5 Review of Insurance Industry

The insurance industry plays an important role in the financial system by providing indemnification of financial risk in the economy and also serves as an institutional investor for both capital and money market instruments.

Like many other developing countries, the size of Pakistan's insurance industry is relatively small in proportion to its GDP. **Table 5.1** shows the penetration of insurance as a ratio of gross premiums to GDP. The total size of insurance business in various countries depends on the nature of insurance markets, regulatory environment, accounting procedures and financial development. Moreover, the demand for insurance depends on real disposable income of the prospective policyholder, the individual's preference about the need for financial security, economic environment, interest rates, inflation and insurance premium rates. Furthermore, cultural and religious aspects of a country may also affect the development of insurance business. The insurance markets in developing countries are characterized as suppliers of insurance services as supply usually exceeds demand in these economies. In case of Pakistan where 67.5 percent of the population lives in rural areas and given the low per capita income, the insurance industry has not been able to create sizeable demand for its services.

Table: 5.1 Insurance Penetration in CY2000

Gross premiums as percentage of GDP at market prices

Countries	Total	Non-Life	Life
USA	8.8	4.3	4.5
Brazil	2.1	1.8	0.4
Mexico	1.7	0.9	0.9
UK	15.8	3.1	12.7
China	1.8	0.7	1.1
India	2.3	0.6	1.8
Malaysia	3.7	1.6	2.1
Indonesia	1.2	0.6	0.5
Nigeria	0.7	0.5	0.1
Kenya	2.6	1.9	0.7
Pakistan*	0.5	0.3	0.2

Source: IRDA India Year Book 2001
* = Life insurance data from balance sheets of life insurance companies. Non life data from Insurance Association of Pakistan

5.1 Structure of Insurance Industry

The insurance market in Pakistan is broadly categorized in two main classes, life insurance and non-life insurance. Moreover, the country has one reinsurance company that carries out reinsurance activities and further spreads the risks. The insurance market is highly concentrated in urban areas and many insurance companies are subsidiaries of large industrial groups that were created mainly to reduce the outflow of funds in the form of premiums, to manage the risks of these industries and to generate profits out of it. At present there are 54 insurance companies out of which 49 companies offer non-life insurance and 5 offer life insurance services (see **Table 5.2**). The non-life insurance industry also includes six companies that also provide health insurance coverage.

Table 5.2: Number of Insurance Companies

	CY00	CY01	CY02	CY03
Non-Life	**58**	**52**	**52**	**49**
State Owned	1	1	1	1
Private				
Domestic	53	47	47	45
Foreign	4	4	4	3
Life	**5**	**5**	**5**	**5**
State Owned	1	1	1	1
Private				
Domestic	2	2	2	2
Foreign	2	2	2	2
Total	**63**	**57**	**57**	**54**

Source: Securities and Exchange Commission of Pakistan

The total assets of overall insurance industry have grown by 14.5 percent in CY02 and further recorded a growth of 15.4 percent in 2003. **Table 5.3** shows the asset shares of various classifications of insurance companies in the total assets of the insurance industry. Life insurance industry has a disproportionately higher share because of State Life insurance Corporation (SLIC). SLIC alone had a 74.0 percent share of total assets in CY01 that decreased to 70.5 percent in CY03. Similarly, the non-life insurance industry is dominated by a government owned insurance company, i.e. National Insurance Company whose share in total assets has decreased from 10.3 percent in CY01 to 9.6 percent in CY03. The reason for decline in the share of state-owned non-life insurance service provider is due to the privatization process, whereas the decrease in share of state-owned life insurer is mainly due to increased share of private domestic companies. Overall the assets to GDP ratio of the insurance industry has increased from 2.6 percent in CY01 to 3.0 percent in CY03. If the assets of State Life Insurance are excluded, the assets to GDP ratio becomes 0.7 percent in CY01 and 0.9 percent in CY03. Given the smaller ratios, it is reflected from **Table 5.3** that there is almost a monopolistic structure in life insurance industry. It is important to note that both of these state-owned insurance service providers were created in the post nationalization period.

Table 5.3 Asset Structure of Insurance Industry

percent share

	CY01	CY02	CY03
Life	**75.8**	**76.0**	**74.3**
State Owned	74.0	73.4	70.5
Private			
Domestic	1.1	1.5	3.1
Foreign	0.7	1.1	0.7
Non-Life	**24.2**	**24.0**	**25.7**
State Owned	10.3	9.7	9.6
Private			
Domestic	13.3	13.3	15
Foreign	0.6	1.0	1.1
Total	**100.0**	**100.0**	**100.0**
Total Assets (million rupees)	110,077	125,770	144,884

Source: Companies' Balance Sheets

5.2 Overview of Non-Life Insurance industry

The number of companies offering non-life insurance products including health insurance has decreased from 58 in CY00 to 49 in CY03. Out of the above, 7 non-life insurance companies were ceased from underwriting new insurance business during CY03 due to shortfall in their paid-up capital. Moreover, the number of foreign non-life insurance companies has also shrunk from 4 in CY00 to 3 in CY03.

With the existence of state-owned insurance company, the private domestic insurance companies offer various sets of insurance policies[1]. These insurance policies cover the assigned risk for a maximum of one year and can be renewed afterwards. With the implementation of financial reforms and changes in the structure of insurance companies, the assets of non-life insurance companies has been growing at an average rate of 18.6 percent per annum, however, the growth rate in CY03 accelerated by 23.4 percent over CY02 as shown in **Table 5.4**.

Along the growth of assets, another significant development in non-life market is the accumulation of stock of investment, which is also a major component of assets owned by the insurance companies. These investments are usually made in government securities, corporate debt market instruments such as TFCs and the stock exchanges. The stock of investment grew by 36.2 during CY03 after witnessing a fall in the preceding two years that accounted for decline of 11.5 and 3.5 percent in CY02 and CY01 respectively. This decline in investment stock was due to cover interest rate risk and to benefit from capital gains. Since the core business of an insurance company is to underwrite risk and to hedge against claims, the income is earned by investing the premium amount in various investment options.

[1] The insurance policy is an undertaking between the insurer and the insured and serves as a legal document that defines circumstances in which the claim amount must be paid to the insured given that proper care has been taken by the insured to avoid the losses that have been occurred.

Table 5.4: Non Life insurance Business in Pakistan

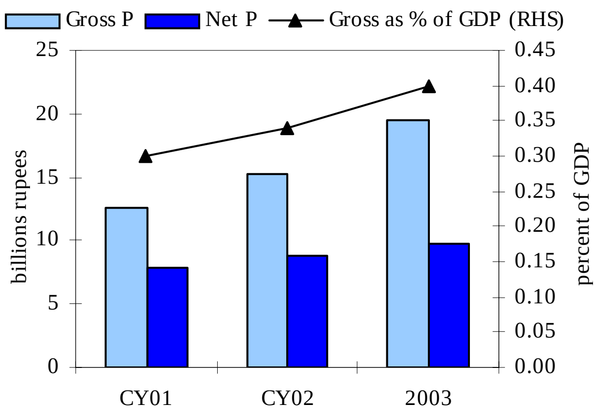
million Rupees

	CY00	CY01	CY02	CY03
Paid up capital	2,947	5,005	5,477	5,965
Reserves and Retained earnings	6,980	3,330	4,504	9,262
Investments	12,548	12,114	10,720	14,605
Gross Premium	11,713	12,643	15,221	19,571
Net Premium	8,038	7,835	8,810	9,740
Net Claims incurred	3,965	5,088	4,949	5,266
Management expenses	2,156	2,098	2237	2583
Net Profit after tax	1,727	1,514	2,731	2,642
Total Assets	22,362	26,534	30,207	37,266

Source: Balance Sheets of Non-Life Insurance Companies and the Insurance Association of Pakistan Year Book

Moreover, given the general principle of insurance i.e. probability of incidence of various claims simultaneously is low, the return on investment normally covers the cost of claims and other expenses of the company. The amount of insurance premium depends on the nature of the risk factors associated with the insurance policy. The gross premiums and net premiums of the insurance industry show an increasing trend as shown in **Figure 5.1.** Moreover, the percentage of gross premium[2] to GDP also showed an increasing trend over the period of assessment. This trend is indicative of growth of insurance penetration in the economy as discussed in **section 5.1**.

Figure 5.1: Composition of Non-life Premiums



5.2.1 Composition of Non-Life insurance Industry

The number of foreign non-life insurance companies decreased from four to three during CY03. This is mainly because of losses incurred by these companies. Furthermore, the losses incurred by foreign companies led towards mergers with domestic companies. **Table 5.5,** highlights the distribution of some macro indicators between private domestic, foreign and state-owned insurance companies. The ratios show that the share of private domestic non-life insurance companies is increasing over CY01-CY03. The share of private domestic companies in CY01 was 54.9 percent of the total assets of non-life insurance companies that increased to 55.5 percent in CY02 that further increased to 58.2 percent in CY03.

Table 5.5: Composition of Non-Life Insurance Investments and Assets

percent share	CY01			CY02			CY03		
	Assets	Investment	Property	Assets	Investment	Property	Assets	Investment	Property
State owned	42.4	58.9	46.5	40.4	48.6	43.7	37.5	54.1	52.1
Domestic	54.9	40.7	53.4	55.5	49.2	56.3	58.2	45	47.9
Foreign	2.6	0.4	0.0	4.1	2.1	0.0	4.3	0.8	0.0
Total share	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Amount in million rupees	26,534	12,113	982	30,207	10,720	931	37,266	14,604	1,162

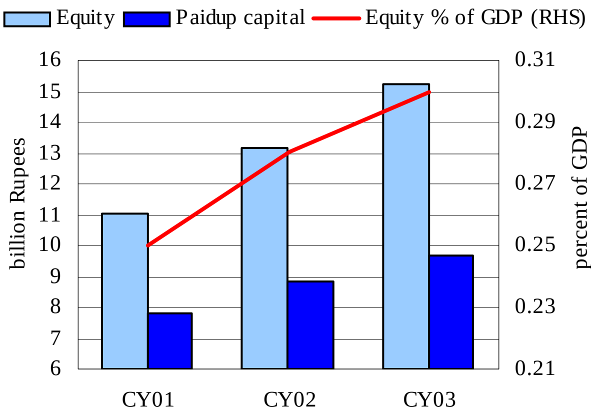
Source: Balance Sheets of various non-life insurance companies. 2002 / 2003

[2] The Gross Premium is the underwriting premium that is to be paid to an insurance company by the insured so as to initiate the insurance contract. The Net Premium is the gross premium less reinsurance ceded for the un-expired risk.

5.2.2 Capitalization Structure of Non-Life Insurance Industry

One of the main objectives of regulatory bodies of financial institutions is to strengthen the financial health of organizations that are the part of the system. The Insurance Ordinance has emphasized heavily on the paid-up capital of insurance companies. A high capital base facilitates an insurance company to undertake huge financial risks and to expand its business, to be innovative, to maintain a competitive stance and hence to enable the domestic insurance market to meet the challenges of rapidly integrating financial markets of the world economy.

Figure 5.2: Capitalization of Non-life Insurance



The **Figure 5.2** shows aggregate paid-up capital and equity of non-life insurance companies. Since the SECP has made compulsory for insurance companies to increase their minimum paid-up capital limit to Rs 50 million by the end of CY02 and further to Rs 80 million by the end of CY04, the volume of paid-up capital has shown an increasing trend. **Table 5.6** shows that the share of equity of private domestic companies has marginally decreased from 42.9 percent in CY01 to 40.8 percent in CY02 because of higher accumulated losses faced by majority of non-life insurance companies as a consequence of September 11 events, however, it increased again to 42.7 percent in CY03. The share of state-owned non-life insurance company towards total equity saw an opposite picture of this increasing trend, whereas, foreign companies witnessed a gradual increase in their share from 2.7 percent in CY01 to 4.3 in CY03. Moreover, the percentage of total equity to GDP has shown an increasing trend. Generally, the accumulation of reserves has helped the companies to achieve higher equity that has also enabled the companies to withstand financial losses.

Table5.6: Capitalization of Non-Life Insurance Companies

percent share

	CY01	CY02	CY03
Paid-Up Capital			
State Owned	39.9	36.5	33.5
Domestic	57.6	60.9	60.1
Foreign	2.4	2.6	6.4
Total share	100.0	100.0	100.0
Total (million rupees)	5,005	5,477	5,965
Equity			
State Owned	54.4	55.7	53.0
Domestic	42.9	40.8	42.7
Foreign	2.7	3.5	4.3
Total share	100.0	100.0	100.0
Total (million rupees)	11,250	13,284	15,316

Source: Balance Sheets of various Non-Life Insurance Companies, 2002-03

5.2.3 Structure of Premiums and Claims of Non-Life Insurance

The Premiums are the input for insurance business. The core underwriting business of an insurance company is considered to be profitable if the accumulated premiums are greater than the sum of the management and underwriting expenses and the net claims payments. The non-life insurance companies have experienced underwriting losses[3] over a period of time. In CY01, 12 companies registered underwriting losses, 13 companies in CY02 and 11 companies in CY03. This is mainly due to the increased management and reinsurance expenses. The loss ratio as a percentage of net claims to net premiums is actually the premium returned to the policyholders as an insurance benefit was 64.9

[3] Underwriting loss is the excess of expenses, net commission and net claims over the net premiums accumulated by an insurance company.

percent for CY01, 56.2 percent in CY02 and 54.1 percent in CY03. The implication of a higher loss ratio is that it directly affects the underwriting profit generated by the company. Lower or negative underwriting performance will decrease the contribution towards total stock of investment and results in a lower yield on return on investments.

The insurance principle suggests that higher claim ratio describes favorable insurance performance since companies are honoring the claims. Moreover, it is also used as a marketing tool but in case of Pakistani market in which the paid-up capital and equity base of firms is relatively small, consistent high loss ratios create difficulties for the insurance companies and increase the chances of bankruptcy. Besides higher claims ratio, another major expense of insurance companies is reinsurance. The purpose of reinsurance is to further cover the risks taken by the insurance companies so that the burden of loss can be minimized. The events of September 11 severely affected the insurance industry. The world's largest reinsurers such as Lloyds, Swiss Re, Munich Re, and Berkshire Hathaway increased the reinsurance premium rates. Moreover, Pakistani market had to pay even higher rates because of the Afghan war. Given this situation, the government created a task force, which recommended the formation of a fund by the government of Rs. 500 million as seed money. The maximum amount that can be given to the beneficiary company would be 25 percent of the sum assured or Rs. 100 million or whichever is less, however such a fund was not created.

According to section 41 of the Insurance Ordinance 2000, insurance companies are required to have reinsurance agreements from "A" rated companies worldwide so as to safeguard the interest of the policyholders. This obligation has increased the cost of reinsurance. The reinsurance expense faced by the non-life industry, as a ratio of gross premiums was 36.1 percent in CY02 and 40.7 percent in CY03 and the picture becomes even worse if compared with net premium, which is the actual premium acquired by the insurance company. The ratio of reinsurance expense to net premium was 62.2 percent in CY02 that further increased to 81.7 percent in CY03. Given these high ratios, it has become very difficult for small insurance companies to survive in the market. If companies do not reinsure their businesses, the whole risk will have to be borne by themselves which is equally worse given the financial health of companies and it may not be acceptable to the regulators and stakeholders.

Table 5.7 Company wise Share in Total Net Premiums

percent share

	CY01	CY02	CY03
Adamjee Insurance	37.4	32.7	32.7
Askari Insurance	1.7	1.8	2.2
Century Insurance	0.7	1.2	2.2
EFU General Insurance	16.5	15.6	17.1
Habib Insurance	1.5	1.4	1.6
IGI Insurance	1.3	1.5	1.5
NJI Insurance	4.7	4.9	6.6
Premier Insurance	1.8	1.7	1.4
Shaheen Insurance	0.9	1.2	2.1
New Hampshire Insurance	3.0	2.1	2.6
Royal and Sun Alliance	2.6	1.9	2.6
National Insurance Company	17.1	22.7	16.2
Other companies	10.8	11.3	11.2
Total share	100.0	100.0	100.0
Net Premium (million Rupees)	7,835	8,810	9,740

Source: Balance Sheets of Various insurance Companies

The average growth rate of net premiums is around 12 percent per annum over the years CY01-CY03. The net premium of different companies may be seen from **Table 5.7**. The share of net premiums for private domestic non-life insurance companies has remained the same during CY01 to CY03 at around 78.2 percent. Despite the takeover of a foreign insurance company by a domestic insurance company, the share of foreign companies has increased from 4.2 percent in CY02 to 6.1 percent in CY03. The rise in net premium growth rates of foreign companies is due to increased business by New Hampshire Insurance Co. Ltd, and Royal and Sun Alliance Insurance company, whose share first decreased in CY02 before increasing in CY03, **(see Table 5.7).** Among the private domestic companies, Adamjee Insurance gets the bulk of the share and has shown consistent growth rate over the period CY01-CY03. EFU General Insurance has the second highest share. Its share has decreased modestly over the period of CY01-

CY02 and then it increased in CY03. Moreover, the share of National Insurance Company Limited (NICL) has also shown an increasing trend during CY02 and then it showed negative growth rate in CY03. Its share has decreased from 22.7 percent in CY02 to 16.2 percent in CY03, (see **Table 5.7**). The premiums acquired by NICL are highly dependent upon the allocation of insurance amount by the government bodies. This reduction in premiums is also due to the effects of privatization of different state owned enterprises.

Table 5.8 shows the percentage share of each category of insurance towards the accumulation of net premiums. The premiums of non-life insurance industry are broadly categorizes into fire, marine, motor liability, health and miscellaneous insurance. The motor insurance generated 41.2 percent of net premium in CY01 and 42.5 percent in CY03 (see **Figure 5.3**).

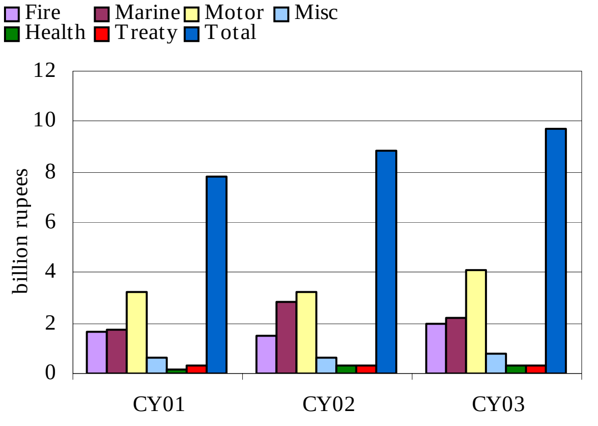
One of the main reasons of robust growth in motor insurance during CY03 is the availability of car financing schemes from banks and leasing companies. Marine insurance is primarily related to transportation of goods via sea. This business is directly related to the volume of trade and the incoterms followed by the importers. On the other hand, the growth of fire insurance premiums is directly linked to the growth of industries and construction activities. There are various sub divisions of miscellaneous insurance offered by insurance companies in Pakistan. These include insurance of cash in transit, cash in vault, burglary etc. Some insurance companies provide health coverage but currently it has a limited scope and often results in net claims in excess of net premiums due to which the claim ratio increased to 108.6 percent in CY03. This implies that the insurer had to pay more than it received resulting in an overall underwriting losses.

Table 5.8: Percentage Share of Net Premiums and Claims

percent share

	CY01	CY02	CY03
Fire			
Share of Premium	21.0	16.7	20.2
Share of Claim	11.8	14.3	12.8
Claim Ratio	36.4	48.1	34.4
Marine			
Share of Premium	22.6	32.5	23.0
Share of Claim	12.2	15.2	12.5
Claim Ratio	35.0	26.2	29.4
Motor			
Share of Premium	41.2	36.6	42.5
Share of Claim	62.1	52.6	56.1
Claim Ratio	97.9	80.7	71.4
Miscellaneous			
Share of Premium	8.5	7.2	8.3
Share of Claim	3.7	9.7	6.7
Claim Ratio	28.6	75.4	43.8
Health			
Share of Premium	2.3	3.2	3.2
Share of Claim	3	5.6	6.5
Claim Ratio	82.3	98.1	108.6
Treaty			
Share of Premium	4.5	3.8	2.9
Share of Claim	7.3	2.8	5.4
Claim Ratio	106.1	40.2	101.4
Total Net Premiums (million Rs)	7,835.3	8,810.3	9,740.5
Total Net Claims (million Rs)	5,087.6	4,948.6	5,265.8
Claim Ratio	64.9	56.2	54.1

Figure 5.3: Composition of Net Premiums



Treaty insurance is a proportional share of reinsurance that insurance companies keep with the reinsurance companies. Some times the limit of treaty exceeds the limit made available by the reinsurance company. Normally all the non-life insurance companies are required to cover at least 10 percent of their business through Pakistan Reinsurance Company Limited and the remaining is to be either borne by themselves or take reinsurance from other reinsurers. This requirement of compulsory cession to PRCL would be abolished on December 31, 2004.

5.2.4 Performance Analysis of the Non-Life Insurance Industry

The overall performance of non-life insurance industry for the period CY01-CY03 is shown in **Table 5.9**, which summarizes a set of indicators on the basis of operational and regulatory aspects of the insurance industry. The capital adequacy indicators deal with the regulatory aspect with emphasis on paid-up capital and total equity. The combined ratio is the sum of loss ratio and expense ratio. It is a measure of insurer profitability which does not consider investment income and takes into account only the income generated by core business of the insurance company.

The combined ratio for CY01 was 81.5 percent. This implies that the 81.5 percent of the insurer's accumulated premium is consumed in meeting underwriting expenses and in honoring claims. In such cases, the insurer has some ability to generate profits out of its core business since the ratio is less than 100 percent. The decreasing trend of combined ratio signifies the increase of premiums along the reduction in percentage share of claims and underwriting expenses out of total premiums.

Table 5.9: Ratio Analysis of Non-Life Insurance Industry

percent share

	CY01	CY02	CY03
Capital Adequacy			
Paid-up Capital / total Equity	44.5	41.2	38.9
Paid-up capital / Total Assets	18.9	18.1	16.0
Equity / Total Assets	42.4	44.0	41.1
Growth rate of Equity	-	18.1	15.3
Growth rate of Assets	18.7	13.8	23.4
Combined ratio	81.5	70.9	67.2
Liquidity			
Liquid Assets / total Assets	14.4	24.0	17.1
Operating Ratio			
Underwriting Expense / Net Premium	26.7	25.4	26.5
Underwriting Expense / Gross Premium	16.6	14.7	13.2
Loss ratio	64.9	56.2	54.1
Operating ratio	54.3	43.6	38.3
Total Assets turnover Ratio	29.5	29.2	26.1
Profitability Ratios			
Investment income / net premiums	27.2	27.3	28.9
Investment income / investment assets	16.2	20.6	17.8
Growth rate of profits	-12.3	80.4	-3.3

Since the business of insurance is to facilitate risk mitigation and provide financial security to the economic system by absorbing huge financial risks, it has become necessary for insurance companies to maintain a certain level of liquid assets to meet unexpected claims. The ratio of liquid assets to total assets is therefore very high across countries. Similarly in domestic market, this share has been on the higher side and has increased from 14.4 percent in CY01 to 17.1 percent in CY03. The non-life insurance industry maintained higher liquidity in CY02 in expectation of unfavorable events in connection to Afghan war and also due to some regional tension that also affected the stock market.

The operating ratios deal with the operational aspects of an insurance company. Since the underwriting result depends on the difference between net premiums and net claims after deducting net commission and underwriting expenses, higher the expenses, lower will be the underwriting surplus. Furthermore, the ratio of underwriting expense to gross premium implies that the insurance companies spent 16.6 percent of gross premium on underwriting expenses, agents' commissions and advertising activities to promote their businesses in CY01 and 13.2 percent in CY03.

The operating ratio is the combined ratio less net investment income ratio, which is the ratio of net investment to net premiums earned. It measurers the insurer's profitability per rupee of premium. According to the **Table 5.9**, this ratio has declined from 54.3 percent in CY01 to 38.3 percent in CY03. Similarly the profitability ratios show various profitability indicators of the insurance industry. The profits declined by 12.3 percent in CY01 mainly because of high reinsurance cost led by 9/11 and subsequent events. Profitability increased in CY02 to 80.4 percent but again fell by 3.3 percent in CY03 due to an increase in underwriting expenses and increased reinsurance cost.

Box 5.1: History of Insurance Industry in Pakistan

At the time of independence, the country had 5 domestic and 77 foreign insurance companies. These companies were regulated under the Insurance Act of 1938. The government in 1948 established the Department of Insurance within the domain of Ministry of Commerce to supervise the affairs of insurance industry and to safeguard the interests of the insured. The Act was amended in 1958 for the first time keeping in view the requirements of domestic market and to have effective control over the insurance premium rates. Since then, various amendments have been made in the Act. The Department of Insurance further created the Controller of Insurance for the same purpose that was abolished in 2000 when SECP was made responsible for supervising insurance business in the country.

Since the business of insurance companies is to spread the risk, therefore, the need for establishment of a domestic reinsurance company was felt that would eventually boost the profitability of national insurance companies and to allow companies to handle growing insurance demand. It was also aimed to reduce the outflow of foreign exchange that was earlier used as reinsurance premiums made to reinsurance companies mainly in the U.K. The Pakistan Reinsurance Corporation (presently called as Pakistan Reinsurance Company Limited) was established in 1953. In 1955, National Coinsurance Scheme (NCS) was initiated to promote insurance culture in Pakistan and to assist small insurance companies in meeting financial requirements. Moreover, it aimed to have checks and balances on government expenditure on insurance and to assist in settlement of claims in which the government was the beneficiary. The formation of NCS yielded favorable results, Moreover, economic growth in 1960s further promoted the insurance business in the country and the number of Pakistani insurance companies increased to 26 and reached to 47 by 1971. However, the number of foreign companies decreased from 77 in 1947 to 25 in 1972 due to political uncertainty and separation of East Pakistan.

The life insurance business (that grew very rapidly from a total sum assured of only Rs. 130 million in 1949 to Rs. 51.7 billion in 1972) was nationalized in 1972. Life Insurance Management Board managed the affairs of these newly nationalized life insurance companies. By consolidating the business of 41 nationalized insurance companies in 1973, the government created State Life Insurance Corporation with a purpose of encouraging life insurance business and to safeguard the interests of policyholders. The initial benefits were the reduction in premium rates by 33 percent and resolution of various outstanding disputes between the policyholders and the insurers.

Moreover in 1973, the government replaced NCS with National Insurance Fund (NIF) for the purpose to manage insurance of government and semi government property. The NIF reduced the premium rates for insuring government property, moreover it shifted all the profits of insurance companies to the government exchequer. In addition to provide government a more conducive environment for undertaking insurance and to reduce its cost, National Insurance Corporation (presently National Insurance Company Limited) was established in 1976. Since then, it has been the sole insurer to the government and semi-government bodies.

In 1980s no significant development took place in the insurance industry until the financial sector reforms were initiated by the government in early 1990s that also encouraged investments in insurance business. The number of domestic insurance companies increased to 62 in 1995 while foreign participation was reduced to 9 insurance companies.

One of the significant changes in insurance regulation was the abolition of the office of controller of insurance and after the conversion of Corporate law Authority in to SECP, a new department was formed in SECP to look after the affairs of the insurance industry. Since the Insurance Act 1938 had become outdated, it was prudent to replace it with some new regulations. The new Insurance ordinance was promulgated in August 19, 2000 by the SECP that increased the minimum paid-up capital of non-life insurance companies to Rs. 80 million and for life insurance companies to Rs. 150 million.

5.3 Overview of Life Insurance Industry

In contrast to the non-life market, there are only 5 companies presently operating in the life insurance industry including one state-owned State Life Insurance Corporation, Postal Life Insurance,[4] two foreign companies and two private domestic companies. There has been a consistent decline in the number of life insurance companies operating in this area mainly due to limited demand for life

[4] Postal Life insurance is a department of Pakistan Post Office working under the ministry of communication. An overview of Postal Life Insurance is given in section 5.3.5.

insurance on account of small urban market, presence of state-owned corporation, which enjoys almost a complete monopoly in the market and thus leaves very little share for other companies. There were 9 life insurance companies in CY95 out of which 4 were foreign, 4 private domestic and one state owned corporation. Since some companies incurred considerable amount of losses consistently, most of the foreign companies merged their businesses with other private companies. However, the recent merger of foreign life insurance company with the other foreign company is due to losses incurred by it and also to meet the increased requirements of paid-up capital of Rs. 150 million by the end of CY04, which was earlier set at Rs. 100 million until December CY03 by the SECP[5].

The life insurance companies deal in many different policies from annuities to death benefits and also health policies. Normally, the event that leads to payment of claim is very straightforward and the amount of benefit is mentioned in the contract as opposed to non-life business in which surveyors and loss adjusters are appointed to measure the loss as third party. The annuity contracts as opposed to life insurance contracts provide a benefit for survival. Therefore annuity provides periodic payments to the survivors as mentioned in the insurance contract.

Table 5.10: Structure of Life Insurance Business in Pakistan
million Rupees

	CY01	CY02	CY03
Paid up capital	1,937	1,977	2,202
Investments	69,385	79,834	89,190
Gross Premium	8,328	10,315	13,029
Net Premium	8,028	9,994	12,662
Net Claims incurred	5,833	5,388	6,687
Management expenses	3,336	3,916	4,767
Net Profit after tax	302	246	394
Total Assets	83,543	95,563	107,618

Source: Balance Sheets of Life Insurance Companies

As shown in **Table 5.10** the Gross premium has increased by an average of 25.1 percent per annum. The reduced net profit after tax in CY02 was mainly due to revaluation of assets by the companies. Moreover, the effects of September 11 in which the foreign reinsurance companies increased their premium rates also deteriorated the profitability of life insurance companies.

5.3.1 Capitalization Structure of Life Insurance Industry

Table 5.11 shows the capitalization structure of life insurance companies. In response to regulatory changes, there has been a substantial growth in the capital base of private domestic life insurance companies that resulted in a gradual increase in their share from 14.7 percent in CY01 to 16.7 percent in CY03. Among foreign life insurance companies, Commercial Union Life Assurance Company was acquired by Aga Khan Fund for Economic Development and the company was re-named as New Jubilee Life Insurance in CY03. This has enabled the share of foreign companies to increase from 12.6 percent in CY02 to 18.9 percent in CY03. Meanwhile, the share of SLIC capital in total equity of life insurance rose from 66.4 percent in CY01 to 70.2 percent in CY02, but fell sharply to 64.4 percent in CY03, mainly due to disproportionate rise in the capital of foreign life insurance companies.

Table 5.11: Capitalization of Life Insurance Companies
percent share

	CY01	CY02	CY03
Private domestic	14.7	17.2	16.7
Foreign	18.9	12.6	18.9
State Life	66.4	70.2	64.4
Total	100	100	100
Total Equity (million rupees)	1,129.60	1,327.20	1,826.10
Equity as percent of GDP	0.02	0.03	0.04

Source: Balance Sheets of Life Insurance Companies

Since the number of life insurance companies is very small in addition to limited business activities by foreign and private domestic companies, the overall level of equity as percentage of GDP is very

[5] The latest merger in life insurance market was of Commercial Union Life Assurance with New Jubilee Life Insurance Company in 2002.

low in contrast to the non-life insurance industry. However, with the increasing trend of equity due to regulatory requirements, the ratio of equity to GDP has remained stable during CY02-03 (see **Table 5.11**).

5.3.2 Structure of Premiums and Claims of Life Insurance

Since the majority of life insurance policies cover a long duration, the gross premiums accumulated by life insurance companies include first year premium and the renewal premiums. The ratio of first year premium to gross total premiums shows the growth of new insurance policies and increase in underwriting risks by the companies. Moreover, the ratio of second year renewal to net premium shows the consistency and willingness of the policyholders to continue their policies. This also shows the level of interaction of the insurer with the policyholder.

Table 5.12 shows the share of foreign, private domestic companies and State Life Insurance Corporation (SLIC) towards net and gross premiums. The dominance of SLIC is apparent from its 83.8 percent share in total gross premiums in CY01 that declined to 76.1 percent in CY03. Most of this reduction was due to the penetration of private domestic life companies, which have come up with new products to attract prospective policyholders. The share of private domestic life insurance companies in gross premium increased from 8.8 percent in CY01 to 15.2 percent in CY03. Moreover, the share of first year premiums to total gross premium for domestic private domestic life companies increased from 2.0 percent in CY01 to 2.7 percent in CY03.

Table 5.12: Share of Gross and Net Life Insurance Premiums

percent share

	CY01	CY02	CY03
Private domestic Life Insurance			
First year Premium / G.P	2.0	2.3	2.7
Second Year Renewal / N.P	1.5	1.4	1.7
Group Policies / N.P	2.8	3.3	3.2
Net Premiums	7.1	9.6	14.1
Gross Premiums	8.8	11.0	15.2
Foreign Life Insurance			
First year Premium / G.P	1.5	1.7	2.0
Second Year Renewal / N.P	0.9	1.0	1.0
Group Policies / N.P	3.9	3.6	3.3
Net Premiums	6.4	6.7	7.8
Gross Premiums	7.4	7.7	8.6
State Life Insurance Corporation (SLIC)			
First year Premium / G.P	13.6	13.1	13.8
Second Year Renewal / N.P	6.2	8.1	8.4
Group Policies / N.P	15.7	15.3	18.1
Net Premiums	86.5	83.7	78.0
Gross Premiums	83.8	81.3	76.1
Total Life Insurance			
First year Premium / G.P	17.0	17.1	18.5
Second Year Renewal / N.P	8.5	10.5	11.0
Group Policies / N.P	22.4	22.2	24.7

The foreign private domestic companies have also shown progress in attracting new business as their ratio of first year premium to total gross premium increased from 1.5 percent in CY01 to 2.0 percent in CY03. This is mainly due to the re-organization and re-capitalization of one foreign company mentioned earlier. Moreover, this has also increased the share of foreign companies towards total gross premium from 7.4 percent in CY01 to 8.6 percent in CY03.

An increasing trend is also observed in business of SLIC that has modestly increased the ratio of first year premium to total gross premiums from 13.6 percent in CY01 to 13.8 percent in CY03. In aggregate, the percentage of first year premium to total gross premium has increased from 17.0 percent in CY01 to 18.5 percent in CY03. This ratio indicates the gradual growth of life insurance business in the country that is also due to increase in public awareness led by innovation and marketing of new products mostly by the private life insurance companies.

The renewal ratio shows the willingness of policyholders to keep their policies intact . Furthermore, the growth rate of renewal ratio also shows the trust of policyholder on the insurance company and the services it provides. This is observed in private domestic life insurance companies from their ratio of second year renewal to total net premium that has increased from 1.5 percent in CY01 to 1.7 percent in CY03. Similarly, the figures of SLIC also show steadiness of policies. The ratio increased from 6.2 percent in CY01 to 8.4 percent in CY03. Furthermore, the ratio of renewal premiums to net premiums showed a stable trend in foreign companies that has remained in the range of 0.9-1.0 percent in CY01 to CY03. Overall, the renewal ratio has increased from 8.5 percent in CY01 to 11.0 percent in CY03. An increase in renewal ratio is also an encouraging sign for the development of life insurance industry. Moreover, higher renewal percentage yields lower surrender ratio of insurance policies.

The **Table 5.13** shows the actual amount of different compositions of net and gross premiums for the insurance industry. The insurance policy is divided into two components, individual policies and group policies. However, the volume of individual policies is much lower than the group policies, the percentage share of individual policies towards gross premium has increased from 0.7 percent in CY01 to 5.5 percent in CY03 whereas, the share of group policies in total gross premium has increased from 21.6 percent in CY01 to 24.0 percent in CY03. Moreover, the reinsurance premium ceded by the life insurance companies increased from Rs 168.7 million in CY01 to Rs 252.9 million in CY03. The ratio of reinsurance premium to gross premium shows the extent of reinsurance activity. Since the reinsurance premium rates increased all over the world, the ratio decreased from 2.0 percent in CY01 to 1.9 percent in CY03. This also shows that life reinsurance from foreign companies has decreased.

Table 5.13: Composition of Gross and Net Life Insurance Premiums

million Rupees

	CY01	CY02	CY03
Private domestic Life Insurance			
First year	167.1	239.2	360.5
Second year renewal	117.2	137	209.7
Subsequent renewal	187.3	280.8	388.1
Single premium individual policies	35	150.6	616.5
Group Policies	226.7	325.5	409.6
Annuities		-	
Total gross premium	733.2	1,133.10	1984.7
Reinsurance premium ceded	122.7	176.7	182.1
Net Premiums	570.5	956	1787.9
Foreign Life Insurance			
First year	120.4	171.7	259.2
Second year renewal	69	96.5	126.7
Subsequent renewal	94.7	133.5	218.1
Single premium individual policies	22.4	31.3	96.2
Group Policies	312.3	363.8	425.9
Annuities	-	-	-
Total gross premium	618.8	796.9	1126.3
Reinsurance premium ceded	14.6	19	33.3
Net Premiums	512.8	673.3	993.8
State Life Insurance Corporation (SLIC)			
First year	1,128.70	1,351.70	1,794.70
Second year renewal	496.1	811.1	1,058.70
Subsequent renewal	4,088.90	4,686.40	4,770.10
Single premium individual policies	0	0.4	0.2
Group Policies	1,259.90	1,529.30	2,287.80
Annuities	2.5	6.8	6.7
Total gross premium	6,976.20	8,385.30	9,918.10
Reinsurance premium ceded	31.5	20.7	37.5
Net Premiums	6,944.70	8,364.60	9,880.60
TOTAL			
First year	1,416.20	1,762.60	2,414.50
Second year renewal	682.3	1,044.60	1,395.10
Subsequent renewal	4,370.90	5,100.80	5,376.30
Single premium individual policies	57.4	182.3	713
Group Policies	1,798.90	2,218.60	3,123.30
Annuities	2.5	6.8	6.7
Total gross premium	8,328.20	10,315.20	13,028.90
Reinsurance premium ceded	168.7	216.3	252.9
Net Premiums	8,028.00	9,993.90	12,662.40

Source: Balance Sheets of Life Insurance Companies

As annuity is defined as income from capital investment paid in a series of regular payments, it has showed a positive growth rate during CY02. Since annuities are in early stages of development in Pakistan and only the SLIC deals in annuities, the share of total premium of annuities in total gross premium has been very low.

A high claim ratio is often considered desirable from marketing perspective since it helps retain the interest of the policyholders in their insurance policies. Moreover, the insurance companies that have high claim ratio tend to attract more prospective clients. However, consistent high claims ratio may create unanticipated financial obligations that often result in huge underwriting losses and thus wipe-out equity of the firm. **Table 5.14** shows amount of gross and net claims incurred by the life insurance companies.

Overall life insurance industry has shown a declining trend of claims ratio with an increase in gross and net claims. Moreover, since the tenure of policies lasts more than one year, the net premium accumulated by life insurance companies is far greater than net claims incurred. Likewise, the phenomenal decrease in the claim ratio of State Life is mainly due to larger increase in net premiums as compared to net claims.

Table 5.14: Claims of Life Insurance Industry

million Rupees

	CY01	CY02	CY03
Private domestic Life Insurance			
Total gross claims	201	253	494
Reinsurance recoveries	80	100	150
Net claims	121	153	343
Net Premiums	571	956	1,787
Claim ratio (percent)	21.2	16	19.2
Foreign Life Insurance			
Total gross claims	163	227	200
Reinsurance recoveries	10	6	23
Net claims	140	229	220
Net Premiums	513	673	993
Claim ratio (percent)	27.2	34.1	22.2
State owned Corporation			
Total gross claims	5,587	5,016	6,128
Reinsurance recoveries	15	11	5
Net claims	5,572	5,005	6,123
Net Premiums	6,945	8,365	9,881
Claim ratio (percent)	80.2	59.8	62
Total Life Insurance			
Total gross claims	5,950	5,496	6,822
Reinsurance recoveries	105	116	179
Net claims	5,833	5,388	6,687
Net Premiums	8,028	9,994	12,662
Claim ratio (percent)	72.7	53.9	52.8

5.3.3 Investment Portfolio of Life Insurance Companies

Being an institutional investor, the insurance industry has emerged as the largest investor after commercial banks in government securities and other capital market instruments. It is the return to investments that enables insurance companies to pay its obligations such as claims and other liabilities. Since the tenure of policies is of long-term duration, therefore, the net premium accumulated by the companies is invested in long-term securities and in real-estate. The life insurance companies have accumulated investments at an average growth rate of 13.3 percent over the years CY01-CY03.

Only SLIC has made investments in real-estate in the form of buildings. The rental income of the corporation has increased substantially over the years from Rs 30 million in CY01 to Rs 152 million in CY03. This increase in rental income is mainly attributed to increase in economic activity leading to increase in demand for office premises by the businesses. Meanwhile, the return to investment i.e. net investment income increased from Rs. 8.8 billion in CY01 to Rs. 10.3 billion in CY03, showing a decline of 9.7 percent in CY03 (see **Table 5.15**).

While considering the share of private domestic and foreign life insurance companies in total investment income, their combined share was only 1.4 percent of total investment income in CY01 that increased to 3.4 percent in CY03. It is important to note that total investments increased by 15.8 percent in CY02 further increased by 12.2 percent in CY03. This reduction in growth rate of investment is largely attributed to the prevailing low-level interest rate environment in the country.

5.3.4 Performance Analysis of Life Insurance Industry

Since the capital adequacy ratio signifies the strength of companies to absorb losses and unexpected claims, it is therefore, an important indicator of the health of an insurance industry. The paid-up capital to total equity ratio exceeding 100 percent illustrates the effect of losses on capital of the company in form of accumulated losses that reduce the retained earnings and thus reducing the equity (see **Table 5.16).** These losses are mainly due to the monopolistic market structure and lesser demand for life insurance. Keeping in view of strengthening the insurance industry and raising the minimum paid-up capital requirements by the SECP, the total equity grew by 17.5 percent during CY02 and then further increased by 37.6 percent during CY03.

The assets of life insurance companies have also increased by 14.4 percent and 12.6 percent in CY02 and CY03 respectively. Since the combined ratio is the sum of loss ratio and underwriting expense ratio, a ratio exceeding 100 percent means that the company is paying more in losses and underwriting expenses as compared to its net premium. This has been a primary reason for accumulation of losses by the companies. The decline of combined ratio from 112.7 percent in CY01 to 89.4 percent in CY03 shows that companies have reduced their expenses. Moreover, the underwriting expense to net premium ratio also showed a decline from 41.6 percent in CY01 to 37.7 percent in CY03. The liquidity of life insurance companies has increased from 4.3 percent of total assets in CY01 to 7.1 percent in CY03.

The operating ratio is negative in CY02 since it is the difference between combined ratio and net investment income ratio reflecting that companies face higher claims and expenses and underwriting losses. Moreover, the investment income by life insurance companies have exceeded net premium as shown in **Table 5.16** that has deteriorated the operating income ratio. The growth of profits registered a fall of 18.4 percent during CY02. However with reduction in management expense ratio and claims, the life insurance companies have shown significant

Table 5.15: Composition of Investments and Investment Income

million Rupees

	CY01	CY02	CY03
Private domestic Life Insurance			
Investments	848	1,377	2,410
Investment property	-		-
Rental income	-	-	-
Net investment income	82	157	220
Foreign Life Insurance			
Investments	565	956	1,437
Investment property	-	-	-
Rental income	-	-	-
Net investment income	40	158	125.2
State owned Corporation			
Investments	65,378	74,993	82,913
Investment property	2,594	2,508	2,429
Rental income	30	53	152
Net investment income	8,643	11,047	9,910
Total Life Insurance			
Investments	66,791	77,326	86,761
Investment property	2,594	2,508	2,429
Rental income	30	53	152
Net investment income	8,765	11,362	10,256

Source: Balance Sheets of Life Insurance Companies

Table 5.16: Ratio Analysis of Life Insurance Industry

percent share	CY01	CY02	CY03
Capital Adequacy			
Paid-up Capital / total Equity	171.5	149.0	120.6
Paid-up capital / Total Assets	2.3	2.1	2.1
Equity / Total Assets	1.4	1.4	1.7
Growth rate of Equity	-	17.5	37.6
Growth rate of Assets	-	14.4	12.6
Combined ratio	112.7	91.9	89.4
Liquidity			
Liquid Assets / total Assets	4.3	5.6	7.1
Operating Ratio			
Underwriting Expense / Net Premium	41.6	39.2	37.7
Underwriting Expense / Gross Premium	40.1	38.0	36.6
Loss ratio	72.7	53.9	52.8
Operating ratio	1.6	-22.4	8.2
Total Assets turnover Ratio	9.6	10.5	11.8
Profitability Ratios			
Investment income / net premiums	111.1	114.2	81.2
Investment income / investment assets	12.9	14.3	11.5
Return on Assets	0.4	0.3	0.4
Growth rate of profits	-	-18.4	60.2

improvement in CY03 by recording a robust growth in profitability by 60.2 percent over CY02.

5.3.5 Postal Life Insurance

Postal Life Insurance (PLI) has been working as a federal government organization under the jurisdiction of ministry of communication. It is the oldest organization providing life insurance coverage to general public and various organizations. Historically, the creation of PLI dates back to 1884 when it was established to provide life insurance cover to employees of post office. The coverage was then extended to employees of government departments and later to other individuals and organizations as well.

Figure 5.17: Business of Postal Life Insurance

million Rupees

	Fresh Business		Total Business			Total	Balance of
	No. of Policies	Premium	No. of Policies	Premium	Sum Assured	Claims	Insurance Fund
2001	19,332	69.3	226,464	518	14,930.3	-	6,548.8
2002	19,448	74	228,714	616.6	15,878.8	-	7,315.1
2003	24,983	110.8	239,272	759.3	18,051.6	255.6	8,326.7

Source: Securities and Exchange Commission of Pakistan

The total number of policies of PLI has grown by 29.3 percent over CY01-CY03, while the average sum assured has increased from Rs 65,927 in CY01 to Rs 75,443 in CY03. The marginal increase in average sum assured is probably be due to PLI's concentration in same income group market. The **Table 5.17** shows the underwriting performance of PLI over the period 2001-03. The share of fresh premiums in total premiums, a measure of growth of life insurance business has increased from 13.3 percent in CY01 to 14.6 percent in CY03 as against 18.5 percent for other life insurers (see **Table 5.13**). Moreover, the fresh or first year insurance premiums have grown by 49.6 percent in CY03 as against to 36.9 percent for other life insurers (see **Table 5.13**). However, the claims ratio for PLI has been 33.6 percent for CY03 as against 52.8 percent for the life insurance industry (see **Table 5.14**). Out of Rs 255.6 million as claim settlement amount, 52.8 percent has been the surrender amount, while only 14.6 percent has been paid in case of death of the insured. The huge share of surrender amount in total claims shows the lack of interest of policyholders in continuing their policies.

The balance of insurance fund demonstrates the ability of an insurance organization to meet its contingencies and other liabilities. The balance of insurance fund of PLI has grown by 14.9 percent in CY01, 11.7 percent in CY02 and 13.9 percent in CY03. Given an increasing trend of premium accumulation with an increase in balance fund, the statistics of PLI show a healthy financial position.

5.4 Reinsurance Industry

Since the primary function of insurance industry is to spread the risks, the insurance companies reinsure their own risk with reinsurance companies. Pakistan's insurance industry has one reinsurance company owned by the government responsible for underwriting reinsurance business of non-life insurance companies.

It is mandatory for non-life insurance companies to reinsure at least 10 percent of its total business with Pakistan Reinsurance Company and the rest of the risk from elsewhere. Earlier the compulsory cession was 20 percent of total insurance business by the company that was reduced to 15 percent in CY01.

Being the only reinsurance company that enjoys complete monopoly, the Pakistan Reinsurance Company's financials illustrate an excellent performance over CY01-CY03. Its total assets have grown by 37.2 percent during CY01-CY03. The main reason for this increase is revaluation of its assets in CY01 and CY02.

5.4.1 Premiums and Claims of Reinsurance Industry

As shown in **Table 5.18**, the net premiums declined in CY03 mainly due to decline in cession rates from 15 percent to 10 percent in CY03. The fire insurance has shown significant decline from Rs 656.6 million to Rs 568.3 million. In contrast, the gross premium increased 24.5 percent over CY01-CY03. The claim ratio has witnessed an increase from 54.1 percent in CY01 to 69.9 percent in CY03. One of the main reasons for increase in claim ratio is the increase in claims of accident and motor insurance as witnessed by the non-life insurance industry (see **Table 5.8)**.

Table 5.18: Reinsurance Business in Pakistan

million Rupees

	CY01	CY02	CY03
Paid up Capital	50	450	450
Reserves and Retained Earnings	758	796	981
Investments	1,661	1,905	1,886
Gross Premium	3,045	3,500	4,697
Net Premium	1,312	1,588	1,447
Net Claims incurred	709	848	1,011
Management Expenses	98	108	140
Net Profit after tax	67	297	333
Total Assets	3,332	4,192	6,232

Source: Balance Sheets of Pakistan Reinsurance Company Limited

5.4.2 Investments and Profitability of Reinsurance Industry

The investments of the Pakistan Reinsurance Company declined in CY03 to cover the interest rate risk (see **Table 5.18**). Earlier, it increased in CY02 when it diversified its assets and made more investment into fixed income securities such as Pakistan Investment Bonds. The profitability of the company increased by 123.1 percent on annual basis from CY01-CY03. The reason for increase in profits is the exchange gain and revaluation of investments by the company.