6 Developments in the Insurance Sector

6.1 Overview

A well-developed and efficiently working insurance sector can play an important role in the economic and social development of a country by reducing uncertainty for economic agents, and pooling long-term financial resources. The insurance industry also contributes in the development of other financial institutions and markets, thus indirectly facilitates economic progress in a country (for details see **Box 6.1**).

Like many developing countries, the insurance sector in Pakistan has remained dormant. This is reflected in very low level of insurance density and insurance penetration in the country.[1] In fact, both these indicators suggest that the relative size of the insurance industry is significantly smaller in Pakistan than in other regional countries such as India and Sri Lanka (see **Table 6.1**).

To put in historical perspective, the insurance industry in Pakistan had been affected by nationalization measures that perpetuated a limited and segmented insurance sector in the years ahead. Only a state-owned insurance

Box 6.1: Role of the Insurance Industry in Economic Growth

Broadly, there are two main channels through which the insurance sector can help the economic and social development of a country: first, by reducing uncertainty, and second, by generating long-term financial resources.

Through the first channel, a well functioning insurance sector facilitates the investment decision-making process and enables businesses to continue operating even if catastrophic events (such as earthquake, floods, and severe weather conditions, etc) hit the economy. The latter, in turn, provides some protection to households by reducing probability of job and income losses. A developed and healthy insurance industry also protects households from any major financial losses resulting from idiosyncratic shocks such as fires, thefts, illness, accident and death, etc.

The second channel, i.e. increasing supply of long-term financial resource, plays a vital role in economic development. Funds generated by the insurance industry are mainly invested in other financial instruments; especially in government securities, stocks, corporate debt and long-term certificates of deposits issued by other financial institutions.

The insurance sector also plays a supportive role in the development of other financial institutions and markets. For example, both availability of funds and insurance facility, allow financial intermediaries to enter into new markets.

Table 6.1: Cross-Country Insurance Premium Performance

Insurance density in US$; insurance penetration in percent

	Insurance density				Insurance penetration			
	2001	2002	2003	2004	2001	2002	2003	2004
Pakistan	2.7	2.7	3.3	4.0	0.7	0.6	0.7	0.7
Argentina	187.0	63.0	86.0	105.4	2.6	2.4	2.6	2.7
Bangladesh	1.6	1.6	2.1	2.5	0.5	0.5	0.6	0.6
Brazil	64.0	72.0	82.6	101.1	2.1	2.8	2.9	3.0
India	11.5	15.0	16.9	19.7	2.7	3.3	3.3	3.1
Indonesia	7.7	12.0	14.6	15.8	1.1	1.5	1.3	1.3
Kenya	9.4	12.0	12.1	11.1	2.7	3.1	2.8	2.7
Malaysia	198.3	198.0	226.4	25.7	5.2	4.9	5.3	5.3
Sri Lanka	9.7	11.0	13.0	14.2	1.2	1.3	1.4	1.5
Thailand	53.9	65.0	79.5	92.1	2.9	3.2	3.5	3.5
United Kingdom	3,393.8	3,879.0	3,887.3	4,484.4	14.2	14.8	12.8	12.5
United States	3,266.0	3,642.0	3,651.1	3,790.2	9.0	9.6	9.6	9.4

Source: Sigma, world insurance in 2001, 2002, 2003, 2004

[1] Insurance density is defined as gross premium per capita and insurance penetration as gross premium as percent of GDP.

company was operating on a monopoly basis which made no real effort in harnessing the depth and strength of the insurance market in Pakistan. In fact, even after financial liberalization in 1991, which allowed introduction of private domestic and foreign life insurance companies in Pakistan, the state-owned corporation continued to dominate the life insurance sector.[2] Additionally, the mushroom growth of small-sized domestic private non-life insurers with limited professional expertise restricted the development of the non-life insurance sector in the country.

However, from 2001 onwards, the insurance sector saw a consistent improvement in terms of structure and growth. Macroeconomic stability and high economic growth played a vital role in this regard (see **Box 6.2**). Specifically, higher per capita income, expansion in trade sector, and the growing private sector credit spurred the exceptional growth in the insurance sector during CY01-05; as reflected by 15.5 percent and 20.4 percent compound annual growth rate (CAGR) in insurance industry assets and gross premium, respectively. Importantly, this growth was broad-based, as both the life and non-life insurance sectors witnessed double-digit growth during CY01-05.[3] Though the life insurance sector continued to dominate the insurance industry, the share of non-life insurance sector increased slightly from 23.4 percent to 26.6 percent during CY01-05 (see **Table 6.2**).

Box 6.2: Macroeconomic Environment and Growth of Insurance Business

In order to quantify the impact of macroeconomic growth on that of the insurance industry during CY01-05, a fixed effect model has been estimated by using panel data for the top ten non-life insurance companies and all the five companies in life insurance business.[1] Net premium (in log) has been used as proxy for growth in insurance business. Different industry specific variables have been used in the model along with real GDP and banks lending rates.

Results are summarized in **Table B.2.1**, which support the proposition that high macroeconomic growth has contributed significantly in the development of the insurance industry during CY01-05. Specifically, controlling for industry specific variables, one percent increase in GDP led to 0.69 percent growth in the net premium. Among industry specific variables, retention level, growth in gross premium and share of liquid assets in total assets have positive relationship with growth in net premiums. On the other hand, net claim ratio showed negative relation with net premium growth.

Table B.2.1: Estimates of Regression

Dependent variable: Log of net premium

	Coefficients	t-stats
Constant	-11.7554	-3.64*
Macroeconomic variables		
Growth in real GDP	0.6957	3.12*
Weighted average lending rate	0.0056	1.07
Control variables (industry specific)		
Retention level	0.0153	20.84*
Growth in gross premium	0.9258	23.15*
Liquid assets to total assets	0.0015	1.08
Net claim ratio	-0.0006	-1.13
R-squared	0.94	
Total panel (balanced)	75	

* Represents significant at 1 percent level

Note: Reference group is insurance companies

[1] Top ten non-life insurance companies cover 82.6 percent share in total assets during CY05.

Besides favorable macroeconomic environment, reforms in the insurance sector, which began in 2000, paved the way for the deepening of the insurance business in Pakistan. In this regard, the most significant development was the promulgation of the insurance ordinance in 2000 which laid down the comprehensive regulatory framework for the insurance industry. The insurance ordinance was aimed at developing a dynamic and competitive insurance industry through strengthening of regulatory and supervisory measures. In

[2] The key factors that helped the state-owned corporation in maintaining hefty share in the life insurance market are deep outreach, huge customer base, actuarial expertise, large sales force and low premium products offerings.

[3] Assets of the Life and the Non-life insurance sectors grew at a CAGR of 14.0 percent and 19.3 percent respectively during CY01-05.

order to achieve these objectives, rules for insurance companies were introduced in 2002.[4] An important regulatory change was the enhanced paid-up capital requirement, aimed at accelerating the consolidation process so that insurers attain the size and scale needed to remain competitive and efficient in the insurance industry.[5] As expected, this increased capital requirement resulted into the closure of some weak institutions in the industry, particularly in the non-life insurance business. Specifically, the number of insurance companies reduced from 64 in December 2001 to 52 in December 2005 (see **Table 6.3**).

Table 6.2: Asset Structure of the Insurance Industry

Share in percent

	CY01	CY02	CY03	CY04	CY05
Life	**73.7**	**73.7**	**71.4**	**71.0**	**70.6**
State owned	71.6	71.2	67.7	66.8	65.5
Private	2.0	2.5	3.7	4.2	5.1
Domestic	1.1	1.5	2.4	2.6	3.1
Foreign	0.9	1.0	1.3	1.6	2.0
Non-Life	**23.4**	**23.1**	**24.5**	**25.2**	**26.6**
State owned	9.9	9.4	9.3	8.6	8.4
Private	13.5	13.7	15.2	16.6	18.2
Domestic	12.7	12.8	14.2	15.9	17.4
Foreign	0.8	0.9	1.0	0.6	0.8
Reinsurance	**2.9**	**3.2**	**4.1**	**3.8**	**2.8**
State owned	2.9	3.2	4.1	3.8	2.8
Total assets (billion Rs)	**113.4**	**129.8**	**151.4**	**174.6**	**201.7**

Source: Annual audited reports of insurance companies

Table 6.3: Number of Insurance Companies

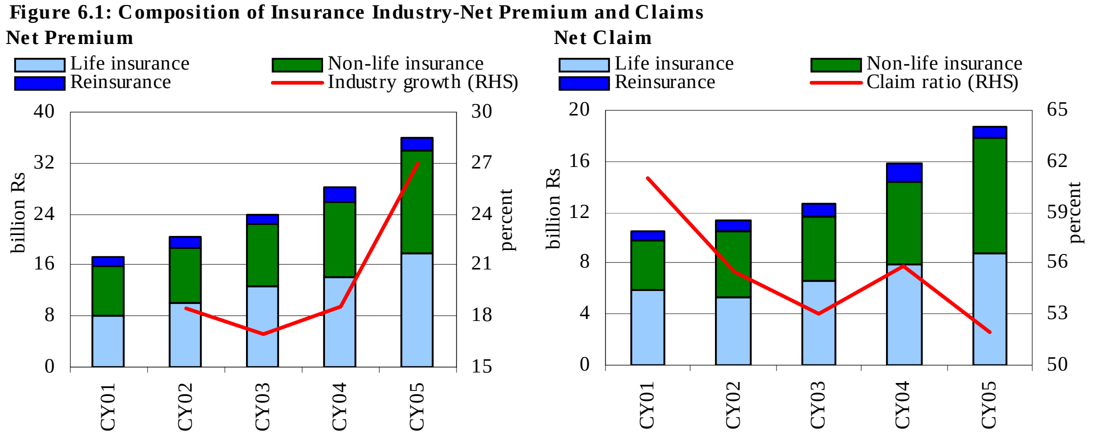
numbers

	Dec-01	Dec-05
Life insurance companies	5	5
Non-life insurance companies	58	46
Reinsurance company	1	1
Total	**64**	**52**

Source: SECP

During CY01-05, the financial health of the insurance industry has improved considerably. Increased capital requirement and higher profitability improved the capital adequacy of insurance companies. In specific terms, capital to assets ratio increased from 12.1 percent in CY01 to 13.7 percent by the end of CY05 (see **Table 6.4**). Moreover, the underwriting practice by the insurance industry became more prudent, as claim ratio registered a substantial fall from 61.0 percent in CY01 to 52.0 percent in CY05. This decline in claim ratio was primarily because of higher growth in net premium than that in net claims (see **Figure 6.1**). As a result, profitability of the insurance sector improved as ROA increased from below 2 percent in CY01 to 3.4 percent in CY05 (see **Table 6.4**).

Figure 6.1: Composition of Insurance Industry-Net Premium and Claims



[4] This reform process continued in period afterwards. Some important regulatory changes made during FY06 are summarized in **Chapter 2**.

[5] Minimum paid up capital requirement increased to Rs.80 million for non life and Rs.100 million for life insurance companies.

It is important to note that compared to CY04 the insurance sector performed relatively better in CY05; as both growth and financial health of the insurance companies improved significantly in CY05. Specifically, in CY05 gross premium of the insurance sector grew at 20.1 percent, against corresponding values of 12.5 percent in the previous year. Similarly, as shown in **Table 6.4**, indicators for financial health including profitability; capital adequacy; and retention and claim ratios suggest improvement during CY05.

Table 6.4: Financial Indicators of Insurance Industry
percent

	CY02	CY03	CY04	CY05	CY02-05
Growth					
Paid up capital	13.0	9.0	14.5	6.9	10.8
Gross premium	20.9	28.5	12.5	20.1	20.4
Net premium income	18.7	17.0	18.6	27.0	20.2
Net claims incurred	-3.8	15.9	21.7	18.2	12.5
Net profit after tax	73.9	2.9	18.8	71.1	38.1
Total assets	14.4	16.6	15.4	15.6	15.5
Total investments	11.2	14.3	11.8	14.2	12.9
Total equity	20.2	17.3	17.7	26.0	20.2
	CY01	**CY02**	**CY03**	**CY04**	**CY05**
Ratios					
ROA	1.7	2.5	2.2	2.3	3.4
ROE	15.9	13.0	18.6	18.3	24.8
Capital adequacy	12.1	12.6	12.9	12.5	13.7
Retention ratio	71.5	70.2	63.9	67.4	71.2
Claim ratio	61.0	54.8	54.4	55.8	52.0

Source: Annual audited reports of insurance companies

6.2 Life Insurance Sector

The basic rationale of life insurance business is to provide protection against adverse financial consequences of death, illness and health damages. However, by now this business has not remained confined to these conventional products, rather it has evolved into an important avenue for long-term saving products. This concept of investment-linked life insurance policies is getting popular in Pakistan as well.

Table 6.5: Gross Premium of Individual Life Insurance Business

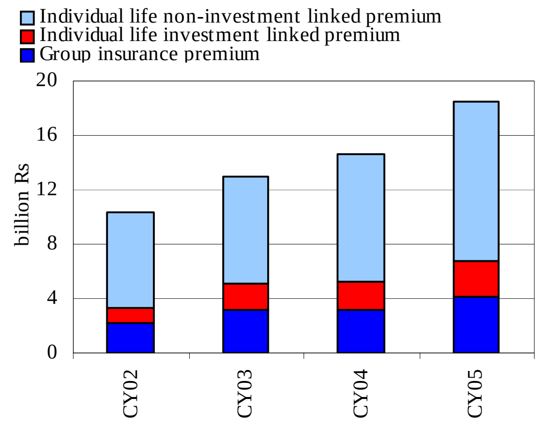
	CY01	CY02	CY03	CY04	CY05	CY01-05
	billion Rupees					in percent
New business	1.5	1.9	3.1	3.5	4.0	28.6
Business-in force	5.1	6.1	6.8	8.1	10.4	19.7
Total	**6.5**	**8.1**	**9.9**	**11.5**	**14.4**	**21.9**

Source: Life insurance companies

6.2.1 Growth and Structure of the Life Insurance Business

During the last couple of years, a surge in the overall economic activity, low interest rate environment and strengthening of the regulatory framework have helped the life insurance sector (henceforth LI) to grow.[6] Specifically, during CY01-05, the gross premium of the LI sector recorded a CAGR of around 22.2 percent. This robust growth was broad-based as both individual as well as group insurance businesses saw double-digit CAGR of 21.9 percent and 22.8 percent, respectively, during CY01-05. Moreover, exceptional performance of individual life gross premium was spurred by growth in both new as well as renewal businesses (see **Table 6.5**).[7,8] Although conventional plans continued to

Figure 6.2: Life Insurance Gross Premium



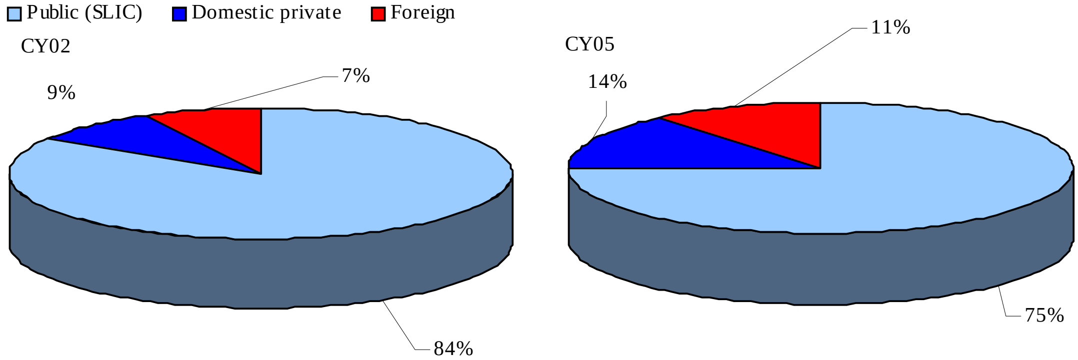
[6] The regulatory reforms in the insurance sector were initiated in 2000 with an aim to make the LI sector more progressive, resilient and competitive through effective policy measures and providing level playing field to insurers (for details see **Chapter 2**).

[7] There is a clear distinction between individual life and group life business. Individual life business comprises of both new and renewal businesses, while the group life business is composed of new business only (with a contract of a year).

[8] While growth in new business premium is important for further deepening of individual life business, the higher business-in-force helps in sustaining the existing size.

dominate the life insurance industry,[9] investment-linked products witnessed an encouragingly sharp growth in CY01-05 (see **Figure 6.2**).[10]

Figure 6.3: Share in Gross Premium of Life Insurance

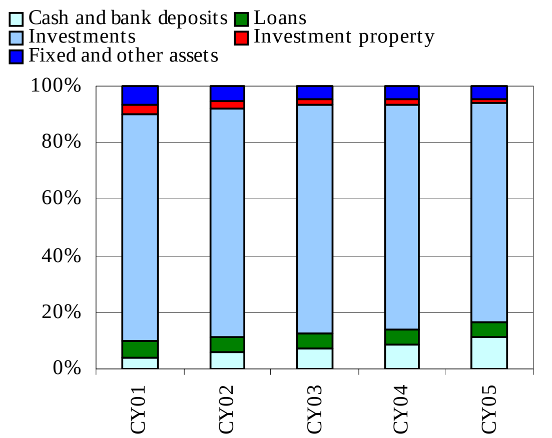


The market structure of the LI sector has also witnessed some welcome changes during CY01-05. The share of the public-owned State Life Insurance Company (SLIC) has declined from almost 87 percent in CY01 to around 75 percent at the end of CY05 in the overall LI sector gross premium (see **Figure 6.3**). While the increased paid-up capital requirement forced the private insurance companies to launch and aggressively market new-innovated insurance products, increasing demand due to high income growth provided them the enabling environment. As a result, the market share of private insurance companies, both local and foreign, almost doubled during the CY01-CY05 period. In order to extend outreach, some of the private LI companies started using the bancassurance channel (see **Box 6.3**), which is an encouraging development and can play a vital role in further increasing the share of these companies.

6.2.2 Asset Composition of Life Insurance Companies

In broad terms, the asset composition of the LI sector remained almost same during CY01-05. As shown in **Figure 6.4**, investment in financial instruments largely dominated the assets of these companies. Specifically, the share of investments in the financial markets solely accounted 77 percent of total asset of LI in CY05 compared to 80 percent recorded in CY01.

Figure 6.4: Composition of Assets



However, a gradual shift has been observed in the investment strategy. While government securities continue to have a disproportionately larger share (see **Figure 6.5**), the exposure to stock market (as percent of overall investment portfolio) surged from 10.1 percent in CY01 to

[9] Due to unavailability of disaggregated level data, all products that are not listed as investment-linked products in financial reports of LI companies are considered as conventional products.

[10] Specifically, during CY02-05 the investment-linked products grew at a CAGR of 35.2 percent.

Box 6.3: Bancassurance – An Introduction

Introduction

Bancassurance, in broader perspective, is defined as the collaboration between banks and insurers to distribute insurance products to bank customers. Bancassurance in Europe has enjoyed considerable success as two-thirds of LI products are being processed through banks. However, this concept is relatively new for Asian countries and has emerged since 2002. In Pakistan, the concept is at the infancy stage and only some of the insurers have experimented with this mode of distribution channel. However, the prospects of bancassurance in Pakistan are very promising. It can help LI companies in the private sector to partially address the disadvantage of a very small outreach compared to widely spread SLIC branches. Moreover, it will also help banks in increasing their revenue through fee income and foster universal banking concept.

Benefits of Bancassurance

LI products have gained more prominence in bancassurance due to the complementary nature of LI and bank products, both of which are geared towards asset accumulation and management by financial institutions. Since LI products are generally long term in nature, therefore they require the trust of financial institutions such as banks. Similarly, knowledge of the customer's financial background is important and is a requirement for LI products. Some of the benefits of bancassurance under different arrangements are highlighted in **Table B.6.3.1**.

Table B.6.3.1: Benefits of Bancassurance Under Different Arrangements

Benefits to Banks	Distribution agreements	Joint Venture	Integrated operators	Benefits to Insurers	Distribution agreements	Joint Venture	Integrated operators
Secure an additional and more stable stream of income through diversification into insurance and reduce their reliance on interest spreads as the major source	Yes	Yes	Yes	Tap into the huge customer base of banks	Yes	Yes	Yes
Leverage on their extensive customer bases	Yes	Yes	Yes	Reduce their reliance on traditional agents by making use of the various channels owned by banks	Yes	Yes	Yes
Sell a whole range of financial services to clients and increase customer retention	No	Yes	Yes	Share service with banks	No	Yes	Yes
Reduce risk-based capital requirement for the same level of revenue	Yes	No	No	Develop new financial products more efficiently in collaboration with their bank partners	No	Yes	Yes
Work towards the provision of integrated financial services tailored to the life-cycle of customers	No	Yes	Yes	Establish market presence rapidly without the need to build up a network of agents	Yes	Yes	Yes
Access funds that are otherwise kept with life insurers who sometimes benefit from tax advantage	No	Yes	Yes	Obtain additional capital from banks to improve their solvency and expand business	No	Yes	Yes

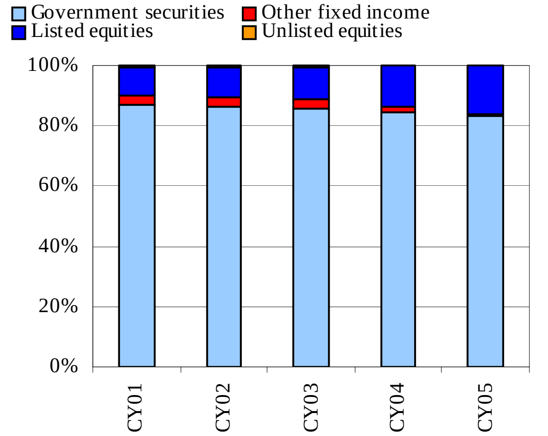
Risks

Benefits in using bancassurance are not free of costs, as some risks are associated with this channel as well. Firstly, there is always the risk of substitution between similar banking and insurance products. Secondly, there is likelihood of a contagion effect (reputation risk) from bank's insurance operation; therefore, selection of insurer should be done on prudent grounds. Lastly, acceptability of bancassurance by insurance agents is vital, which can only be fostered if business through bancassurance leads to additional demand rather than shift in business from insurance agent to bancassurance channel.

Sources: (1) "Banassurance Developments in Asia – shifting into a higher gear", Swiss Re, Sigma No. 7/2002.
(2) "Development of Bancassurance in Malaysia" , Annual Insurance Report (2004),. Bank Negara Malaysia.

16.1 percent at the end of CY05. The increase in the share of equity market investment was primarily at the cost of investment in government securities. Besides high returns in the stock market, this change was primarily driven by sharply declining yield and scarcity of long-term government securities (i.e. PIBs).[11] In fact, in the event of the declining return on PIBs, LI companies have very few options to diversify investment portfolio. While, corporate companies, including insurance companies, were banned to invest in National Saving Schemes (NSS) since March 2000, supply of other long-term securities, such as TFCs, has also declined from 2003 onwards. These developments, in turn, forced life insurance companies to invest relatively more in stock markets. This development underscored the need to revive PIB issues and promote long-term bond market in Pakistan in general.

Figure 6.5: Investments Composition of LI Companies



6.2.3 Financial Performance of Life Insurance Companies

Analysis in this section is based on CARMELS framework proposed by IMF to evaluate the financial performance of insurance companies.[12] CARMELS represents capital adequacy, asset quality, reinsurance and actuarial issues, management soundness, earning profitability, liquidity and sensitivity.[13]

Table 6.6: Financial Soundness Indicators of Life Insurance

percent

Ratios	CY01	CY02	CY03	CY04	CY05
Capital to total assets	1.4	1.4	1.7	1.5	1.5
Investment in equity market to total assets	8.2	8.5	9.1	10.8	12.4
Risk retention ratio[1]	96.9	96.9	97.2	97.0	96.8
Gross premium per employee (million Rupees)	167.0	209.4	262.8	294.6	369.9
Administrative expenses to gross premium	40.1	38.0	36.6	38.7	35.1
Loss ratio[2]	65.5	47.4	64.0	56.5	62.2
Expense ratio[3]	113.6	93.2	90.8	95.6	85.6
Combined ratio[4]	179.1	140.6	154.8	152.1	147.9
Investment income to net premiums	108.6	113.7	82.5	98.0	78.9
ROA	0.4	0.3	0.4	0.3	0.3
Investment income to Investment assets	79.9	80.9	80.6	79.9	77.0
Liquid assets to current liabilities	88.0	89.3	92.1	94.2	95.3

[1]: Net premium to gross premium ratio; [2]: Net claims to net premium ratio

[3]: Management expenses to net premium ratio; [4]: Loss ratio plus expense ratio

Source: Annual audited reports of the life insurance companies

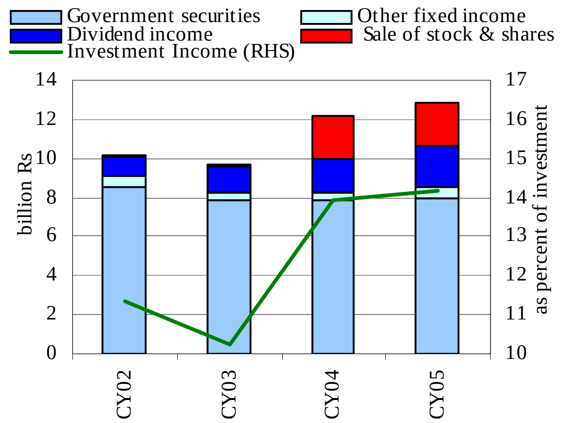
[11] The latter was true due to two reasons: first, the government did not issue fresh PIBs during FY03-05; and second, banks opted to keep a substantially larger portion of PIBs in the held-to-maturity category (for details see **Chapter 8**).

[12] For details see Das, Udaibir S; Davies, Nigel; and Podpiera, Richard (2003) on "Insurance and Issues in Financial Soundness", IMF working paper no. 03/138.

[13] Due to non-availability of data related to sensitivity indicator, only CARMEL framework is assessed for LI industry in Pakistan.

Financial indicators in CY01-05 suggest that the financial health of LI companies (in aggregate) have improved somewhat: capital adequacy has enhanced, operating efficiency has increased, and liquidity ratios reflect a relatively better position by end CY05. However, Return on Assets (ROA) and assets quality indicators saw little deterioration.

Figure 6.6: Composition of Investment Income



Improvement in capital adequacy, as shown by the increase in capital to asset ratio (see **Table 6.6**), primarily resulted from an increase in paid-up capital requirement, retained earnings from increasing profit levels and increased accumulated net surplus.[14] Another encouraging development was the improvement in operating efficiency, as reflected by a fall in operating expense ratios (for details see **Box 6.4**). As shown in **Table 6.6**, both expense and loss ratios registered significant decline in CY05 compared to CY01. A relatively higher growth in net premiums than expenses and net claims resulted into the fall of the two ratios.[15] However, despite the improvement in operational efficiency, return on assets of the LI sector has declined from 0.4 percent in 2001 to 0.3 percent in 2005. Fall in yield on government securities, a main avenue of LI investment funds, was a prime factor in reducing the profitability ratio (see **Figure 6.6**).

In fact, lower yields on government securities and significantly better returns in stock market provided incentives to LI companies to increase their exposure in the stock market, which is a relatively risky avenue for insurance companies. As a result, investment in stock market to total assets, a generally used indicator of asset quality of LI companies where increase shows deterioration, has increased from 8.2 percent in CY01 to 12.4 percent in CY05.

[14] It may be important to note that capital to asset ratio of LI companies is considerably lower than that of non-life insurance companies. However, as assets of LI companies mainly comprise of investment in government securities, this low capital to asset ratio may not reflect a bad sign.

[15] For details on trends and composition in claims see **Box 6.5**.

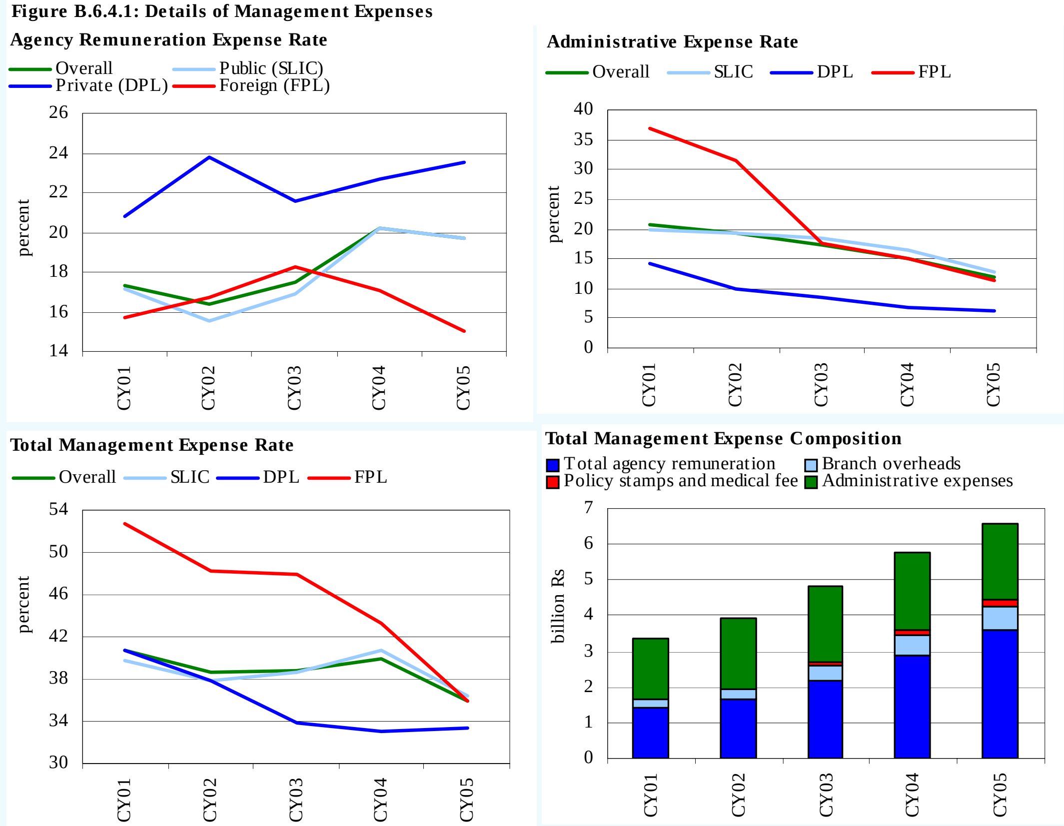
Box 6.4: Operating Efficiency of Life Insurance Sector in Pakistan

The operating efficiency of insurance companies has generally been gauged by trends in Management Expense Rate (MER) and its compositional changes. The MER is a ratio of management expense to gross premium, where management expense largely comprises of agency remuneration and administrative expenses. Thus, changes in MER can largely be explained by trends in Agency Remuneration Rate (ARR) and Administrative Expense Rate (AER).[1] Declining trends in MER, especially if it results due to a fall in AER, are being considered as improvement in operating efficiency. During CY01-05, both trend and compositional changes in MER suggest that the operating efficiency of the LI sector in Pakistan has improved.

Specifically, management expense of LI companies exhibited a CAGR of 17.9 percent during CY01-05, which is significantly lower than the average growth in gross premium during this period. As a result, the management expense rate fell from 40.8 percent in CY01 to 35.9 percent at the end of CY05. Encouragingly, all the three groups have shared this improvement (see **Figure B.6.4**). Moreover, this improvement mainly stemmed from the decline in AER from 20.6 percent in CY01 to 11.7 percent in CY05.

While the MER declined in CY01-05, ARR increased from 17.3 percent to 19.7 percent during the same period. The higher increase in agency remuneration indicates the incentive offered by LI companies to make the sales force more productive, the lower increase in administrative expenses suggests the operating efficiency achieved by LI sector, particularly by DPL and FPL during CY01-05.

Figure B.6.4.1: Details of Management Expenses



[1] ARR and AER are computed as agency remuneration expenditure and administrative expenses relative to gross premium respectively.

Box 6.5: Composition of Claims Against the Life Insurance Sector

Claims against LI policies witnessed a CAGR of 10.9 percent during CY01-05. Both individual and group life claims contributed in growth of claims as reflected by 9.9 and 13.3 percent CAGR during CY01-05 respectively. Since LI claims were largely filled against individual life policies as reflected by 66.6 percent share, its significance in growth pattern is more than the claims against group life.

Individual Life Insurance Claims

Within individual life, claims were largely logged against the maturity and surrender of the policies. In fact, the share of maturing policies in total claims increased from 31.8 percent in CY01 to 49.1 percent in CY05 (see **Table B.6.5.1**). The higher claims on account of maturity is not necessarily a bad sign for the growing insurance industry as it suggests the confidence of the customer in retaining the policy till fixed tenor, which is beneficial as the company is able to take profit from regular premium payment for the whole tenor. On the other hand, the share of claims on account of surrender declined from 52.0 percent in CY01 to 34.5 percent in CY05. In fact, the amount surrender as a percent of total individual premium declined from 33.1 percent in CY01 to 14.6 percent in CY05. The declining trend in surrender of policies is a healthy sign for the LI sector as companies were able to retain the policyholders, which in turn helped in developing the LI sector.

Table B.6.5.1: Classification of Individual Life Insurance Claims

Amount in million Rupees; share in percent

	Amounts					Share in total				
	CY01	**CY02**	**CY03**	**CY04**	**CY05**	**CY01**	**CY02**	**CY03**	**CY04**	**CY05**
By death	632	620	718	691	915	15.2	13.8	15.7	12.9	15.0
By maturity	1,323	1,593	1,745	2,464	2,997	31.8	35.5	38.2	45.9	49.1
By surrender	2,166	2,212	2,052	2,135	2,105	52.0	49.3	44.9	39.8	34.5
Others	42	62	56	74	82	1.0	1.4	1.2	1.4	1.3
Total gross claims	4,162	4,486	4,571	5,363	6,099	100	100	100	100	100

Source: Insurance Companies

Group Life Insurance Claims

Unlike individual life, larger share of claims in group life were paid on account of death (see **Table 6.5.2**). The higher proportion of death claims in group LI business is expected given the nature of group LI that largely aimed at hedging risk against death of the employee or any accidental event damaging the health of employee. During CY01-CY05, share of death claims in total group claims has further increased to reach around 93 percent in CY05. On the other hand, experience refund, which is the bonus shared with master policyholder, declined from 10.2 percent of total claims in CY01 to 1.8 percent in CY05.

Table B.6.5.2: Classification of Group Life Insurance Claims

Amount in million Rupees; share in percent

	Amounts					Share in total				
	CY01	**CY02**	**CY03**	**CY04**	**CY05**	**CY01**	**CY02**	**CY03**	**CY04**	**CY05**
By death	1,522	830	1,911	2,415	2,802	83.3	75.7	79.9	85.7	92.9
By maturity	2	2	8	16	15	0.1	0.2	0.3	0.6	0.5
By surrender	22	12	-	-	-	1.2	1.1	-	-	-
Experience refund	187	189	358	261	54	10.2	17.3	15.0	9.3	1.8
Others	94	63	115	125	144	5.2	5.7	4.8	4.4	4.8
Total gross claims	1,827	1,096	2,392	2,816	3,015	100.0	100.0	100.0	100.0	100.0

Source: Insurance Companies

6.3 Non-Life Insurance Sector[16]

Unlike life insurance, the non-life insurance sector comprises of a large number of companies predominantly owned by the domestic private sector. At end-CY05, out of a total of 46 companies, 43 were owned by the domestic private sector. In fact, most of the non-life insurance (NLI henceforth) companies were established by large industrial groups in urban areas. These companies were aimed at enhancing the flow of funds in the form of regular premiums. The NLI sector, thus evolved, was facing challenges such as lack of professional expertise, small capital base, weak regulatory structure and inadequate supervision.

The promulgation of insurance ordinance in 2000 and subsequent regulatory changes strengthened the regulatory and supervisory infrastructure for NLI companies. For instance, enhancement in paid-up capital requirement improved the equity structure and reduced the number of non-profitable companies.[17] These regulatory reforms, in a robust economic growth environment, started generating some dividends. During CY01-05, the financial health of the NLI sector has also improved considerably. Nevertheless, the structure of the NLI sector is still very skewed. For instance, the top 5 companies have more than 70 percent in the overall assets and net premium of the sector at the end of CY05.

6.3.1 Growth of Non-Life Insurance Sector

The consistent high economic growth, in particular the surge in industrial and trade activities, helped the NLI sector to record a double-digit growth in premium income from CY03 onwards. In specific terms, during CY02-05, gross and net premiums of the NLI sector registered a CAGR of 22.5 and 26.9 percent, respectively (see **Table 6.7**).[18] Relatively higher growth in the latter suggests increase in retention ratio, which could largely be explained by two factors: first the share of motor insurance (in the overall premium) has increased, which is generally less reliant on reinsurance support; and second mandatory requirement for domestic NLI companies to get reinsurance for a certain proportion of insurance portfolio was completely abolished in 2004.

Table 6.7: Growth Pattern in Non-Life Insurance Sector

percent

	Gross premium				Net premium			
	Public	Private	Foreign	Overall	Public	Private	Foreign	Overall
2002	-	-	-	-	49.3	2.9	-15.7	39.3
2003	44.9	23.4	29.4	27.3	-21.1	19.0	46.0	10.8
2004	8.5	22.9	-10.7	14.8	0.8	38.0	-28.0	23.9
2005	5.9	23.6	57.6	25.7	41.3	27.8	78.1	35.6
2002-05*	18.5	23.3	22.1	22.5	13.8	21.2	12.1	26.9

* CAGR

Source: Insurance Companies

Stepping back, decomposition of growth in gross premium suggests that *motor*, *marine* and *fire* categories were prime contributors (see **Figure 6.7**). This was attributed to the followings:

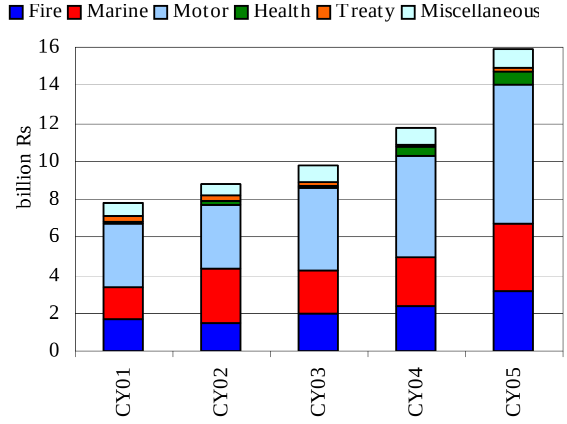
[16] The NLI sector comprises of any insurance cover including automobile, mortgage, health, fire and treaty that provides compensation against the financial loss incurred in a catastrophic event. At end-CY05, there were 46 companies; however, analysis here is based on 41 companies as data for the five companies is not available. It may be important to note that in CY04 aggregate share of these five companies in total assets of non-life insurance sector was below 1 percent.

[17] As a result, the number of general insurers including health insurance companies declined from 58 in CY00 to 46 (including one state owned, two foreign private and 43 domestic private non life insurers) in CY05. In addition, six companies ceased to undertake any new business because of the shortfall in required capital base.

[18] Because of this robust premium growth and increased paid-up capital requirement, aggregate assets of non-life insurance grew by 19.3 percent during CY01-05.

- Exceptional domestic credit growth, particularly availability of consumer financing at low interest rates, spurred the growth of auto sales that in turn, enhanced the need for motor insurance.[19]
- Similarly, the unprecedented rise in trade volumes, war in Afghanistan and Iraq, and increased uncertainty due to terrorist attacks in many regions increased the demand for marine insurance. [20]
- Moreover, surge in industrial activity, increased investment in new plants and machinery, and high growth in construction business led to improvement in the fire insurance business.[21]

Figure 6.7: Composition of NLI Gross Premium



6.3.2 Structure of Non-Life Insurance Sector

In sharp contrast to the life insurance sector, the NLI business is predominantly owned by the private sector, in particular by domestic private companies. The share of the domestic private sector has further increased from CY02 onwards (see **Table 6.8**), primarily at the cost of the state-owned National Insurance Corporation Limited (NICL).[22]

Table 6.8: Ownership Structure of Non-Life Insurance Sector

percent

	Net premium			Assets		
	Public	Private	Foreign	Public	Private	Foreign
CY02	23.3	72.3	4.4	40.7	55.2	4.1
CY03	16.6	77.7	5.7	37.8	58.0	4.2
CY04	13.5	86.5	3.3	34.3	65.7	2.6
CY05	14.1	81.5	4.4	31.6	65.5	2.9

Source: Insurance Companies

While the NLI sector comprises of a large number of private insurers, the structure is highly skewed; only a few companies dominated the overall sector (see **Table 6.9**). During CY02-05, asset concentration has marginally improved. The share of the top five companies (in total assets) declined by 4.9 percentage points to reach 71.1 percent, which is still very high (see **Table 6.9**). In fact, there is considerable scope for consolidation in the NLI sector.

Table 6.9: Concentration in Non-Life Insurance Sector

percent

	Net premium		Assets	
	Top five	Top ten	Top five	Top ten
CY02	79.4	88.6	76.0	85.8
CY03	75.9	87.1	73.9	84.6
CY04	75.1	86.4	72.5	83.4
CY05	73.2	85.3	71.1	82.8

Source: Insurance Companies

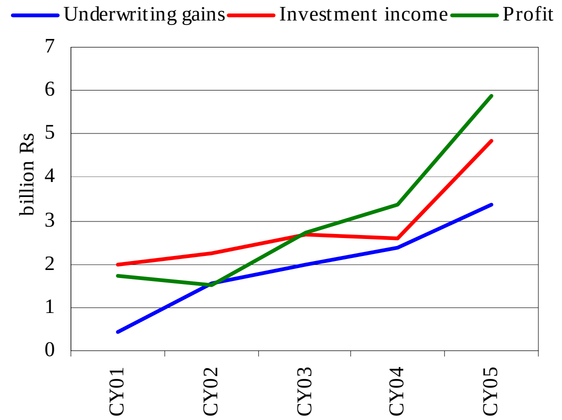
6.3.3 Financial Performance of Non-Life Insurance Companies

The high growth of the NLI sector during CY01-05 was accompanied by an improvement in companies' financial health as well. As shown in **Table 6.10**, financial indicators reflecting profitability, operating efficiency, capital adequacy and liquidity suggest a relatively better financial position in CY05. Profits of NLI companies registered a sharp average annual growth rate of 35.7 percent; which was well above the asset growth. As a result, ROA has increased from 7.7 percent in CY01 to 10.9 percent in CY05.

[19] For availing auto-finance, banks necessitate borrowers to insure their vehicles.
[20] During CY01-05, marine insurance recorded a CAGR of 19.3 percent.
[21] Fire insurance business registered a CAGR of 17.5 percent during CY01-CY05.
[22] This is the only state-owned company in NLI business.

In fact, growing underwriting gains and a strong rise in yield on investments (in CY05) contributed significantly in achieving this remarkable growth in profits (see **Figure 6.8**).[23] Encouragingly, the improvement in underwriting gains stemmed from both fall in claim ratio and increase in operating efficiency (see **Table 6.10**).[24]

Figure 6.8: Major Sources of Profit



6.4 Reinsurance

Up till 2003, it was mandatory for domestic companies in NLI business to get 5 percent of their business underwritten from the state-owned Pakistan Reinsurance Company Ltd. (PRCL), the only reinsurance company in Pakistan.[25] This compulsory requirement has been withdrawn completely in CY04 onwards and by now domestic non-life insurance companies are free to get the mandatory reinsurance either from PRCL or any foreign company.

Table 6.10: Financial Ratios of Non-Life Insurance Industry

percent

	CY01	CY02	CY03	CY04	CY05
Capital adequacy ratios					
Equity / total assets	41.3	26.5	41.1	41.4	43.2
Growth rate of equity	-	18.1	15.3	19.1	27.4
Growth rate of assets	-	18.7	13.8	45.8	22.1
Liquidity ratios					
Liquid assets / total assets	14.1	24.1	17.1	19.4	20
Operating ratio					
Underwriting expense / gross premium	16.9	14.2	13.3	11.7	11.3
Claim ratio	65.2	55.7	52.6	55.9	56.6
Operating ratio	40.8	28.8	24.1	45.7	37.4
Combined ratio	65.4	60.5	65.8	67.6	67.9
Profitability ratios					
Return on assets (ROA)	7.7	5.7	9.0	7.6	10.9
Investment income / net premiums	24.6	27.1	28.6	21.9	30.5
Investment income / investment assets	16.2	21.3	18.3	15.7	21.6
Growth rate of profits		-12.3	80.4	23.0	74.6

Source: Insurance Companies

As the domestic NLI sector registered double-digit growth in gross premium, during CY01-04 PRCL also recorded a substantial growth at 8.1 percent CAGR in gross premium. As expected from the withdrawal of compulsory cession for domestic non-life insurance companies in CY05, both assets and gross premium of PRCL registered negative growth of 14.8 and 20.6 percent, respectively (see **Table 6.11**). However, despite this slowdown, profitability of the company improved significantly. After tax ROA improved from 4.9 percent in CY04 to 10.5 percent in CY05. This was primarily due to sharp decline in net claims from PRCL.

Interestingly, the net retention ratio of PRCL has climbed steadily since CY03, indicating that PRCL net underwritten premium increased proportionally more than increase in gross underwritten premium (see **Figure 6.9**). On the other hand, claim ratio, measured by net claims as percent of net premium, declined to 19.7 percent in CY05; after increasing from 21.5 percent in CY03 to 25.3 percent in CY04. While PRCL business retention level has increased from CY03, which in turn, exposed PRCL to a relatively higher risk, however, lower claim ratio helped to record higher profitability.

[23] Improvement in underwriting discipline is reflected from the fact that only 9.7 percent of total insurers registered underwriting losses in CY05 against 30.7 percent in CY02.

[24] For composition of claim ratio see **Box 6.6**.

[25] In contrast, companies in LI business can get the reinsurance from foreign companies operating in this business.

While the abolition in mandatory cession from PRCL may retard its premium growth, this would help in harnessing competition by encouraging business for direct reinsurance. In this context, the possibility of granting licenses to private domestic and foreign professional re-insurers can be explored, as it will help in the development of reinsurance business in Pakistan.

Table 6.11: Reinsurance Business in Pakistan

million Rupees

	CY01	CY02	CY03	CY04	CY05	CY01-05*
Paid up capital	50	450	450	450	450	73.2
Reserves and retained earnings	758	796	981	1,306	1,789	23.9
Investments	1,661	1,905	1,886	2,719	2,873	14.7
Gross premium	3,045	3,500	4,697	5,241	4,160	8.1
Net premium	1,312	1,588	1,447	2,289	2,005	11.2
Net claims incurred	709	848	1,011	1,329	823	3.8
Management expenses	98	108	140	134	171	14.9
Net profit after tax	67	297	333	325	594	72.6
Total assets	3,332	4,192	6,232	6,613	5,634	14.0

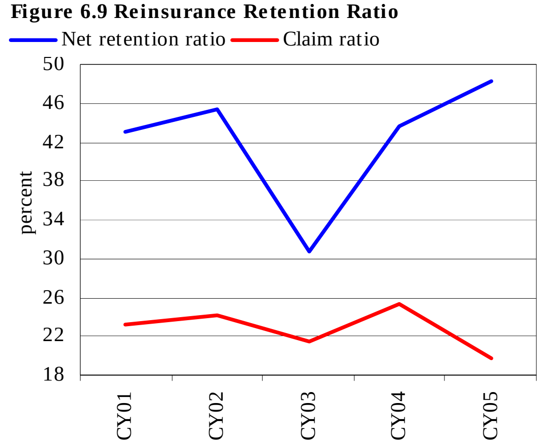
*:Showing CAGR during the period

Source: Balance Sheets of Pakistan Reinsurance Company Limited

6.5 Conclusions

The insurance industry in Pakistan showed a consistent improvement during CY01-05 spurred by macroeconomic stability, higher economic growth and continuation of reform process. This improvement was clearly visible in the exceptional growth of the insurance industry. Encouragingly, the growth was broad-based as both the life and non-life insurance sectors witnessed a double digit growth in assets and gross premium. Moreover, in aggregate terms, the financial health of the insurance sector has improved considerably; as compared to CY01, at the end of CY05 insurance companies were relatively better capitalized, had lower claim ratio and higher profits.

Figure 6.9 Reinsurance Retention Ratio



Nevertheless, the insurance industry in Pakistan generally remained dormant. This is reflected from the fact that at end-CY05 the gross premium of the insurance industry was below 1 percent of the country's GDP, which was also significantly lower compared to other regional countries, including India and Sri Lanka. The low share of the insurance industry in the financial sector calls for taking concrete steps in order to enhance the role of the insurance sector in financial deepening.

While rapid growth and continuity of reforms process has reduced the concentration ratio in the insurance industry, there exists a considerable scope for further consolidation of small-sized weak institutions in the non-life insurance sector. It is important to note that paid-up capital requirement for insurance companies, both in life and non-life businesses, is significantly lower than that of the other developing countries.[26] In fact, SECP has recently proposed to increase the capital requirement for the insurance sector.

The continued progress in the surveillance and monitoring efforts is another factor that may help in development of insurance industry in Pakistan. While substantial progress has been made in formulating the regulatory framework and subsequently developing off-site inspection of insurers, in particular ensuring compliance of solvency requirements; however, comprehensive enforcement of regulations demands more in-depth surveillance in the form of on-site inspection of insurers as well as intermediaries. Moreover, it is imperative for insurers and SECP to harness public confidence by strengthening the consumer protection infrastructure. The recent appointment of insurance ombudsman would subscribe insurers to high ethical and standard moral values through greater sales accountability and consumer redress. Moreover, the promotion of consumer awareness and education would also be needed to safeguard consumers from unfair practices in the insurance industry. Similarly, dissemination of information related to insurance sector would also highlight the integrity of insurance companies. In this regard, SECP needs to build comprehensive database of financial position of insurers so that effective policies can be formulated to provide enabling environment for development of insurance industry.

Box 6.6: Claim Ratios of Different Classes of Non-life Insurance Sector

The non-life insurance sector experienced a significant improvement in claim ratios that declined from 65.2 percent in CY01 to 56.6 percent in CY05. This suggests that the underwriting practice of the NLI sector became relatively more prudent. The improvement was clearly visible in *motor*, *marine* and *health* insurance businesses as these sectors saw a sharp decline in claim ratio during CY01-05. In fact, motor insurance business, which has the largest share in total claims, showed improvement during CY01-05 due to significant growth in premium and security measures such as installation of tracker and locking devices. The medical and health sector, though smaller share, also witnessed significant decline in claim ratio (see **Table B.6.6.1**).

Similarly, Marine insurance, which is the second largest business in terms of premium, experienced a substantial decline in claim ratio on the back of lower cargo losses and greater implementation of safety measures. In contrast, fire and property insurance claim ratio showed increasing trend during CY01-05.

Table B.6.6.1: Composition of Claim Ratio

percent

	Share in total claims					Claim ratio				
	CY01	**CY02**	**CY03**	**CY04**	**CY05**	**CY01**	**CY02**	**CY03**	**CY04**	**CY05**
Fire	11.7	13.6	12.5	26.4	21.0	36.2	47.0	33.7	71.8	60.5
Marine	12.1	15.1	16.2	10.2	10.2	35.0	26.0	37.5	26.3	25.5
Motor	63.1	57	58.2	53.9	56	98.4	82.3	70.3	66.5	69.1
Misc.	3.8	9.1	6.6	5.3	7.5	26.5	71.7	43.1	39.0	64.9
Health	2.2	2.8	1.1	4.1	4.1	83.6	93.2	93.3	57.7	51.4
Treaty	7.1	2.4	5.4	0.1	1.3	117	39.3	102	4.4	83.7

[26] For instance in India both life and non-life insurance companies are required to have paid-up capital of Indian Rs 1.0 billion (or around US$ 22 million). While in Pakistan the paid-up capital requirement is Rs 100 million (or US$ 1.7 million) and Rs 80 million (or US$ 1.3 million) for life and non-life insurance companies, respectively.

Box 6.7: Takaful Insurance –An Alternate to Conventional Insurance

Similar to a financial system in general, successful development of a robust and resilient Islamic financial system also depends on the ability to integrate the Islamic banking industry, financial markets including money and capital markets, and takaful (Islamic insurance). Takaful, which is at infancy stage, is being practiced by over 60 companies in 23 countries. In Pakistan, Takaful business is recently introduced after formulation of Takaful insurance rules in 2005. Only one company, Pak-Kuwait Investment Company is offering Takaful General business, while a number of other companies have showed interest in launching Takaful business including Family Takaful.

Origin of Takaful

Though a debatable issue, crude form of takaful was practiced before the era of the Holy Prophet Muhammad (PBUH). However, a Hanafi lawyer Ibu Abidin (1784-1936) was the first Islamic scholar to come up with the meaning, concept and legal basis of an Islamic contract.

Underlying Concept

Takaful is derived from an Arabic word which means joint guarantee, whereby a group of participants agree to jointly guarantee among themselves against the defined loss. Therefore, any member faced with a calamity will be financially compensated from funds contributed by the participants,. These funds are managed and distributed through a Shariah-complaint process. There are many forms of takaful business such as:

(a) Tabarru: This word means donation, gifts or contribution. A participant in takaful business agrees to relinquish, as a donation, a certain proportion of the contribution into a takaful fund to assist other participants faced with difficulties. It embraces the elements of shared responsibility, joint indemnity and mutual protection. In fact, it is the core of the takaful system that makes the uncertainty element allowable under takaful contract.

(b) Mudarabah/Wakalah: In this form of business, the takaful operator is the administrator of the fund and manages the fund in trust on behalf of participants, and contract between the participants and the operator is governed under the contract of mudarabah (profit-sharing) or wakalah (agency). The contract gives the right to the contracting parties to share the profit, while liability for losses is borne by the participants. In fact, under wakalah model, the takaful operator earns a fee for services rendered while liability for losses is borne by the participants. The fee may be varied based on performance of the takaful operator.

Models of Takaful

The most dominant model followed internationally is mixed model of Wakalah/Al-Mudarabah, which has several sources of income for the operator like: (1) profit from the investment of its shareholder; (2) agency/wakalah fee; (3) share of investment profit of takaful funds; and/or (4) surplus of takaful funds. The separate characteristics of model are outlined as:

(a) Non-profit Model: This refers to social governmental owned enterprises and programs operating on a non-profit basis. The contribution paid by participants are wholly for tabaruu (donations) to unfortunate members. This model is being used in Sudan and Malaysia.
(b) Al-Mudarabah Model: This refers to the co-operative risk sharing where participants and operations share in distribution profit.
(c) Al-Wakala Model: In this model, the co-operative risk sharing occur among participants with a takaful operator whereby a fee is agreed to be paid to the operator for the services rendered. The operator shall not participate in the underwriting result.

Operational System of Takaful

There are two classes of Takaful business in operations:

(a) Family Takaful Operations: The plan available is somewhat similar to the endowment policy in conventional insurance practice in which participants may choose a fixed period of coverage for which installments are paid. Each installment is divided and credited into two separate accounts, i.e. the participant's account (PA) and the participant's special account (PSA). The portion that goes into the PA is for saving and investment whilst the balance of the installment is credited into the PSA as the tabarru contribution (donation).

(b) General Takaful Operations: The general operations are for protection on a short-term basis, i.e. up to 12 months. The participant's contribution is wholly on the basis of tabaruu (donation) and sharing of profit on underwriting surplus and investment income.

Comparison of Insurance and Takaful

There are three elements present in the conventional insurance that do not conform to the requirement of the Shariah. They are:

(a) Al-Gharar: This refers to unknown or conventional insurance contract. In conventional contracts it is not made known to the policy-holder on how much profits are distributed and mode of investment is also not outlined, which is clearly mentioned in Takaful business.

(b) Al-Maisir: This is gambling element and is said to derive from the 'gharar' element. In conventional insurance, the policy-holder loses all premiums paid if the risk does not occur and only gets huge amount when misfortune occurs. In takaful, participant gets full contribution he made in any case, with additional pooled donation amount if misfortune occurs.

(c) Riba: This refers to interest rate earned on investments, which is prohibited in Islamic ideology.

Contract	Insurance	Takaful
Contract	An exchange contract (sale & purchase) between insurer and insured.	A combination of tabaruu contract (donation) and agency or profit sharing contract.
Responsibilities of policy-holders/ participants	Policy-holder pays premium to the insurer.	Participants make contributions to the scheme. Participants mutually guarantee each other under the scheme.
Liability of the insurer/ operator	Insurers are liable to pay the insurance benefits from its assets.	Takaful operator acts as the administrator of the scheme and pays the takaful benefits from the takaful funds. In the event of deficiency in the takaful funds, operator will provide interest free loan to rectify the deficiency.
Investment of funds	There are no restrictions other than prescribed in rules for insurance companies in a country.	Assets of the takaful funds are invested in shariah-compliant instruments.

Global Takaful Standards

In the international arena, efforts have been made to formulate global standards for takaful insurance. The International Financial Services Board (IFSB) and the International Association of Insurance Supervisors (IAIS) are jointly developing these standards. In fact, IAIS technical committee has accepted paper presented by IFSB-IAIS joint working group in October 2005. The paper highlights in-depth coverage of issues such as background of takaful, the need for a standard, the relevance of IAIS Core Principles to takaful, governance issuance, financial and prudential issues, market conduct issues and supervisory skills and training. The paper is broadly divided into four major themes: (1) Corporate governance; (2) Financial and prudential regulation; (3) Transparency, reporting and market conduct; and (4) Supervisory review process. The paper concludes that corporate governance is the foremost requirement for global takaful standards.

Source: '20 years experience of Malaysian Takaful industry', Bank Negara Malaysia (2004).