6 PERFORMANCE AND STABILITY REVIEW OF THE INSURANCE SECTOR

6.1 Introduction

The insurance sector provides an avenue through which financial risks are pooled and dispersed. With growing inter-linkages between the banking and the insurance sectors worldwide, risks associated with banking also carry implications for the insurance industry (**Table 6.1**). In the global financial crisis (GFC) of 2007-2010, leading insurance companies with a global presence faced severe financial distress, primarily due to the contagion effect transmitted through insurance coverage provided to securitized instruments. More specifically, risks to the insurance sector during the GFC materialized due to a combination of various factors, including: (1) mark to market decrease in asset valuations of insurance companies, (2) increased volatility in financial markets, (3) exposure to insolvent and bankrupt financial institutions and, (4) liquidity crunch and overall economic slowdown. The near collapse and subsequent bailout of world's largest insurance company, the American International Group (AIG) in 2008, gave credence to the notion of "too big to fail" in the financial sector.[1] However, with the support of government bailouts, the global insurance sector continues to struggle towards attaining positive growth in its premiums and profitability in 2009.

Table 6.1: Risk Transfer among Banks, Insurance Companies and Capital Markets

Direction of risk transfer		Risk Type: Credit risk	Risk Type: Market risk	Risk Type: Insurance risk
	Banks to Insurance Companies	Bank equities and bonds. Trade credit insurance. ABS, CDOs, Portfolio CDs, financial guarantees, residual value insurance, other forms of credit insurance and surety bonds	Bank equities and bonds. Insurance companies writing options and buying bonds with embedded options such as callable bonds.	Insurance on bank property, legal liability etc, insurance provided to borrowers to facilitate loans, newly introduced policies for operational and political risk.
	Insurance companies to banks and other capital market investors	Letter of credit, liquidity facilities	Hedging of embedded options in portfolio of life insurance and pension products.	Catastrophe bonds

Source: Rule (2001)

Table 6.2 shows the growth rates of inflation- adjusted premiums around the world. It is evident from the data that the insurance sector in emerging economies has outperformed its counterparts in advanced countries' in terms of growth in real premiums.

Table 6.2: Real Premiums Growth in year 2009

	Life	Non-Life	Total
Developed Economies	-2.8	-0.6	-1.8
Emerging Economies	4.2	2.9	3.5
Pakistan*	5.4	-11.9	-3.9
World	-2.0	-0.1	-1.1

* Annual audited accounts of insurance companies

Source: Sigma Re (2010)

In case of Pakistan, the persistently high rate of inflation in recent years has substantially reduced the real premium growth rates. In nominal terms, total insurance premiums in Pakistan grew by 12.5 percent, while premiums for life and non-life (or general) insurance surged by 20.3 and 3.0 percent respectively in

[1] According to the "Too Big to Fail" hypothesis, entities that are central to the functioning of specific sectors in particular and to overall economic activity in general cannot be allowed to fail given the risk of systemic repercussions, and the government / relevant regulatory agency should always intervene in such a situation to prevent a severe shock to the financial system and to the national economy.

CY09. Notably, higher premium growth in emerging economies is believed to emanate in large part from the impact of the rising capital flows from advanced economies, on economic growth. More precisely, the productive capacity in some leading emerging economies has benefited from the increased flow of foreign investment, with a consequent increase in insurance penetration. This is particularly true for the ASEAN region and for China, where increased economic activity in recent years has necessitated higher insurance coverage.[2]

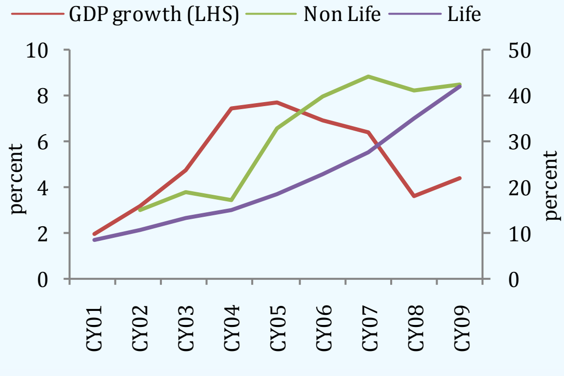
Just like the rest of the financial sector, Pakistan's insurance sector was not directly impacted by the GFC on account of low level of integration with the rest of the world. The insurance sector has performed relatively well given the deteriorating macroeconomic environment and law and order situation in recent years. With a 13.3 percent YoY increase in assets in CY09, its share in total financial system was 4.4 percent at-CY09, indicating an improbable likelihood of posing a potential threat of systemic risk to the economy in general and the financial system in particular, due to both its rather small share as well as the low level of penetration.[3]

The chapter reviews the developments and performance of the insurance sector in 2009, and in doing so, it also highlights the role of the government in promoting the role of insurance services in the country. Section 8.2 provides a brief overview of the insurance sector at end-CY09 and section 8.3 discusses the role of the government in the growth and development of the insurance industry in Pakistan. Performance of the life insurance sector is discussed in section 8.4, and of shariah-compliant mode of insurance i.e. Takaful in section 8.5. Section 8.6 discusses the performance review of the non-life sector, and 8.7 details the developments in reinsurance, while the last section concludes the chapter.

6.2 Overview of the Insurance Sector

The size of the insurance and reinsurance industry expanded by 13.3 percent[4] YoY in CY09, despite the rather gradual pace of economic recovery during the year, coupled with the rising incidence of calamities of various nature and a deteriorating security situation (**Figure 6.1**). Encouragingly, the insurance sector remained immune to some extent to the second round effects of the global financial slowdown, on account of low level of integration and enhanced capital base. Moreover, even the fall in demand for consumer finance related products, which necessitate compulsory insurance coverage, did not hamper the growth of new non-life insurance policies and the rising volume of gross premiums, indicating a certain degree of diversification of business lines. Notably, the premium growth pattern in **Figure 6.1** suggests that life-insurance is not as correlated with the economic cycle as non-life insurance, showing a steady rise since the start of the decade despite the economic slowdown in the last two years.

Figure 6.1: GDP and Premiums of Insurance Sector



Source: SBP

CY09 showed slightly increased profitability in the insurance sector despite sluggish macroeconomic performance, but also due to the launch of new players in the market. The life insurance sector saw the entry of two new companies in the domestic private market,

[2] Please see Box 10.1 "The Emerging Market Phenomenon in the Insurance Industry" in Chapter 10, FSR 2006.

[3] Insurance penetration is the ratio of gross premiums to GDP. Insurance penetration in Pakistan is considerably low at 0.7 for 2009, in comparison with peer countries and across the region. For instance Insurance penetration in India is 5.2. Source: Swiss Re Sigma 2/2010.

[4] In terms of total assets.

making a total of 7 life-insurance providers. In the non-life sector, there are 34 general insurance companies offering non-life and health insurance coverage.[5] Furthermore, one state-owned non-life reinsurance company offers reinsurance coverage to the non-life insurance market. There are also 5 Takaful (offering shariah-compliant insurance products) operators in the sector.

Most of the growth in the insurance industry in CY09 has been on account of the increase in the capital base of the companies mostly in the non-life sector in compliance with regulatory requirements, coupled with improvement in profitability leading to increase in reserves. The total gross premiums of the entire industry witnessed a significant increase of 12.5 percent in CY09, translating into a higher stock of investments and liquid assets.

Despite the strong growth in asset base of 13.3 percent, the share of insurance sector assets (including reinsurance) in GDP declined marginally to 2.8 percent as against 2.9 percent in the previous year (**Table 6.3**).

Table 6.3: Asset Structure of the Insurance Industry

Share in percent, amount in billion Rupees

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Share in percent									
Life	**73.7**	**73.7**	**71.4**	**71**	**70.6**	**67.1**	**58.8**	**62.2**	**64.3**
State owned	71.6	71.2	67.7	66.8	65.5	61.5	52.1	56.2	56.3
Domestic	1.2	1.5	2.4	2.6	3.1	3.3	4.2	3.6	5.0
Foreign	0.9	1.0	1.3	1.6	2.0	2.3	2.5	2.4	3.0
Non-Life	**23.4**	**23.1**	**24.5**	**25.2**	**26.6**	**30.2**	**37.2**	**33.4**	**31.7**
State owned	9.9	9.4	9.3	8.6	8.4	7.4	6.6	6.5	6.9
Domestic	12.7	12.8	14.2	15.9	17.4	22.0	29.8	26.2	24.0
Foreign	0.8	0.9	1.0	0.7	0.8	0.8	0.8	0.7	0.7
Reinsurance									
State owned	2.9	3.2	4.1	3.8	2.8	2.6	3.2	3.6	3.2
Takaful	...	...	...	...	...	0.3	0.5	0.7	0.8
GDP share	2.6	2.8	2.9	2.8	2.9	3.0	3.4	2.9	2.8
Total Assets	**113.4**	**129.7**	**151.3**	**174.6**	**201.7**	**246.1**	**325.1**	**341.4**	**386.8**

Source: Annual Audited Accounts of Insurance Companies and Economic Survey of Pakistan 2009-10

6.3 Role of Government in the Insurance Sector

Like other components of the financial system, the insurance sector is also affected by issues related to adverse selection, moral hazard, and market asymmetries and failures. Advanced economies, which had predominantly advocated a *laissez-faire* approach in the last few decades, eventually came to rely heavily on government intervention for the survival of its financial institutions in the aftermath of the GFC, in the form of bail-outs (capital injection, troubled assets rehabilitation and temporary financial support). The situation deteriorated to the extent that AIG and other leading insurance companies were given a bailout package of USD 130 billion in 2008, to meet immediate liquidity needs and to remain solvent.[6]

In developing and emerging economies on the other hand, the insurance sector remained significantly unaffected from the contagion effect of the GFC, largely due to the low level of financial integration with international financial institutions and markets. Notably, the insurance sector in developing countries relies heavily on the government in terms of providing reinsurance and disaster/calamity coverage, as the private insurance providers

[5] There is one dedicated company for Health Insurance.

[6] The other insurance companies that received the bailout package include: Met Life, Hartford Financial Services, Prudential Financial, Glenworth Financial Inc. and Lincoln National Corporation.

are generally under-developed and lack access to risk financing (or reinsurance), raising issues related to solvency. This is evident from the fact that most of the reinsurance and large insurance (life and non-life) companies in developing countries are still owned and operated by the government. Moreover, issues such as lack of sufficient historical statistics on disaster and calamity risk and a general lack of awareness of the significance of insurance as a financial product, impede the entry and penetration capacity of large insurance companies in the private sector.

In case of Pakistan, the role of the government has been instrumental in the development of the insurance and reinsurance sectors since the time of independence. From safeguarding the interest of the policyholders by creating the office of the Department of Insurance, which was later changed to the Controller of Insurance, to the establishment of Pakistan Reinsurance Corporation (presently called Pakistan Reinsurance Company Limited, PRCL) in 1953, the government has actively promoted insurance services in the country. Furthermore, the National Coinsurance Scheme (NCS) was established in 1955 to assist small insurance companies in resolving financial issues related to solvency / leverage positions, etc. With nationalization in full swing in the year 1973,[7] the government focused on strengthening the life insurance sector by merging 41 small life insurance companies and establishing the State Life Insurance Corporation (SLIC), which to this day is the largest insurance company in Pakistan. In the non-life sector, the government established the National Insurance Corporation (presently National Insurance Company Limited, NICL) in 1976.

At present, the insurance sector is jointly regulated by the Securities and Exchange Commission of Pakistan (SECP), and the Ministry of Commerce. However, from July 27, 2009,[8] the Ministry of Commerce has conferred its powers and functions under Section 167(2) of Insurance Ordinance, 2000 to the SECP. This will ensure an effective and centralized supervision of the insurance industry along with the consolidation of its regulatory framework. In a historical perspective, the promulgation of the Insurance ordinance 2000, and the abolition of the Controller of Insurance and designation of the SECP as the insurance regulator are some of the positive measures taken by the government in encouraging the growth of industry. However, when assessing the impact of government intervention in the domestic insurance sector, especially when financial sector reforms implemented over the last two decades have resulted in a radical transformation of the rest of the financial sector in terms of ownership and efficiency gains, the opportunity cost of non-intervention also needs to be considered. For instance, if the government didn't have the foresight of establishing a domestic reinsurance company, the opportunity cost would have been in the form of outflow of foreign exchange as premium payments to international reinsurers.[9] Moreover, in the absence of large state-owned insurance companies such as NICL and SLIC, the accumulation of the large pool of savings (in the form of premiums generated) by these entities would not have been possible. Both NICL and SLIC invest their pool of premiums in the capital and money markets, and are a crucial source of liquidity in these markets.[10]

Notwithstanding the facilitating role of the government, the continued government ownership of these large entities has also impeded efficiency gains and product innovation in the insurance sector. In case of non-life insurance, high premium rates charged by NICL (in

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[7] A detailed overview of the Nationalization process is given in Chapter 3: State vs. Privately Owned Financial Institutions: Does Ownership Affect Performance? in this edition of the Financial Stability Review.

[8] Ministry of Commerce Notification dated July 27, 2009 vide S.R.O. 708(I)/2009.

[9] All registered insurers are required to ensure at all times provisions of maintaining reinsurance treaty arrangements. Although from 2005 onwards, compulsory quota share cessions to PRCL have been abolished, but it continues to be obligatory for non-life insurers to offer at least a 35 percent share to PRCL in their treaties. In order to control the outflow of foreign exchange, the insurers are required to approach the SECP for permission/ approval of facultative reinsurance placement abroad.

[10] SLIC is the single largest institutional investor of Pakistan Investment Bonds (PIBs).

comparison with more competitive rates offered by private sector insurance providers) on insuring government assets not only impose an additional cost to the government, but are also indicative of monopolistic inefficiencies given that all public sector organizations can only avail insurance coverage from state-owned companies. The lethargic pace of implementation of insurance sector reforms is another factor which hasn't received the attention it deserves, resulting in one of the lowest insurance penetration level in the region. One of the suggested reforms is the privatization of all state-owned companies i.e. SLIC, PRCL and NICL, which continues to be postponed. Notably, the insurance sector is currently the only component of the financial sector with the largest proportion of government ownership, since most of the rest of the financial sector is now owned and operated by the private sector on a market-based mechanism.

Proponents of the free-market system advocate the need for firms to operate on the basis of the market mechanism to promote efficiency, competition and innovation. Interestingly however, a branch of economic literature suggests that insurance is a unique component of the financial sector in which a high level of competition is actually undesirable. This is because insurance companies are in the business of circumventing the elements of moral hazard and adverse selection when providing insurance coverage and excessive competition tends to cloud their financial judgment of these decisions.[11]

6.4 Performance Review of Life Insurance

The purpose of life insurance products is to indemnify policy holders from threats emanating from adverse events in their lives, while also providing an avenue for long terms savings. Given the mismatch in the nature of long-term liabilities generated by the life insurance contract and the relatively shorter tenor of assets (in terms of requirement of rollover, and hence reinvestment risk) that the premiums are invested in, the life insurance business poses greater potential risks to financial stability than conventional non-life insurance products. Furthermore, as opposed to non-life insurance, the demand for life insurance is based on several factors which vary from economic to demographic, and have a substantial influence on the performance of life insurance companies. **Box 6.1** gives an overview of life insurance demand and supply, and the overall life insurance consumption in developing countries.

The contribution of life insurance sector assets towards total industry assets has witnessed a gradual increase in CY09 on account of increased insurance business in terms of rising gross premiums that eventually led to a significant increase in investments (**Table 6.4**). Moreover, the performance of the life insurance sector that witnessed a net loss in CY08 on account of sluggish capital market performance, registered a significant recovery by posting a profit of Rs. 1.0 billion in CY09. Much of the recovery in profits emanates from the increase in investment income which also helped in containing the incidence of rising claims. Besides an increase in the asset base and recovery in profitability, another important development pertains to the rising share of private life insurance companies in the total asset structure over the last few years, highlighting the increased participation and rising interest

Table 6.4: Overview of Life Insurance Sector

billion Rupees

	2007	2008	2009
Assets	191.8	214.0	228.8
Equity	3.6	3.6	5.3
Investments	154.5	165.3	199.4
Gross Premiums	27.7	34.9	42.0
Net Premiums	26.8	33.8	40.8
Gross Claims	13.4	16.8	19.8
Expenses	9.3	12.6	17.1
Profitability	1.6	-0.1	1.0

Source: SECP

[11] Rothschild and Stiglitz (1997).

Box 6.1: Determinants of Life Insurance Consumption Across Countries

In both developed and developing countries, the insurance sector is considered to be the third important component of the financial sector, after the banking sector and capital markets. However, with increasing financial globalization, urbanization of population and improvements in financial literacy, the consumption of life insurance has risen rather more robustly in the developing world. As the consumption for life insurance products is based on the supply of and demand for such products, it is usually the case that the supply exceeds the demand in developing economies. The supply of life insurance products is based primarily on the cost of insurance, whereas the demand is based on the expected maximization of the policy holder's utility function, dependent upon the desired income, prevailing level of wealth, level of interest and inflation rates as well as the cost of the insurance policy.

Table 1 highlights the three major components that affect life insurance consumption i.e. Demographic, Economic and Institutional. The consumption for life insurance is assumed to impact the (a) savings component of life insurance and (b) mortality risk component faced by the life insurance provider. The combined effect is explained by the panel regression by Beck & Webb (2004) on the basis of life insurance data from a sample of 63 countries. Accordingly, life expectancy is positively related with savings (premiums) for the company. Therefore, a higher life expectancy decreases the mortality risk of the life insurance provider.

Table 1: Determinants of Life Insurance Consumption

		Savings Component	Mortality Risk Component	Combined Effect
Demographic	Young Dependency Ratio	–	+	ambiguous
	Education	+	+	+
	Urbanization Ratio	+	+	+
	Religion	muslim	muslim	muslim
	Life Expectancy	+	–	ambiguous
Economic	Income	+	+	+
	inflation			
	Banking Sector Growth	+	+	+
	Social Security	–	–	–
	Gini Coefficient	ambiguous	ambiguous	ambiguous
Institutional	Rule of Law	+	+	+
	Bureaucratic Efficiency	+	+	+
	Corruption	+	+	+

Source: Beck and Webb (2004)

Source: Beck, Thorsten and Webb, Ian (2002), "Determinants of Life insurance Consumption Across Countries". World Bank and International Insurance Foundation, mimeo.

of prospective policyholders. The domestic private and foreign companies have also been offering new products to prospective clients, including unit linked policies,[12] retirement schemes through new distribution channels such as Bancassurance,[13] which has increased its share in recent years. Notably, the increase in share, no matter how gradual, bodes well for instilling competitive rates and products in the industry. The entry of two new domestic private companies in CY09 is an encouraging sign for increasing market penetration, given the large untapped market potential (**Figure 6.2**). In 2009, with a view to curb the tendency of illustrating unrealistic and excessively optimistic rates of return by life insurance companies to boost their sales of unit-linked policies, SECP framed comprehensive guidelines to enhance transparency, provide better understanding of the product to prospective policyholders, and enable them to make an informed decision.[14]

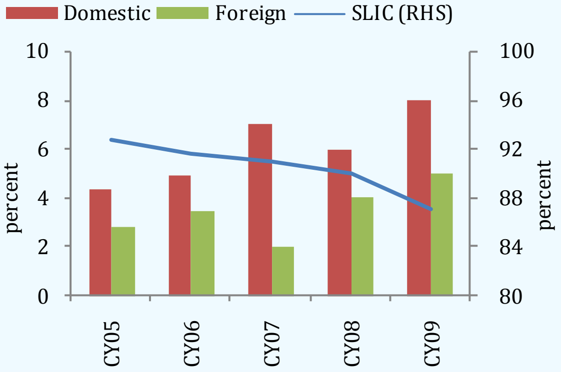
[12] The profits in a Unit-linked policy are determined in a manner similar to a conventional insurance policy, but instead of being distributed, these profits are pooled in a fund and then invested in stocks or bonds. Details in Box 10.4, 'Unit-linked Insurance Products" in Chapter 10, FSR 2006.

[13] In this method, a bank and an insurance company mutually agree to use a bank's distributive channels or branches to sell insurance products. Details in Box 10.3, "Bancassurance in Pakistan" in Chapter 10, FSR 2006.

[14] SECP Circular 39/2009.

These guidelines are intended to pave the way towards bringing consistency and standardization resulting in enhanced confidence of the policyholders. These guidelines became effective from 1st January 2010, and all new products launched by life insurers and family takaful operators are now following these guidelines. For new policies of existing products, the illustrations have been modified to fall in line with these guidelines, while there was no restriction on the sale of these products during the transition period, whereas insurers were asked to take step to modify the illustrations as early as possible, but not later than 31st March, 2010.

Figure 6.2: Share in Life Insurance Assets

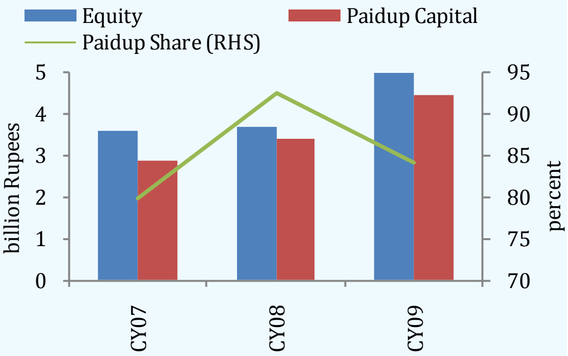


Source: Annual Audited Accounts of Life Insurance

6.4.1 Capital Structure of Life Insurance

With the introduction of 2 new companies in CY09, the total capital base of the life insurance sector has improved significantly (**Figure 6.3**). The equity base of life insurance companies increased by 45 percent YoY and the paid-up capital level also grew by a healthy 14.8 percent in CY09. Overall, the paid-up capital constitutes a share of 84 percent in total equity, which is indicative of a strong capital base and consequently the enhanced resilience and capacity of these companies to absorb adverse shocks and developments. Increased profits have also served to strengthen the level of reserves in total equity.

Figure 6.3: Capital Structure of Life Insurance

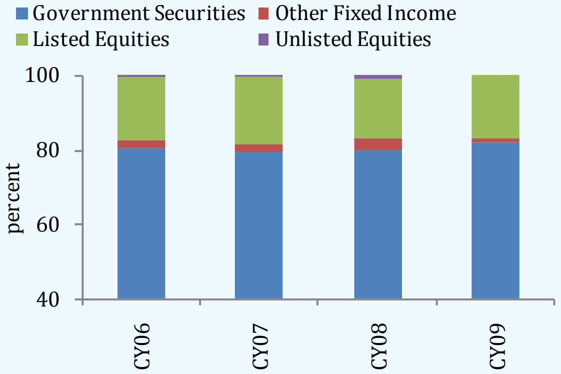


Source: Annual Audited Accounts of Life Insurance

6.4.2 Investment Structure of Life Insurance

The investment portfolio of life insurance companies constitutes 80 percent of their total assets. As shown in **Figure 6.4**, these companies generally prefer investing in risk-free government securities, with the share of such investments accounting for 82.0 percent of total investments. The long-term nature of life insurance policies is commensurate with investments in longer-tenor government securities such as Pakistan Investment Bonds, which constitute 50 percent of their total investment in government securities. Also, with the revival of the equity market in 2009, the share of investments in listed equities has also registered a moderate increase to reach 17.0 percent of total investments.

Figure 6.4: Investment Portfolio of Life Insurance

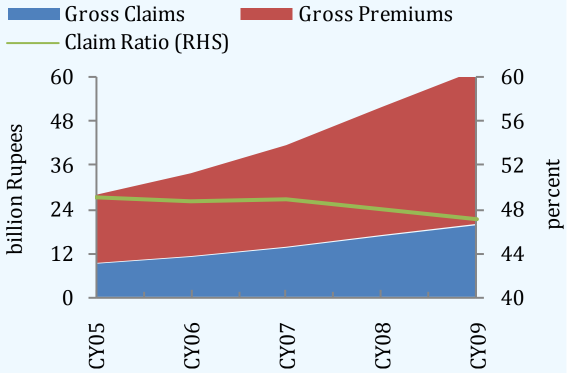


Source: Annual Audited Accounts of Life Insurance

6.4.3 Life Insurance Business – Claims and Premiums

The life insurance industry witnessed a growth of 20 percent in gross premiums in CY09 (**Figure 6.5**), as against 26 percent in CY08. This growth in premiums can be attributed to the increased outreach of life insurance business in recent years, in response to the growing demand for life insurance products on account of relatively improved awareness and their dual role as a long-term savings instrument. Furthermore, with the launch of two new life insurance companies and Bancassurance distribution channel, such an increase in premiums is indicative of substantial untapped market potential.

Figure 6.5: Gross Premium and Claims



Source: SECP

Notably, life insurance claims also recorded a growth of 18 percent in CY09. However, with the growth in premiums exceeding that in claims, the claims ratio itself declined marginally from 47.4 percent in CY08 to 46.4 percent in CY09. More importantly, there has been a considerable reduction in the claims ratio if compared to the level prevalent in the earlier part of the decade. The average claim ratio for the period CY01-05 was 57 percent and it has been declining since then. As newer and investment oriented (unit linked) policies are introduced by insurance companies, gross claims are expected to continue to reduce in view of the prospect of relatively higher returns paid on the maturity of such policies.

6.4.4 Life Insurance Financial Soundness

With an increase in the number of companies from 5 to 7, the capital to total assets ratio of the life insurance industry has marginally increased from 1.8 percent in CY08 to 1.9 percent in CY09, which also led to a significant growth in the equity base by 44.9 percent **Table 6.5**.

Table 6.5: Financial Soundness Indicators of Life Insurance Sector

percent

Category	Formula	2006	2007	2008	2009
Capital Adequacy	Capital/Total Assets	1.7	1.5	1.8	1.9
	Growth Rate of Equity	28.9	40.4	2.0	44.9
	Growth Rate of Assets	15.4	17.5	11.6	6.8
Asset Quality	Investment income/net Premiums	73.1	78.3	-1.9	0.2
Operating Ratio	Net Claims Ratio = Net claims/Net Premium	49.5	48.5	47.4	46.4
	Expense Ratio = Management expenses/Net premium	32.1	34.7	37.2	41.9
Earning and Profitability	ROA = profit/total assets	0.4	0.9	-0.1	0.4
	Investment Income/Investment assets	12.6	9.7	-0.4	0.0
Reinsurance and Actuarial Issues	Risk Retention Ratio =Net premium\gross premium	96.8	96.8	96.9	97.2

Source: Annual Audited Accounts and SECP

Despite a decline in the claims ratio in CY09, the expense ratio has deteriorated considerably, from 36.8 percent in CY08 to 41.9 percent in CY09. Increase in the expense ratio is indicative of the higher cost incurred by an insurance company in acquiring premiums. The considerable improvement in earnings and profitability is reflected in the improved ROA at 0.4 percent in CY09. Similarly, the risk retention ratio also increased in CY09 indicating higher retention of insurance risks by the companies in order to avoid the high cost of reinsurance. Higher insurance retention may lead to an increased claims ratio in future;

however, with the rising capital base, the companies are well-equipped to bear the cost of expected loss in the life insurance market.

6.5 Performance Review of Takaful

Takaful, the shariah-compliant mode of insurance has seen substantial growth since its introduction in 2006 as it aimed to provide Islamic mode of coverage and product innovation in the industry. Like all businesses, Takaful is also market driven and requires a multi-channel distribution outreach to be sold effectively. Due to its inherent Islamic and ethical element, Takaful has a stronger appeal to an individual rather than to a business, therefore a B2C (business to customers) selling approach would have been the right model for its launch. But the concept of retail insurance is still at a nascent stage, such that even in Malaysia, Takaful is approximately 10 to 12 percent of the total insurance market. However, in its early stage of development and with a small starting base, overall takaful assets have increased by 47 percent in the last three years (2007-09). Given the growing demand for shariah-compliant financial products in the country, Takaful has been well received by prospective clients to some extent and gross takaful contributions increased by 450 percent in 2007-09 period (**Table 6.6**). In CY09 alone, gross contributions increased by 83 percent. However, the takaful claim ratio has been relatively higher initially as compared to the conventional insurance companies. Encouragingly however, the claims ratio has started to decline, from 95 percent in CY07 to 40 percent in CY09. It is expected that with enhanced coverage of takaful and increased contributions, the claims ratio will further reduce over time. Similarly, The Takaful Rules, 2005 are being reviewed to be replaced by a new set of Takaful Rules, 2011 with the objective of removing the existing anomalies and addressing the areas which are silent on certain provisions.

Table 6.6: Overview of Takaful Insurance

million Rupees

	2007	2008	2009
Assets	2049	2573	3028
Equity	1047	1875	1908
Investments	330	1027	1055
Gross Contribution	265	799	1463
Net Contribution	195	469	1160
Gross Claims	253	389	584
Underwriting results	-54	-103	-62
Claim Ratio	95	49	40
Profitability	-36	-147	-103

Source: Annual Audited Accounts and SECP

6.6 Performance Review of Non Life insurance

The non-life insurance sector plays an important role in the indemnification of losses emanating from various events, other than death. Similar to life insurance, the non-life insurance sector also performed well in CY09 in comparison with CY08 **Table 6.7**). With an increase in asset base by 7.9 percent YoY due to increased non-life business measured by the rise in gross premiums, the non-life sector has made a remarkable recovery from a loss of Rs. 4.0 billion in CY08, to a profit of Rs. 5.9 billion in CY09. Much of this recovery is attributed to improved returns on investment and revival of gross premiums.

Table 6.7: Overview of Non Life Insurance Sector

billion Rupees

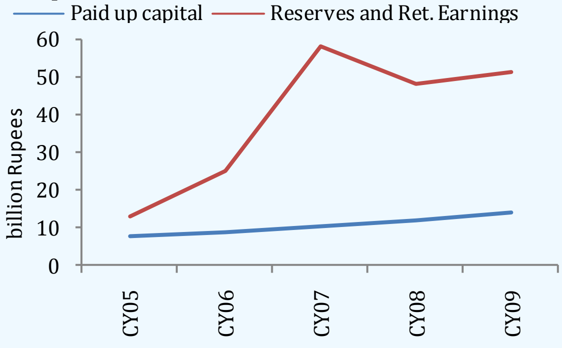
	2007	2008	2009
Assets	121.7	114.5	123.6
Equity	72.7	67.3	71.4
Investments	69.6	60.2	63.1
Gross Premiums	38.2	41.8	43.4
Net Premiums	23.1	26.3	25.2
Gross Claims	17.3	26.2	21.2
Expenses	7.4	8.8	9.5
Profitability	56.2	-4.0	5.9

Source: SECP

6.6.1 Equity Structure of Non Life Insurance

The capital structure of the non-life insurance sector has improved considerably over the past four years in response to the regulatory requirements set forth by the SECP, with the minimum paid-up capital of the companies set at Rs. 200 million for CY09. The SECP has prepared a roadmap to increase paid-up capital requirements to Rs. 300 million by CY11. The **Figure 6.6** shows the trend in paid-up capital, reserves and retained earnings of the non-life insurance sector over the last few years. Unlike the life insurance sector with a paid-up capital to total equity share of around 82.0 percent, the share of paid-up capital in the non-life sector is 19.0 percent, whereas reserves and retained earnings account for 71 percent of total equity.

Figure 6.6: Equity Structure of Non Life Insurance Companies

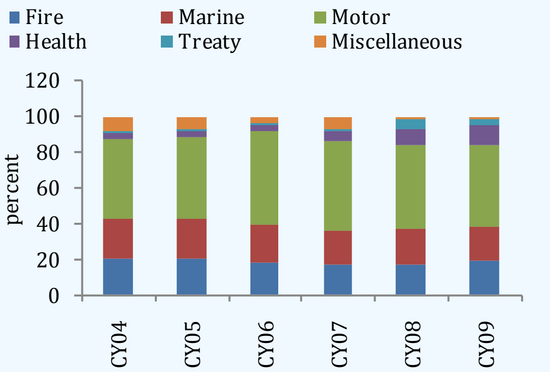


Source: Annual Audited Accounts of Non Life Insurance

6.6.2 Premiums and Claims of Non Life Insurance

Gross premiums of non-life insurance showed a slight recovery in CY09, however owing to rising expense of reinsurance ceded, overall net premiums declined in CY09. **Figure 6.7** shows the share of net premiums of different categories of non-life insurance. Premiums from motor insurance continue to hold the largest share, despite a sharp reduction in the provision of automobile finance by banks in recent years which may affect the motor portfolio of insurance companies in coming years, and which has caused the actual proportion to decline from 50 percent in CY07 to 46 percent in CY09. On the other hand, premiums for both fire and health insurance have registered an increase from 16.0 percent to 19.0 percent and from 5.0 percent to 11.0 percent in CY09 respectively.

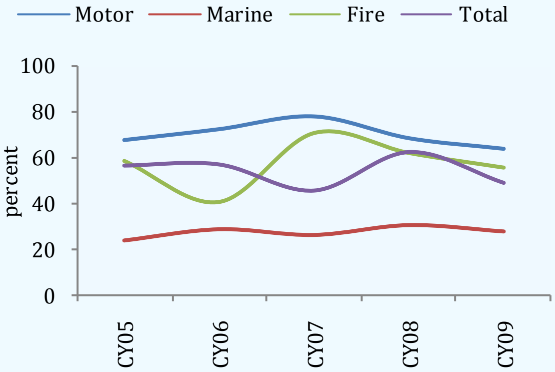
Figure 6.7: Composition of Net Premiums



Source: Annual Audited Accounts of Insurance Companies

The claim ratio of the non-life sector decelerated to 58.2 percent in CY09, as against 60.1 percent in CY08. The bulk of the claims was on account of motor insurance, which posted a claim ratio of 64 percent in CY09 (**Figure 6.8**), despite the declining trend evidenced in recent years. The claim ratio of non-life insurance is also assumed to be directly correlated with real economic activity and political / social conditions. On account of the prevalent security situation in the country, the non-life claim ratio is expected to remain high, which may result in increasing the cost of insurance for policy-holders, in addition to affecting the capital base of the sector.

Figure 6.8: Claim Ratio



Source: SECP

6.6.3 Concentration in Non-Life business

One of the significant features of non life insurance business is the level of concentration in total gross premiums generated by the industry. Despite the fact that the concentration levels have declined in 2009, however, within the domain of private and foreign non life companies, the amount of premiums accumulated by the top 10 companies account for 70.7 percent of total non-life premiums, as against 75.7 percent in year 2007[15] (**Table 6.8**). Interestingly, the share of NICL in total non-life premiums increased from 10 percent in CY07 to 14 percent in CY09, indicating a proportionately significant increase in the insurance of public sector assets in recent years.

Table 6.8: Concentration in Non Life Business

share and HHI (absolute value)

	2007	2008	2009
Top 5	66	61	62
Top 10	76	70	71
NICL	10	13	14
HHI	1334	1552	1479

Source: SBP Calculations

6.6.4 Performance of State Owned Insurance

The National Insurance Company (NICL) was created in 1976 with the purpose of providing non life insurance coverage to government entities. Since its creation, NICL has been one of the few profit-making government owned entities. The increased economic activity on account of expansionary monetary stance during 2003-07 also increased the business of NICL, leading to higher profitability and strong capital base. Despite the grim macroeconomic outlook in recent years (2007-09), the asset base and profitability of NICL has seen considerable growth (**Table 6.9**). This growth is reflective of increased insurance premiums from the government sector.

Table: 6.9: Overview of NICL

billion Rupees

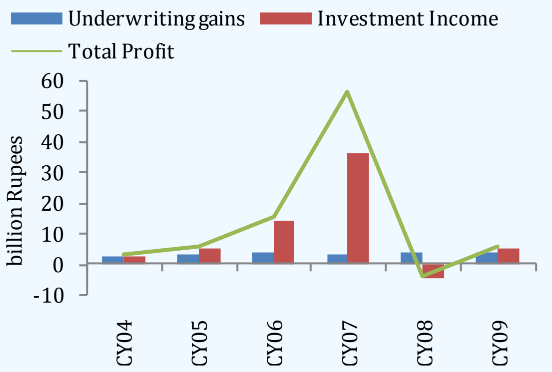
	2007	2008	2009
Assets	21.5	22.2	26.8
Equity	13.3	14.1	15.8
Investments	10.3	10.9	10.9
Gross Premiums	4.3	5.4	6.0
Net Premiums	2.4	2.9	3.0
Gross Claims	0.2	1.0	0.9
Expenses	0.2	0.3	0.4
Profitability	2.2	1.0	2.5

Source: Annual Audited Accounts of NICL

6.6.5 Non Life Insurance Profitability

The underwriting practices of the non-life business witnessed no significant change in CY09. However, investment income that contributed to a loss of Rs. 4.7 billion in CY08 on account of sluggish equity market performance, yielded profits of Rs. 4.8 billion in CY09 as shown in **Figure 6.9**. Similarly, the overall profitability of the insurance sector recovered from a loss of Rs. 4.1 billion in CY08 to Rs. 5.9 billion in CY09. The rationale for the significant increase in profits is mainly due to rising investment income coupled with low impairment of investments in capital market instruments for CY09.

Figure 6.9: Major Sources of Profit



Source: Annual Audited Accounts of Insurance Companies

6.6.6 Non-Life Insurance Financial Soundness

The non-life insurance sector plays an important role in the indemnification of losses emanating from various events, other than death. Similar to the life insurance, the performance of the non-life insurance sector was also reasonable in CY09 in comparison with CY08. With an increase in asset base by 7.9 percent YoY due to increased non-life business measured by the rise in gross premiums, the non-life sector has made a recovery from a loss of Rs. 4.0 billion in CY08 to a profit of Rs. 5.9 billion in CY09. Much of this

[15] Almost all of the insurance business pertaining to the federal and provincial governments is directed towards the state-owned insurance company (NICL).

recovery is attributed to improved returns on investment and revival of gross premiums (**Table 6.10**).

Table 6.10: Financial Soundness Indicators for Non Life Insurance Sector

percent

Category	Indicator	2006	2007	2008	2009
Capital Adequacy	Capital / Total Assets	11.0	7.8	10.3	10.3
	Paid-up Capital / Total Equity	32.0	14.1	18.0	19.5
	Growth rate of Equity	59.3	72.2	-9.8	8.8
	Growth rate of Assets	34.8	67.1	-5.9	7.9
Operating Ratio	Underwriting Expense / Gross Premium	15.6	14.3	15.7	15.4
	Claim Ratio	57.1	64.4	60.1	58.2
	Expense Ratio	8.0	18.9	19.2	21.4
	Combined Ratio	65.1	83.3	79.3	79.6
Earning and Profitability	Investment Income/ Net Premiums	71.0	158.7	-18.2	19.7
	Growth Rate of Profits	154.8	229.6	-107.3	246.6
	ROA	20.6	46.3	-3.6	4.9
Reinsurance and Actuarial	Risk Retention Ratio	50.0	60.4	62.9	58.2

Source: SECP

With an increase in profitability and capital base, the overall non life financial soundness indicators have improved in CY09 (**Table 6.10**). The equity base of the companies witnessed an improvement of 8.8 percent in CY09. Similarly the claims ratio also improved marginally to 58.2 percent. However, the expense ratio has deteriorated from 19.2 to 21.4 percent on account of increased cost of premium accumulation which has also increased the combined ratio. Moreover, with the revival of the equity market, the ratio of investment income to net premiums has also improved to 19.7 percent in CY09 as against losses faced on investment returns in CY08. Similarly, the Return on Assets (ROA) of the non life companies has improved substantially to 4.9

Like many other developing countries, the size of Pakistan's insurance industry is relatively small in proportion to its GDP, and the insurance density is a mere 6.5 USD per capita. Despite the economic recession in the country and the reduced purchasing power of the consumers, if the B2C (Business to Customers) selling approach is adopted by the insurance companies and small ticket size products are developed which meet the demand in the retail market, the insurance density and penetration in the country can increase dramatically, thus providing an impetus to the economy. The major challenge facing the insurance industry today is the economic slowdown in the country. The growth and development of the insurance industry is directly dependent on all these factors. The sector is under stress with rising expense ratios being one of the reasons, and is focusing mainly on the agency model[16] of distribution which is an expensive way of selling insurance.

Pakistan has a huge population with immense potential for growth in the personal lines of the insurance business. Since the domestic insurance industry has been mainly focusing on the Commercial Lines of business, this huge potential still remains untapped. Unlike the more developed markets, only the B2B (Business to Business) selling approach is prevalent which has become expensive and has begun to erode profits and reserves. In order to enhance its outreach, the industry must reposition itself and change its business model.

[16]The agency model of distribution / selling of insurance products refers to selling of insurance via agents to prospective policyholders.

6.7 Performance Review of Reinsurance Sector

Reinsurance provides insurance coverage to insurance companies, and is usually necessary for covering large risk exposures. Pakistan has one state-owned reinsurance company (Pakistan Reinsurance Company Limited, PRCL) which undertakes non-life reinsurance coverage. Until 2005, it was compulsory for Pakistan-based non-life insurance companies to cede certain proportion of reinsurance business to PRCL. Even now, it continues to be obligatory for non-life insurers to offer at least a 35 percent share to PRCL in their treaties.

Table 6.11: Reinsurance Business in Pakistan

Amount in million Rupees

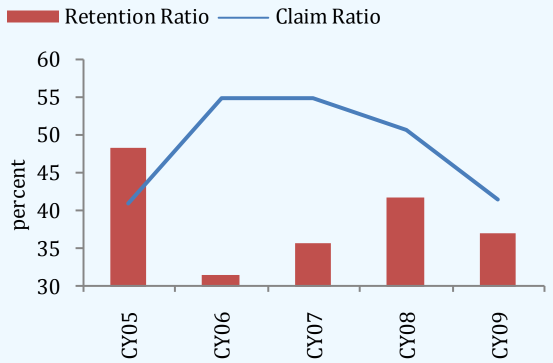
	CY02	CY03	CY04	CY05	CY06	CY07	CY08	CY09
Paid up Capital	450	450	450	450	450	540	3,000	3000
Reserves and Retained earnings	796	981	1,306	1,789	2,280	5,827	4,266	3,504
Investments	1,905	1,886	2,719	2,873	3,588	6,412	5,459	5,481
Gross Premium	3,500	4,697	5,241	4,160	4,499	4,731	4,555	5,839
Net Premium	1,588	1,447	2,289	2,005	1,415	1,695	1,896	2,170
Net Claims incurred	848	1,011	1,329	823	777	931	962	904
Management Expenses	108	140	134	171	146	158	250	231
Net Profit after tax	297	333	325	594	672	3,727	886	269
Total Assets	4,192	6,232	6,613	5,634	6,464	10,447	12,528	12,372

Source: Annual Audited Accounts of Pakistan Reinsurance Company Limited

Despite a significant gross premium growth of 28 percent in CY09, PRCL registered a profitability decline of 69 percent in CY09 on account of rising reinsurance expense. The total assets exhibited a marginal decline of 1.2 percent as shown in **Table 6.11**.

The **Figure 6.10** highlights the trend of reinsurance retention and claims ratio. The retention ratio has lowered significantly from CY05, however the claims ratio shows a significantly declining pattern since CY07, indicating the incidence of large risks (held with PRCL) to be less frequent (42 percent) than the claims ratio of 57 percent faced by the non life insurance market.

Figure 6.10: Reinsurance Retention and Claim Ratio



Source: Annual Audited Accounts of Insurance Companies

6.8 Conclusion

The insurance sector in Pakistan has undoubtedly a huge potential which has not been realized as yet. The sector can be effectively utilized to provide support to the economy despite its relatively small size and low penetration. The industry can enhance its outreach and penetration in the market by leveraging state of the art technology and accessing multiple channels of distribution.

While both SLIC and NICL have a virtual monopoly in life and non-life insurance business respectively, it is notable to see the declining level of concentration in the life and non-life business. This concentration of business is clearly visible in the top 5 and top 10 companies in the non-life sector, where the total number of companies was 34 at end-CY09. Clearly, the non-life sector has a large number of small players, indicating market fragmentation. Consolidation through mergers and acquisitions would be helpful in enhancing the aggregate financial position of the sector.

Notably, the pace of implementation of financial sector reforms has been rather gradual in the insurance sector, and the apparent lack of direction can partly be attributed to the dilution of responsibilities given the joint regulatory role of the Ministry of Commerce with the SECP. It is the only component of the financial sector with a predominant ownership of the government in all three spheres i.e. life (SLIC), non-life (NICL) and re-insurance (PRCL).

While the presence of the government was an important pre-requisite for the development of the insurance sector in the country, it now needs to be phased out in a gradual manner by allowing market forces to take hold, the need for private sector companies to increase outreach and enhance customer awareness about the significance of insurance not only in its capacity for risk indemnification, but also as a lucrative savings instrument.

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