
THE PRC INSURANCE INDUSTRY

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OVERVIEW

The PRC insurance market is the third largest insurance market in terms of total premiums in Asia after Japan and South Korea and the eleventh largest insurance market worldwide, based on Sigma Report No. 8 published by Swiss Reinsurance Company in 2003. The PRC insurance market is also one of the fastest growing insurance markets in the world. Between 1998 and 2003, life insurance premiums and property and casualty premiums in the PRC increased 302.5% and 73.8%, respectively based on data published by the National Bureau of Statistics of China and the China Insurance Regulatory Commission, or CIRC. Key factors in the dramatic expansion of the PRC insurance market include economic policy initiatives undertaken by the PRC government over the past 25 years and significant changes in a number of demographic trends in the PRC.

In 1978, the PRC government initiated a policy of economic reform and opened the country gradually to the outside world. Principal reforms that the PRC government has undertaken or initiated since 1978 include rural reforms, state-owned enterprise reforms, social security system reforms, price reforms, fiscal and tax reforms, monetary and financial sector reforms, foreign trade and investment related reforms and housing reforms. Overall, the reform programs aim at transforming the centrally planned economy of the PRC into a more market-oriented economy with a more effective system of macroeconomic management, a modern enterprise system, a modern financial system and an equitable system of income distribution and social security. In addition, the PRC's accession to the WTO in December 2001 has contributed to the growth in foreign trade and foreign direct investment, while further intensifying the domestic corporate restructuring process. Foreign direct investment in the PRC increased to US\$53.5 billion in 2003, approximately twice the level of foreign direct investment ten years earlier. In 2002, the PRC surpassed the United States to become the country that absorbed the most foreign direct investment in the world.

Rapid economic growth, coupled with strong foreign investment, has resulted in substantial wealth creation and accumulation in the PRC. Since the beginning of its economic reform, the PRC has experienced rapid increases in GDP and per capita GDP. From 1995 to 2003, GDP per capita increased 86.9% from RMB4,854 to RMB9,073.

The following table sets forth GDP and per capita GDP in the PRC in 1980, 1985 and 1990 and from 1995 to 2003:

| | <u>1980</u> | <u>1985</u> | <u>1990</u> | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> |
|-----------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| GDP (RMB billion) | 452 | 896 | 1,855 | 5,848 | 6,788 | 7,446 | 7,835 | 8,207 | 8,947 | 9,731 | 10,517 | 11,690 |
| GDP per capita (RMB) | 460 | 853 | 1,634 | 4,854 | 5,576 | 6,054 | 6,308 | 6,551 | 7,086 | 7,651 | 8,214 | 9,073 |

Source: China Statistical Abstract 2004.

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Complementing policy reform initiatives, demographic factors have also contributed to the growth of the insurance market in the PRC. According to the World Bank, the percentage of the population aged 65 or older in the PRC will increase from less than 7% in 2000 to approximately 9% by 2015 and to approximately 12% by 2025. As a result of an increase in life expectancy and a decrease in birthrate, a typical family in the PRC now has fewer income-earning members to support the elderly. Policies that call for the dismantling of the social welfare system in the PRC, which for over 50 years has been linked to work units, amplify these demographic trends and, in turn, underscore the need for third-party providers of insurance and pension products.

In addition, the traditionally high savings rate in the PRC, coupled with the wealth generated by the economic reforms, has resulted in significant increases in individual savings deposits at banks. In particular, households in the PRC have generally placed most of their savings in bank deposits, and have invested relatively small amounts of their savings in life insurance products and pension funds. In contrast, households in the United States and United Kingdom have generally invested a substantially higher portion of their savings in life insurance products and pension funds. In particular, deposits and life insurance and pension fund reserves represented 16.9% and 29.8%, respectively, of the total financial assets in the United States in 2002, and 22.1% and 52.9%, respectively, of the total financial assets in the United Kingdom in 2000. As disposable incomes rise, consumers have looked to insurance policies with investment-like features as well as other investment products as alternatives to savings accounts.

The following table sets forth the individual savings deposits in the PRC from 1994 to 2003:

| | <u>1994</u> | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> |
|---------------------------------------|----------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | (in billions of RMB) | | | | | | | | | |
| Individual savings deposits | 2,152 | 2,966 | 3,852 | 4,628 | 5,341 | 5,962 | 6,433 | 7,376 | 8,691 | 10,362 |

Source: National Bureau of Statistics of China.

The following table sets forth the insurance premiums received by life insurance and property and casualty insurance companies in the PRC from 1994 to 2003:

| | <u>1994</u> | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003</u> |
|---------------------------------|----------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | (in billions of RMB) | | | | | | | | | |
| Life insurance | 16.2 | 19.4 | 31.1 | 60.0 | 74.8 | 87.2 | 99.7 | 142.4 | 227.5 | 301.1 |
| Property and casualty insurance | 33.6 | 42.1 | 44.5 | 48.0 | 50.0 | 52.1 | 59.8 | 68.5 | 77.8 | 86.9 |

Source: National Bureau of Statistics of China.

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The following table presents certain economic and insurance premium data for the PRC, the United States and certain selected countries and regions in Asia and Europe in 2002:

| Market | Economic indicator | | | Life insurance | | | Property and casualty insurance | | |
|----------------------|--|----------------|------------|--|--------------------------------|----------------------------------|--|--------------------------------|----------------------------------|
| | GDP | GDP per capita | GDP growth | Premiums | Insurance depth ⁽¹⁾ | Insurance density ⁽²⁾ | Premiums | Insurance depth ⁽¹⁾ | Insurance density ⁽²⁾ |
| | (in billions of US\$, except capita and percentages) | | | (in billions of US\$, except insurance depth and density data) | | | (in billions of US\$, except insurance depth and density data) | | |
| China | 1,237 | 963 | 8.0% | 25.1 | 2.0% | 19.5 | 11.8 | 1.0% | 9.2 |
| United States | 10,446 | 36,145 | 2.4% | 480.5 | 4.6% | 1,662.6 | 519.9 | 5.0% | 1,799.0 |
| Japan | 4,102 | 32,198 | 0.1% | 354.6 | 8.6% | 2,783.9 | 91.0 | 2.2% | 714.7 |
| Germany | 1,987 | 24,085 | 0.2% | 60.9 | 3.1% | 736.7 | 74.9 | 3.7% | 891.1 |
| United Kingdom | 1,567 | 26,292 | 1.8% | 159.7 | 10.2% | 2,679.4 | 77.0 | 4.6% | 1,199.7 |
| France | 1,432 | 24,067 | 1.2% | 80.4 | 5.6% | 1,349.5 | 44.6 | 3.0% | 714.7 |
| South Korea | 477 | 9,979 | 6.3% | 39.3 | 8.2% | 821.9 | 16.1 | 3.4% | 337.8 |
| India | 475 | 452 | 5.5% | 12.3 | 2.6% | 11.7 | 3.2 | 0.7% | 3.0 |
| Taiwan | 282 | 12,598 | 3.6% | 20.7 | 7.4% | 925.1 | 7.9 | 2.8% | 354.1 |
| Switzerland | 268 | 36,712 | 0.2% | 22.6 | 8.4% | 3,099.7 | 13.2 | 5.0% | 1,822.6 |
| Hong Kong | 162 | 23,824 | 2.3% | 8.4 | 5.2% | 1,237.9 | 2.3 | 1.5% | 345.2 |
| Singapore | 87 | 21,220 | 2.2% | 3.0 | 3.5% | 730.1 | 2.8 | 1.4% | 300.6 |

(1) Total gross written premiums as a percentage of GDP.

(2) Gross written premiums per capita.

Source: Sigma Report, Swiss Reinsurance Company.

While the PRC insurance market has experienced rapid growth, it remains significantly under-penetrated when compared to more developed markets in Asia as well as the United States and markets in Europe. In 2003, total life insurance and total property and casualty insurance premiums represented only 2.6% and 0.7%, respectively, of the PRC's GDP in 2003. In addition, in 2002, total life insurance premiums and total property and casualty insurance premiums as percentages of GDP were 2.0% and 1.0%, respectively, in the PRC, compared to 8.6% and 2.2%, respectively, in Japan and 4.6% and 5.0%, respectively, in the United States. These comparatively low penetration rates suggest potential for further growth in the PRC insurance market.

GEOGRAPHICAL VARIATIONS IN THE PRC INSURANCE MARKET

The PRC insurance market exhibits significant geographical variations in penetration rates. The following table sets forth certain statistical data for life insurance and property and casualty insurance in certain centrally administered municipalities, provinces and autonomous regions in the PRC in 2002:

| Life insurance | | | | Property and casualty insurance | | | |
|-----------------|------------------------------|--------------------------------|----------------------------------|---------------------------------|------------------------------|--------------------------------|----------------------------------|
| Location | Share of national market | Insurance depth ⁽¹⁾ | Insurance density ⁽²⁾ | Location | Share of national market | Insurance depth ⁽¹⁾ | Insurance density ⁽²⁾ |
| | | | | | | | |
| | (in RMB, except percentages) | | | | (in RMB, except percentages) | | |
| Jiangsu | 10.0% | 2.1% | 309.1 | Guangdong | 10.3% | 0.8% | 107.6 |
| Shanghai | 8.5% | 3.6% | 1,448.1 | Zhejiang | 8.0% | 0.7% | 125.8 |
| Beijing | 8.3% | 6.0% | 1,413.4 | Jiangsu | 7.2% | 0.5% | 75.7 |
| Guangdong | 7.5% | 1.8% | 230.4 | Shandong | 7.2% | 0.5% | 60.9 |
| Shandong | 7.4% | 1.6% | 185.7 | Beijing | 5.8% | 1.2% | 336.6 |
| Zhejiang | 6.6% | 1.7% | 325.7 | Shanghai | 5.7% | 0.8% | 340.6 |
| Liaoning | 5.0% | 1.8% | 188.8 | Liaoning | 5.0% | 0.7% | 67.0 |
| Henan | 4.5% | 1.7% | 107.1 | Sichuan | 4.2% | 0.6% | 38.1 |
| Hebei | 3.7% | 1.4% | 125.5 | Shenzhen | 3.9% | 1.4% | 607.3 |
| Sichuan | 3.3% | 1.5% | 88.3 | Hebei | 3.6% | 0.5% | 41.8 |
| Others | 35.2% | 1.7% | 218.7 | Others | 39.0% | 0.7% | 76.3 |

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(1) Total gross written premiums as a percentage of GDP.

(2) Gross written premiums per capita.

Source: Yearbook of China's Insurance 2003.

Although the insurance industry in the PRC as a whole exhibits low penetration rates, the penetration rates are generally higher among the more developed coastal cities and provinces.

DEVELOPMENT OF THE PRC INSURANCE MARKET

Shortly after the founding of the PRC in 1949, the People's Insurance Company of China was established by combining the then existing domestic insurance companies. The People's Insurance Company of China had a monopoly over the entire domestic insurance market. However, as the government aimed to provide social security to all from cradle to grave, insurance was regarded as largely superfluous. By 1958, all domestic insurance operations were suspended. Reflecting the general reduction of insurance activities, the People's Insurance Company of China was reorganized and became a department of the PBOC.

The insurance industry re-emerged after economic reforms began in the late 1970s. In 1983, the People's Insurance Company of China was re-established as an independent insurance company supervised by the PBOC. The establishment of Shenzhen Ping An Insurance Company in Shenzhen in 1988 ended the People's Insurance Company of China's insurance monopoly. With the establishment of China Pacific Insurance Co., Ltd. in Shanghai in 1991, a competitive insurance market began to take form.

In response to rapid developments in the insurance market, the National People's Congress of the PRC promulgated the PRC Insurance Law in 1995, which sets forth the framework for restructuring and rationalizing the PRC insurance industry. Ensuing developments encompassed both the restructuring of state-owned insurance companies and the enhancement of the PRC government's regulatory capacity in the insurance sector. In 1996, People's Insurance Company of China was renamed China People's Insurance (Group) Company with its business transferred to four subsidiaries: Zhongbao Life Insurance Company Limited, Zhongbao Property Insurance Company Limited, Zhongbao Reinsurance Company Limited and China Insurance H.K. (Holdings) Company Limited.

In 1998, CIRC was established and assumed the powers and responsibilities for supervising the insurance industry previously vested in the PBOC. The formation of the CIRC underscored a policy objective of fostering an orderly development of the PRC insurance market. Aiming to build confidence in the market, the CIRC initially focused on curbing abusive practices by unscrupulous operators. The establishment of a viable regulator also paved the way for greater international involvement in the PRC insurance market.

In January 1999, pursuant to a State Council decision, the holding structure of China People's Insurance (Group) Company was dissolved. Following the restructuring:

- Zhongbao Life Insurance Company Limited was renamed China Life Insurance Company with a focus on life insurance;
- Zhongbao Property Insurance Company Limited was renamed People's Insurance Company of China with a focus on property and casualty insurance; and

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- Zhongbao Reinsurance Company Limited was renamed China Reinsurance Company with a focus on reinsurance.

In July 2003, People's Insurance Company of China was restructured into three companies: PICC Holding Company, PICC and PICC Asset Management Company Limited. In August 2003, China Life Insurance Company was restructured into China Life Insurance (Group) Company and China Life. In November 2003, China Life Insurance (Group) Company and China Life established China Life Insurance Asset Management Company Limited.

In connection with its accession to the WTO in December 2001, the PRC agreed to a range of commitments with respect to the participation of foreign insurers in the PRC insurance market. These commitments focus on reducing restrictions on foreign equity ownership of insurance businesses in the PRC, eliminating geographic restrictions on the operations of foreign insurers and expanding the permitted scope of business for foreign insurers. See the section headed "Supervision and Regulation — Major Insurance Industry Commitments upon PRC's Accession to the WTO".

PRINCIPAL PARTICIPANTS IN THE PRC INSURANCE MARKET

The PRC insurance market is currently dominated by China Life Insurance (Group) Company, PICC, our Company and China Pacific Insurance (Group) Company, Ltd., which together controlled over 90% of the market in terms of gross written premiums in 2002. Based on PRC GAAP financial data and PRC insurance industry data calculated in accordance with PRC GAAP and published by the National Bureau of Statistics of China and the CIRC, China Life Insurance (Group) Company, Ping An Life and China Pacific Life Insurance Company, Ltd. together held approximately 91% of the market share in life insurance in 2002, while PICC, China Pacific Property Insurance Company, Ltd. and Ping An Property & Casualty together held approximately 95% of the market share in property and casualty insurance in 2002.

The following table sets forth the market shares in terms of gross written premiums and policy fees, calculated based on PRC GAAP financial data, held by the top insurers in major segments of the PRC insurance industry in 2002:

| Life insurance | | Property and casualty insurance | |
|---|---------------|--|---------------|
| Company | Market share | Company | Market share |
| China Life Insurance Company ⁽¹⁾ | 56.6% | PICC | 70.9% |
| Ping An Life | 23.5 | China Pacific Property Insurance Company, Ltd. . . | 13.2 |
| China Pacific Life Insurance Company, Ltd. | 11.0 | Ping An Property & Casualty | 10.6 |
| New China Life Insurance Company Ltd. | 3.5 | Huatai Insurance Company of China, Ltd | 1.0 |
| Taikang Life Insurance Co., Ltd. | 2.9 | Tianan Insurance Company Limited of China | 0.9 |
| Tai Ping Life Insurance Company, Ltd. | 0.7 | China Export & Credit Insurance Corporation | 0.7 |
| AIA Shanghai Branch | 0.7 | China United Property Insurance Company | 0.7 |
| AIA Guangzhou Branch | 0.4 | Da Zhong Insurance Company, Ltd. | 0.7 |
| Pacific-Antai Life Insurance Co., Ltd. | 0.2 | Yong An Property Insurance Company, Ltd. | 0.4 |
| Manulife-Sinochem Life Insurance Co., Ltd. | 0.2 | Sinosafe Insurance Company | 0.4 |
| Others | 0.3 | Others | 0.5 |
| Total | <u>100.0%</u> | Total | <u>100.0%</u> |

Source: Yearbook of China's Insurance 2003.

- (1) China Life Insurance Company was restructured into China Life Insurance (Group) Company and China Life in 2003.

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CURRENT OPERATING ENVIRONMENT

Effect of Prolonged Low Interest Rate Environment

The one-year deposit rate quoted by the PBOC had fallen from 10.98% in July 1993 to 1.98% in April 2002, and has remained at 1.98% thereafter. As interest rates decline in the PRC, the investment yield that insurance companies could earn may drop below the assumed investment yields used in the calculation of fixed premiums. As the assumed mortality rates and administrative expenses used by insurance companies in calculating premiums are generally estimated conservatively and are generally more stable, they usually offset some shortfall in the investment yield. However, if the shortfall is large enough, lower mortality rates and administrative expenses may not be sufficient to cover the shortfall, and the insurance policy in question may result in a net loss to the insurer. This phenomenon is generally referred to as “negative spread”.

Product Diversification

The traditional non-participating policies sold by insurers generally guarantee returns to the policyholders. In order to reduce exposure to interest rate risks in general and the negative spread problem in particular, life insurers in the PRC have launched products, such as participating and investment-linked products, which may not provide guarantee returns to policyholders but, instead, pay **policy dividends** in accordance with the combined effects of actual mortality rates, investment yields and expense levels as compared to the assumptions of these factors on pricing and the invested assets, respectively.

Channel Proliferation

Insurance companies in the PRC have traditionally relied primarily on their exclusive agent distribution channels to market products, and the use of sales agents has remained as the principal means of distributing life insurance products. In recent years, however, there has been a general increase in the use of new sales methods. In particular, bancassurance, although in its early development stage in the PRC, has become increasingly important as a distribution channel for life insurance. The growth of bancassurance is also facilitating the creation of marketing alliances between financial services institutions leading to broader sales channels.

Potential Investment Opportunities

Insurers in the PRC generally have limited investment opportunities due to the lack of available investment options and vehicles as a result of legal and regulatory constraints as well as the lack of liquidity and depth in the capital markets. With the decrease in interest rates, this limitation on investment options has exacerbated the asset-liability mismatch problem. As a result, the CIRC has indicated that it is considering extending the permissible choices of investment. In particular, since June 2003, the CIRC has allowed PRC insurance companies to invest up to 20% of their total assets as of the end of the previous month in corporate bonds issued by PRC companies that are rated AA or above by a CIRC approved credit rating agency, calculated on the basis of cost. In addition, since January 31, 2004, the State Council has been encouraging the investment of insurance funds in the PRC capital markets, as well as the further development of the PRC bond markets. However, the CIRC has not made any

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further announcements regarding any additional permissible investment choices or the timeframe for allowing such investments.

Deregulation of Automobile Insurance

Until January 2003, the terms and premium rates of automobile insurance policies offered by insurance companies in the PRC were formulated and set by the CIRC. Since then, the CIRC has allowed insurance companies to provide their own terms, and set premium rates, of automobile insurance policies, subject to approval by the CIRC. By allowing insurance companies to customize automobile insurance policies based on specific demographics, safety records and needs of different customer segments, the CIRC aimed to promote competition in the automobile insurance sector and provide an environment in which consumers are able to choose from a broader range of automobile insurance policies based on their specific needs as well as their willingness to pay. While the deregulation of automobile insurance has resulted in price competition among automobile insurers in the PRC, it enables automobile insurers to improve their pricing and risk selection process.