief Executive Officer</p>	<p><b>Mr Wang Yincheng</b> Executive Director, Executive Vice President and Chief Financial Officer</p>	<p><b>Ms Liu Zhenghuan</b> Executive Director and Executive Vice President</p>	<p><b>Mr Fu Zhu</b> Executive Director, Executive Vice President and Secretary of the Board</p>
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The following discussion and analysis should be read in conjunction with the audited financial statements together with the accompanying notes contained on page 58 to page 108 of this annual report. The financial data referred to below are extracted from the audited accountants' report.

## OVERVIEW

The Company is a leading property and casualty insurance company in the PRC providing a broad range of property and casualty insurance and accidental injury insurance products for customers. In 2003, the market share of the Company was 68%.

The following table sets forth the net premiums earned, underwriting profit, net profit and total assets of the Company for the periods indicated.

	Year ended 31 December	
	2003	2002
(RMB in millions)		
Net premiums earned	40,409	36,381
Underwriting profit	1,496	1,080
Net profit	1,451	278
Total assets	84,572	71,626

## RESULTS OF OPERATIONS

Profitability of the Company improved in 2003, with a steady increase in turnover, strong growth in underwriting profit, driven by a decline in combined ratio and a significant increase in investment income. Net profit exceeded the Company's profit forecast set out in the Company's prospectus.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

The following table sets forth selected financial information shown as percentages of net premiums earned and certain financial ratios for the periods indicated.

	Year ended 31 December	
	2003	2002
	(%)	
Net premiums earned	100.0	100.0
Net claims incurred	(71.9)	(73.2)
Amortization of deferred acquisition costs	(6.1)	(4.7)
Insurance protection expense	(1.2)	(1.1)
General and administrative expenses	(17.1)	(18.0)
Underwriting profit	3.7	3.0
Interest and dividend income	1.7	1.8
Net gains/(losses) on trading and non-trading securities	0.6	(1.8)
Profit from ordinary activities before taxation	5.7	2.7
Taxation	(2.1)	(2.0)
Net profit	3.6	0.8
Loss ratio	71.9%	73.2%
Expense ratio <sup>4</sup>	24.4%	23.8%
Combined ratio	96.3%	97.0%

4. The expense ratio for 2002 was different from 23.9% as set out in the prospectus because general and administrative expenses do not include RMB35 million in the finance costs.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

## Segment Information

The following table sets forth the net premiums earned, net claims incurred and amortization of deferred acquisition costs for each segment as a percentages of the respective combined amounts for the periods indicated.

	Year ended 31 December	
	2003	2002
	(%)	
<b>Net premiums earned</b>		
Motor vehicle insurance	66.6	65.8
Commercial property insurance	15.9	17.4
Homeowners insurance	2.6	3.0
Other insurance	14.9	13.8
Total	100.0	100.0
<b>Net claims incurred</b>		
Motor vehicle insurance	74.4	70.2
Commercial property insurance	11.3	15.5
Homeowners insurance	1.2	1.3
Other insurance	13.1	13.0
Total	100.0	100.0
<b>Amortization of deferred acquisition costs</b>		
Motor vehicle insurance	82.8	89.7
Commercial property insurance	5.0	6.0
Homeowners insurance	5.4	6.8
Other insurance	6.8	(2.5)
Total	100.0	100.0

## TURNOVER

Turnover of the Company was RMB54,968 million in 2003, representing an increase of 8.7% over RMB50,571 million in 2002. The increase in turnover was primarily due to an RMB3,858 million increase in turnover from the motor vehicle insurance segment, and also due in part to an RMB1,745 million increase in turnover from accidental injury insurance, which the Company began selling in March 2003.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

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## NET PREMIUMS EARNED

Net premiums earned of the Company was RMB40,409 million in 2003, representing an increase of 11.1% over RMB36,381 million in 2002. This increase in net premiums earned was primarily due to the increase in turnover and a decrease in reinsurance premiums ceded. These changes were partially offset by an increase in the change in unearned premium reserves. The decrease in reinsurance premiums ceded to RMB11,116 million, or 20.2% of turnover, for 2003 from RMB13,441 million, or 26.6% of turnover, for 2002 was primarily due to a decline in the statutory reinsurance rate to 15% in 2003 from 20% in 2002 according to the WTO Accession of China. The increase of net unearned premium reserves in 2003 compared with in 2002 was due primarily to the increase in net premiums written resulting from the increase in turnover and the decrease in reinsurance premiums ceded.

## INTEREST AND DIVIDEND INCOME

Interest and dividend income of the Company was RMB690 million in 2003, representing an increase of 6.5% over RMB648 million in 2002. This increase was primarily due to increases in interest income from trading and non-trading securities and interest income from bank deposits of RMB38 million and RMB78 million, respectively. This increase was partially offset by an RMB74 million decrease in dividend income from trading and non-trading securities. The decrease in dividend income was due primarily to a lack of dividend distributions for the year 2003 from the mutual funds in which the Company invested. The increase in interest income from bank deposits was due primarily to an RMB10,651 million increase in bank deposits as a result of increase in turnover and in funds raised through the initial public offering of shares in the Company. The increase in interest income from trading and non-trading securities was primarily due to an increase in purchase of securities by the Company in 2003 under re-purchase arrangement.

## NET GAIN/(LOSSES) ON TRADING AND NON-TRADING SECURITIES

Net gain of the Company on trading and non-trading securities was RMB260 million in 2003, representing an increase of RMB905 million over a net loss of RMB645 million in 2002. This increase was primarily due to an RMB990 million increase in unrealized gains on mutual funds held for trading purposes, which was partially offset by an RMB122 million decrease in realized gains on debt securities held for trading purposes.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

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## NET CLAIMS INCURRED

Net claims incurred of the Company was RMB29,063 million in 2003, representing an increase of 9.1% over RMB26,634 million in 2002. Loss ratio decreased to 71.9% in 2003 from 73.2% in 2002. The increase in net claims incurred largely reflected an increase of 15.6% in net claims incurred from the motor vehicle insurance segment to RMB21,618 million in 2003 from RMB18,701 million in 2002. This increase in net claims incurred from the motor vehicle insurance segment was primarily due to a 32.4% increase in the number of claims filed to approximately 5.68 million in 2003 from approximately 4.29 million in 2002. The increase in net claims incurred from the motor vehicle insurance segment was partially offset by a decrease in net claims incurred from the commercial property insurance segment to RMB3,285 million in 2003 from RMB4,127 million in 2002. This decrease was primarily due to an increase in the quality of the commercial property insurance portfolio as a result of imposing more stringent policy terms.

## AMORTIZATION OF DEFERRED ACQUISITION COSTS

Amortization of deferred acquisition costs of the Company was RMB2,479 million in 2003, representing an increase of 46.3% over RMB1,694 million in 2002. This increase was primarily due to an RMB264 million increase in commissions paid to insurance intermediaries in 2003 compared with 2002 and an RMB440 million decrease in reinsurance commissions receivable.

## INSURANCE PROTECTION EXPENSE

Insurance protection expense of the Company was RMB468 million in 2003, representing an increase of 15.0% over RMB407 million in 2002. This increase was primarily due to an increase in retained premiums.

## INTEREST EXPENSE CREDITED TO POLICYHOLDERS' DEPOSITS

Interest expense of the Company credited to policyholders' deposits was RMB123 million in 2003, representing a large increase over RMB54 million in 2002. This increase was primarily due to an RMB2,235 million increase, compared to 2002, in reserves for the Golden Bull homeowners insurance product to RMB6,142 million as of 31 December 2003.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

## GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses of the Company was RMB6,903 million in 2003, representing an increase of 5.1% over RMB6,566 million in 2002. This increase was primarily due to increase in depreciation and amortization, provision for doubtful accounts and operating lease charges. The increase of RMB128 million in depreciation and amortization was primarily due to the revaluation of the assets as of 30 September 2002. The increase of RMB95 million in operating lease charges consist primarily of lease charges according to the building and automobile leases agreements entered into by the Company and PICC Holding Company in connection with the Company's Reorganisation. Provision for doubtful accounts increased RMB55 million primarily due to increase in premiums receivable but overdue for more than three months.

## PROFIT FROM ORDINARY ACTIVITIES BEFORE TAXATION

Profit from ordinary activities before taxation was RMB2,288 million in 2003, representing an increase of 130.2% over RMB994 million in 2002. This increase was primarily due to an RMB905 million increases in net gain on trading and non-trading securities and an increase of 11.1% in net premiums earned to RMB40,409 million in 2003 from RMB36,381 million in 2002. The increase was partially offset by an increase of 9.1% in net claims incurred.

## TAXATION

Taxation expense increased by 16.9% to RMB837 million in 2003 from RMB716 million in 2002. This increase was primarily due to an increase of 130.2% in profit from ordinary activities before taxation in 2003 compared with 2002, and a decrease of non-taxable income to RMB59 million in 2003 from RMB76 million in 2002, which more than offset the decrease in taxes payable on non-deductible expenses from RMB445 million in 2002 to RMB141 million in 2003. The decrease in non-deductible expenses was the result of certain additional deductions from personnel expenses made available to the Company beginning from 1 January 2003 with the consent given by the Ministry of Finance and the State Administration of Taxation in a circular.

As a result of the foregoing, the Company's effective tax rate decreased to 36.6% in 2003 from 72.0% in 2002.

## NET PROFIT

As a result of the foregoing, net profit increased to RMB1,451 million in 2003 from RMB278 million in 2002. Net profit exceeded profit forecast for 2003 set out in the Company's prospectus. Basic earnings per share<sup>5</sup> was RMB0.171.

5. See Note 13 to financial statements.



# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

## COMBINED RATIO

The Company's combined ratio decreased to 96.3% in 2003 from 97.0% in 2002, primarily due to a decrease in loss ratio to 71.9% in 2003 from 73.2% in 2002, which more than offset the increase in expense ratio. The decrease in loss ratio was primarily due to the decrease in loss ratio for the commercial property insurance segment and the liability insurance segment by 14.0 percentage points and 10.6 percentage points, respectively, in 2003, which more than offset the 2.1 percentage points increase in loss ratio for the motor vehicle insurance segment.

## RESULTS OF SEGMENT OPERATIONS

### Motor Vehicle Insurance

	Year ended 31 December	
	2003	2002
	(RMB in million, except %)	
Turnover	35,294	31,436
Net premiums earned	26,930	23,928
Net claims incurred	(21,618)	(18,701)
Amortization of deferred acquisition costs	(2,053)	(1,520)
Insurance protection expense	(323)	(269)
Segment profit before unallocated income and expenses	2,936	3,438
Loss ratio	80.3%	78.2%
Segment expense ratio <sup>6</sup>	8.8%	7.5%
Segment combined ratio	89.1%	85.7%

Turnover from the motor vehicle insurance segment increased 12.3% to RMB35,294 million in 2003 from RMB31,436 million in 2002. This increase was primarily due to an increase in the number of motor vehicles covered by the motor vehicle insurance policies. There were approximately 18.06 million motor vehicles covered by the insurance policies the Company sold in 2003, representing an increase of 2.07 million motor vehicles over 2002. This increase was reduced by a decrease in the average premium rates caused by increased competition in motor vehicle insurance and the deregulation of premium rates for motor vehicle insurance by the China Insurance Regulatory Commission (the "CIRC") as of 1 January 2003.

Net premiums earned from the motor vehicle insurance segment increased 12.6% to RMB26,930 million in 2003 from RMB23,928 million in 2002. This increase was primarily due to the increase in turnover and the decrease in reinsurance premiums ceded, which more than offset the increase in the change in net unearned premium reserves.

<sup>6</sup> Since general and administrative expenses are not allocated to individual business segments, segment expense ratio and segment combined ratio are derived without taking into account the aforementioned expenses.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

Net claims incurred from the motor vehicle insurance segment increased 15.6% to RMB21,618 million in 2003 from RMB18,701 million in 2002 primarily due to a 32.4% increase in the number of claims filed to approximately 5.68 million in 2003 from approximately 4.29 million in 2002, due to an increase in the number of motor vehicles covered by the motor vehicle insurance policies, as well as an increase in the accident rate. The Company believes the increase in the accident rate is due to factors such as increasing number of new drivers in the PRC without corresponding road improvement to accommodate increasing volume of traffic.

As a result primarily of the foregoing and the decrease in the average premium rates, the loss ratio for the motor vehicle insurance segment increased to 80.3% in 2003 from 78.2% in 2002.

Amortization of deferred acquisition costs from the motor vehicle insurance segment increased 35.1% to RMB2,053 million in 2003 from RMB1,520 million in 2002. The increase was due to a decrease in reinsurance commissions received by the Company and an increase in the salary of underwriting personnel.

Insurance protection expense from the motor vehicle insurance segment increased 20.1% to RMB323 million in 2003 from RMB269 million in 2002 due to an increase in retained premiums.

Due to an increase in amortization of deferred acquisition costs and an increase in insurance protection expense, the segment expense ratio for the motor vehicle insurance segment increased to 8.8% in 2003 from 7.5% in 2002.

As a result of the foregoing, profit before unallocated income and expenses from the motor vehicle insurance segment decreased 14.6% to RMB2,936 million in 2003 from RMB3,438 million in 2002.

## Commercial Property Insurance

	Year ended 31 December	
	2003	2002
	(RMB in million, except %)	
Turnover	8,090	8,744
Net premiums earned	6,437	6,346
Net claims incurred	(3,285)	(4,127)
Amortization of deferred acquisition costs	(125)	(101)
Insurance protection expense	(59)	(67)
Segment profit before unallocated income and expenses	2,968	2,051
Loss ratio	51.0%	65.0%
Segment expense ratio	2.9%	2.6%
Segment combined ratio	53.9%	67.6%

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

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Turnover from the commercial property insurance segment decreased 7.5% to RMB8,090 million in 2003 from RMB8,744 million in 2002 primarily due to a decrease in the average premium rates resulting from more intense market competition and due to the Company practising more selective underwriting and exiting from certain high risk customers.

Net premiums earned from the commercial property insurance segment increased 1.4% to RMB6,437 million in 2003 from RMB6,346 million in 2002 primarily due to a decrease in the ratio of reinsurance premiums ceded to gross premiums written and an increase in turnover.

Net claims incurred from the commercial property insurance segment decreased 20.4% to RMB3,285 million in 2003 from RMB4,127 million in 2002 and the loss ratio for that segment improved to 51.0% in 2003 from 65.0% in 2002. The decrease in net claims incurred was primarily due to an improvement in the quality of the Company's commercial property insurance portfolio due to the implementation of selective underwriting practices coupled with the use of more stringent policy terms. The measures led to a number of large customers with relatively high claim rate not renewing in 2003. In addition, the Company also successfully reduced net loss, in particular the number of significant claims, by strictly controlling policy terms to limit the scope of the liability and by improving the management of exposure to catastrophe losses. The decrease in net claims incurred was significantly larger than the decrease in net premiums earned, resulting in an improvement in the loss ratio for the commercial property insurance segment in 2003.

Amortization of deferred acquisition costs from the commercial property insurance segment increased 23.8% to RMB125 million in 2003 from RMB101 million in 2002 primarily due to an increase in commissions paid to insurance intermediaries and a decrease in reinsurance commission received by the Company.

Insurance protection expense from the commercial property insurance segment decreased 11.9% to RMB59 million in 2003 from RMB67 million in 2002.

As the increase in amortization of deferred acquisition costs more than offset the decrease in insurance protection expense, the segment expense ratio for the Company's commercial property insurance segment increased to 2.9% in 2003 from 2.6% in 2002.

As a result of the foregoing, profit before unallocated income and expenses from the commercial property insurance segment increased 44.7% to RMB2,968 million in 2003 from RMB2,051 million in 2002.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

## Homeowners Insurance

	Year ended 31 December	
	2003	2002
	(RMB in million, except %)	
Turnover	1,425	1,642
Net premiums earned	1,045	1,105
Net claims incurred	(340)	(351)
Amortization of deferred acquisition costs	(134)	(116)
Interest and dividend income	26	29
Net gains/(losses) on trading and non-trading securities	64	(83)
Interest expense credited to policyholder' deposits Homeowners	(123)	(54)
Insurance protection expense	(17)	(14)
Segment profit before unallocated income and expenses	521	516
Loss ratio	32.5%	31.8%
Segment ratio	14.4%	11.8%
Segment combined ratio	46.9%	43.6%

Turnover from the homeowners insurance segment decreased 13.2% to RMB1,425 million in 2003 from RMB1,642 million in 2002. The decrease was due to an increase in the number of market participants and a corresponding decline in the market share of the Company. Some home loan insurance customers also prepaid their loans in 2003.

Net premium earned from the homeowners insurance segment decreased 5.4% to RMB1,045 million in 2003 from RMB1,105 million in 2002. This decrease was primarily due to a decrease in turnover.

Net claims incurred from the homeowners insurance segment decreased 3.1% to RMB340 million in 2003 from RMB351 million in 2002. Loss ratio for that segment increased from 31.8% in 2002 to 32.5% in 2003. Net premiums earned decreased at a greater rate than that of net claims incurred, resulting in a slight increase in loss ratio.

Amortization of deferred acquisition costs from the homeowners insurance segment increased 15.5% to RMB134 million in 2003 from RMB116 million in 2002. This increase was primarily due to an increase in salary of homeowners insurance segment related personnel and a decrease in reinsurance commission.

Insurance protection expense from the homeowners insurance segment increased to RMB17 million in 2003 from RMB14 million in 2002.

Due to the increase in amortization of deferred acquisition costs, the segment expense ratio for the homeowners insurance segment increased to 14.4% in 2003 from 11.8% in 2002.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

Interest expense credited to policyholders' deposits from the homeowners insurance segment increased 127.8% to RMB123 million in 2003 from RMB54 million in 2002. This increase was due to the launch of the Golden Bull homeowners insurance product in December 2001. As the product had just been launched at the end of 2001, virtually no interest expenses were incurred in the six months ended 30 June 2002. Therefore the interest expense credited to policyholders' deposits in 2002 was relatively low.

As a result of the foregoing, profit before unallocated income and expenses from the homeowners insurance segment increased 1.0% to RMB521 million in 2003 from RMB516 million in 2002.

## Other insurance

The other insurance segment includes cargo insurance, liability insurance, accidental injury insurance, aviation insurance, construction insurance, hull insurance as well as certain other insurance product lines.

	Year ended 31 December	
	2003	2002
	(RMB in million, except %)	
<b>Turnover</b>		
Cargo insurance	2,657	2,966
Liability insurance	2,406	2,752
Accidental injury insurance	1,745	
Other insurance	3,351	3,031
Total	10,159	8,749
<b>Net premiums earned</b>		
Cargo insurance	2,314	2,248
Liability insurance	2,116	1,817
Accidental injury insurance	514	—
Other insurance	1,053	937
Total	5,997	5,002
Net claims incurred	(3,820)	(3,455)
Amortization of deferred acquisition costs	(167)	43
Insurance protection expense	(69)	(57)
Segment profit before unallocated income and expenses	1,941	1,533
Loss ratio	63.7%	69.1%
Segment expense ratio	3.9%	0.3%
Segment combined ratio	67.6%	69.4%

Turnover from the other insurance segment increased 16.1% to RMB10,159 million in 2003 from RMB8,749 million in 2002. This increase was primarily due to the turnover of RMB1,745 million from accidental injury insurance, which the Company began selling in March 2003. The Company's accidental injury insurance is expected to achieve continuous growth by making full use of its extensive distribution network and strong brand recognition.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

Net premiums earned from the other insurance segment increased 19.9% to RMB5,997 million in 2003 from RMB5,002 million in 2002. This increase was primarily due to a decrease of RMB98 million in reinsurance premiums ceded and a decrease in change in net unearned premium reserves resulting in an increase of RMB246 million in net premiums earned from liability insurance.

Net claims incurred from the other insurance segment increased 10.6% to RMB3,820 million in 2003 from RMB3,455 million in 2002. The increase in net claims incurred was primarily due to an increase of RMB106 million in net claims incurred from cargo insurance. The increase in net claims incurred from cargo insurance was primarily due to the occurrence of a large loss in 2003 resulting from the sinking of a cargo ship.

Amortization of deferred acquisition costs from the other insurance segment was RMB167 million in 2003, with a reversal of RMB43 million in 2002. This change was primarily due to an increase in commissions paid to insurance intermediaries and a decrease in reinsurance commissions received.

Insurance protection expense from the other insurance segment increased 21.1% to RMB69 million in 2003 from RMB57 million in 2002. This increase was primarily due to an increase in retained premiums.

As a result of the foregoing, profit before unallocated income and expenses from the other insurance segments increased 26.6% to RMB1,941 million in 2003 from RMB1,533 million in 2002.

## LIQUIDITY

The principal source of liquidity has been cash provided by operating activities, mainly cash from insurance premiums received. Additional liquidity sources include interest and dividend income from investments, proceeds from matured investments, disposal of assets and financing activities.

Liquidity capital is used principally for claim payments and other obligations under outstanding insurance policies, capital expenditures, operating expenses, and tax payments and dividend payment and investment needs. The need for liquidity is generally affected by the timing, frequency and severity of losses under outstanding policies. Catastrophic events, the timing, frequency and effect of which are inherently unpredictable may increase the need for liquidity.

The Company has signed with China Development Bank on 10 October 2003 a subordinated loan agreement, which amounts to RMB2 billion. This loan is unsecured and the interest is calculated on the basis of 90% to 110% of the 5 year lending rate fixed by the People's Bank of China. The loan matures in November 2023.

The Company obtained a 10-year revolving credit facility from China Development Bank for up to RMB10 billion. Each drawdown made under this facility is repayable within one year. As of the date of this annual report, no amount has been drawn down under the facility.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

## CASH FLOW

	Year ended 31 December	
	2003	2002
(RMB in million)		
Net cash from operating activities	7,559	5,145
Net cash used in investing activities	(9,222)	(7,417)
Net cash generated from financing activities	8,038	2,735
Net increase in cash and cash equivalent	6,375	463

Cash flows from operating activities constitute a principal source of liquidity. Net cash generated from operating activities was RMB7,559 million in 2003, an increase of 46.9% from 2002. The increase was primarily due to unearned premium reserves increased by 8.44%, income tax paid for 2003 decreased 97.9% compared with 2002, the decrease rate of premium receivables for 2003 decreased 49.3% compared with 2002, and the increase in reinsurance recoverable on unpaid losses was smaller in 2003 than in 2002. On the other hand, increase in loss and LAE reserve was reduced by 66.7% in 2003 than in 2002, partially offset by a net gain of RMB260 million in 2003 in trading and non-trading securities compared with a net loss of RMB645 million in 2002.

Net cash used by the Company in investing activities increased RMB1,805 million to RMB9,222 million in 2003 from 2002. The increase in net cash used in investing activities in 2003 was primarily due to an increase of RMB10,891 million in funds used by the Company for placement of deposits with banks with original maturity of more than three months and other balances with banks, and an increase of RMB2,643 million in funds used for purchasing trading and non-trading securities. The increase was partially offset by increase of RMB6,430 million in the proceeds of sale of trading and non-trading securities and RMB5,844 million received from mature bank deposits of more than three months.

Net cash generated from financing activities was RMB8,038 million in 2003 and RMB2,735 million in 2002. The increase was primarily due to the receipt of proceeds of RMB5,610 million from the initial public offering of the Company and from a subordinate loan of RMB2 billion arranged in 2003 for the purpose of improving liquidity.

Cash and cash equivalents of the Company as of 31 December 2003 was RMB18,004 million, representing an increase of 54.8% over that in 2002.

## WORKING CAPITAL

The Company typically generates substantial positive cash flow from operating activities because it generally receives insurance premiums on policies it underwrites before it makes loss payments on claims made under such policies. Such cash flows from operating activities have met the Company's working capital requirements in the past. Therefore, save as the subordinated loan and credit facility mentioned above, the Company does not obtain working capital by borrowings.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

The Company expects to fund working capital needs in the future largely from cash generated from operating activities. Taking into account the net proceeds of the global offering and cash generated from other sources, the Directors are of the opinion that the Company has sufficient working capital for its present requirements.

## CAPITAL EXPENDITURE

The capital expenditures have primarily been for property construction, acquisition of motor vehicles and the development of our information systems. Capital expenditure for the year 2003 was RMB1,696 million.

Since the office space and facilities in the headquarters of the Company have failed to meet development needs, the Board of Directors has approved the resolution relating to the construction of a new headquarters building. The total investment of the construction is estimated to be RMB1,500 million.

The Company believes it has sufficient source of capital to fully satisfy any capital expenditure plan and daily working capital requirements.

## SOLVENCY MARGIN REQUIREMENT

The Company is subject to a number of the CIRC's regulations regarding financial operations, including maintaining a stipulated solvency margin, complying with 11 regulatory benchmarks and providing for certain funds and reserves.

Pursuant to relevant insurance laws and regulations in the PRC, the Company is required to maintain a solvency margin that exceeds the minimum statutory level of RMB7,018 million in 2003. The actual solvency margin calculated pursuant to the CIRC's regulations was RMB9,014 million and solvency margin adequacy rate was 128.4% as at 31 December 2003.

Pursuant to the CIRC regulations, if an insurance company fails to meet 4 of the 11 benchmarks regarding solvency, the CIRC has the right to demand an explanation and investigate into the reasons for not meeting the requirements. In 2003, fewer than four of such benchmarks were not met by the Company.

## PREMIUM TO CAPITAL RATIO AND OTHER INSURANCE RATIOS

The premium to capital ratio is the ratio of retained premiums of a property and casualty insurance company in any financial year to the sum of its paid-in capital, capital reserves, surplus reserves and public welfare funds. Pursuant to the amended Insurance Law, this premium to capital ratio may not exceed 4 times for any property and casualty insurance company in any financial year. The premium to capital ratio for 2003 was 2.96 times<sup>7</sup>.

As of 31 December 2003, the gearing ratio<sup>8</sup> was 77.8%, representing a decrease of 8.8 percentage points from 85.6% in 2002.

<sup>7</sup> Calculated according to the PRC Accounting Regulations for Financial Institutions.

<sup>8</sup> Gearing ratio is represented by total liabilities (excluding subordinated loan) divided by total assets.



# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

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## CONTINGENT LIABILITIES

Owing to the nature of the insurance business, the Company is involved in legal proceedings in the ordinary course of business, including being the plaintiff or the defendant in litigation and arbitration. Such legal proceedings mostly involve claims on the Company's insurance policies. While the outcomes of such contingencies, lawsuits or other proceedings cannot be determined at present, the Company believes that any resulting liabilities will not have a material adverse effect on the financial position or operating results of the Company.

## REGULATION ON USE OF FUNDS

The use of funds in Renminbi and foreign currencies by insurance companies in the PRC is subject to the regulatory control by regulatory bodies of the PRC. Therefore, the Company does not use any financial instruments for hedging purposes.

## EMPLOYEES

As of 31 December 2003, the Company had 63,645 employees. Personnel expenses<sup>9</sup> in the year ended 31 December 2003 was RMB3,253 million.

The Company makes contributions to retirement plans and social medical insurance plans for its employees. The Company enhances the performance and efficiency of employees by providing training and performance review to its employees. The Company believes its relationship with its employees to be good.

## SHARE APPRECIATION RIGHTS PLAN

At the shareholders' general meeting of the Company held on 30 July 2003, the Senior Management Share Appreciation Rights Plan was approved. It is designed to link the financial interests of the Company's senior management with the Company's results of operations and the performance of the Company's H Shares. The Board of Directors makes decisions under the scheme and administers the scheme. No shares will be issued under the scheme. Therefore, the shareholdings of shareholders will not be diluted.

Under the share appreciation rights plan, members of the Board of Directors (excluding independent non-executive directors) and the Supervisory Committee, president, vice presidents, chief financial officer, division managers of the Company, presidents of provincial level branch offices, and other senior management at equivalent levels and employees with special contribution to the Company as determined by the nomination, remuneration and review committee are eligible to receive share appreciation rights.

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<sup>9</sup> See Note 7 to financial statements.

# Management's Discussion and Analysis of Financial Condition and Results of Operations *(Continued)*

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## MARKET RISKS

### Interest Rate Risk

Exposure to interest rate changes primarily results from significant holdings of fixed income investments. The Company's fixed maturity investments include term deposits, government bonds, bonds issued by financial institutions and corporate bonds with a rating greater than rated AA, most of which are exposed to interest rate risk. The Company also invests in floating rate instruments, interest proceeds from which can rise and fall due to changes in interest rates. The Company's holding in investment funds is also exposed to price fluctuations caused by changes in interest rates. Interest rate risks may also affect future investments of the Company.

The Company manages exposure to risks associated with interest rate fluctuations through active review of investment portfolio by its management and consultation with financial investment experts. The goal is to maintain liquidity, to preserve capital and to generate stable returns.

### Credit Risk

The Company is subject to credit risk on investments such as corporate bonds and mutual funds. Deterioration of the financial condition or results of operations of the issuers of these instruments may cause a delay in payments of principal or interest when due and eventually result in uncollectibility. The Company tries to manage credit risk by analyzing the creditworthiness of companies prior to making investments as well as strictly following the CIRC guidelines which only permit investments in corporate bonds with a rating greater than AA.

The Company is also subject to credit risk with respect to amounts owed to it by reinsurers pursuant to the terms of reinsurance policies it has with them. As a result, the Company pays particular attention, on an ongoing basis, to the creditworthiness and financial condition of the reinsurers with whom it deals. Except when dealing with national reinsurers, the Company only purchases reinsurance from reinsurers with A.M. Best ratings of at least A-.

### Exchange Rate Risk

The Company conducts its business primarily in Renminbi, which is also its functional and financial reporting currency. However, a portion of its business (including underwriting certain international cargo insurance and aviation insurance) are conducted in foreign currencies, typically US dollars. A portion of its claims and liabilities is also denominated in foreign currencies, typically US dollars.

Most of the Company's sales are domestic and as such it has a limited amount of foreign currency denominated accounts receivable.

Foreign exchange transactions under its capital account, are subject to foreign exchange regulation and require the approval of the State Administration of Foreign Exchange. Actions taken by the PRC government could cause future exchange rates to vary significantly.