10 RISK ANALYSIS OF THE INSURANCE SECTOR

10.1 Introduction

Insurance is a risk management tool primarily used to hedge against the risk of a contingent loss. The role of the insurance sector is significant in promoting the stability of the overall macroeconomic environment by providing a mitigant against uncertainty to economic agents by an equitable transfer of risk, in exchange for a premium. Life insurance companies in particular, due to the nature of their premiums, are also among the large institutional investors for capital and money market instruments.

The insurance sector in Pakistan has seen considerable improvements since CY01 on account of the rise in the demand for insurance by corporate, households and public sector entities. However, with two-thirds of the population living in rural areas and low per capita income, the insurance sector faces various hurdles in its growth and its share in the assets of the financial system of the country was only 4.1 percent in CY06. Insurance business in Pakistan is categorized into two sub-sectors: non-life insurance and life insurance. There are 53 companies providing non-life insurance and 5 companies which offer life insurance products. Despite fewer companies, the life insurance sector accounts for 67 percent of total insurance assets.[1] The reinsurance industry on the other hand, has only one reinsurance company that reinsures the business of the non-life insurance market.

10.1.1 Overview of Global Insurance

The global insurance industry saw an increase in insurance premiums in CY06, after a modest growth during CY05, on account of high premium volumes in life insurance. In case of emerging markets, as shown in **Table 10.1**, growth in premiums in Pakistan's insurance sector is the second highest in the selected sample of countries. The above-average growth of India's insurance industry is attributed to the distributive channel of Bancassurance. Overall, the booming stock markets in nearly all these countries supported unit-linked life insurance products.[2] This favored the profitability of life insurance companies during the year.

Table 10.1 : Real Premiums Growth Rate in CY06
percent

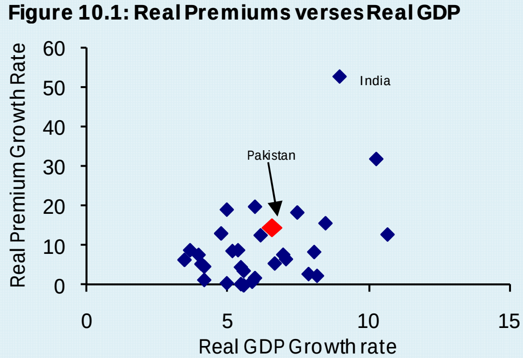
	Life	Non Life
Industrialized Countries	6.6	0.6
Emerging Markets	21.1	10.8
Egypt	5.6	-5.9
India	60.1	17.1
Indonesia	10.5	-11.1
Malaysia	1.6	-0.4
Pakistan	29.3	13.8
Thailand	0.6	1.9
Total (worldwide)	7.7	1.5

Source: Swiss Re, Sigma 4 / 2007

Moreover, the dynamic global macroeconomic environment combined with moderate inflation and low interest rates also augmented the overall growth in premiums worldwide. However, the growth in the insurance sector was more pronounced in emerging markets than in industrialized countries (**Box 10.1**)

While comparing the growth in real premiums with real GDP growth rates, it is generally observed that a higher GDP growth leads to a rise in the volume of premiums. **Figure 10.1** reflects this

Figure 10.1: Real Premiums verses Real GDP



Source: Swiss Re, Sigma 4 / 2007

[1] As of end-CY06

[2] A unit link product or policy is a life insurance policy in which the insured is provided life insurance coverage. The premium paid by the insured is invested by the insurance company in stocks and / or bonds. Hence the insured not only gets life insurance cover but also gains an investment return on the premium paid. More details on unit-linked products are discussed in **Box 10.3**

phenomenon. It is observed that growth in premiums in emerging markets exceeds the growth in real GDP, whereas, in case of industrialized countries, the growth in premium volume lags behind the rate of real economic growth.

BOX 10. 1: The Emerging Markets Phenomenon in the Insurance Industry

At the end of CY06, the insurance sectors in industrialized countries showed an aggregate real growth of 6.6 percent in life premiums, and 0.6 percent in non-life premiums, whereas their counterparts in the "emerging markets" showed a growth of 21.1 percent for life premiums and 10.8 percent for non-life insurance. This may well be because of the fact that insurance markets in the industrialized world have reached a saturation point, and at the same time emerging markets are showing tremendous growth in their economies as well as their populations.

Overall growth in an economy has a positive relationship with growth in its insurance industry. The empirical relationship between GDP per capita and development of the insurance market i.e. the "S-Curve" shows the positive relationship between rising GDP per capita and development of the insurance markets.

The complimentary (with growth) rise in insurance activity has put emerging markets on the radar screen of insurance companies in the industrialized world. Because of the potential of expanding business in these rapidly developing regions, subsidiaries of global insurers are propping up in emerging markets. In 2003, the Life Insurance sector of Hong Kong and Malaysia had 87 percent and 81 percent foreign ownership respectively.

These economies are also benefiting from these inflows as foreign ownership brings with it standards of conducting business which are more in line with international best practices, thus resulting in a rise in overall efficiency as well as integration with the international market.

To benefit from this rising foreign interest, regulators in most emerging markets are pursuing policies that aim at making their domestic markets more efficient as well as at creating a business atmosphere that would attract foreign investors. Steps taken in this regard include: reducing the direct involvement of the state in the insurance industry by privatizing state-owned insurers, removal of any entry barriers on foreign investments, tax incentives, removal of tariffs that retard profitability, and most importantly, insistence on strict solvency standards.

Source : Rudolf (2000), "The S-Curve Relation between per-capita income and Insurance", The

This is certainly true in case of Pakistan, where the real GDP growth for FY06 was 6.6 percent, while the real growth in overall premiums was 22.6 percent. However, Pakistan's share in the US $3.42 trillion global insurance industry stands at a meager 0.03 percent which is much lower than other countries of the region, such as India's 0.73 percent and China's 1.76 percent. Furthermore, insurance penetration in Pakistan is 0.8 due to which it ranks at number 82 in the world, which also reflects the small size of the insurance sector of the country.

10.1.2 Overview of Pakistan's Insurance and Reinsurance Sectors

Insurance is still considered to be an involuntary expense in Pakistan due to the general lack of awareness of insurance products. In view of the various impediments in the growth of the insurance sector, it has performed considerably well in CY06. The improved domestic macroeconomic performance has contributed significantly towards its growth. The total number of insurance companies operating in the country in CY06 was 58 as compared to 63 in CY00 and 54 in CY03. The decline in the number of companies since CY00 is due to losses incurred in core business by some weak players in the industry, and the minimum paid-up capital requirements specified in the Insurance Ordinance 2000. The minimum paid-up capital for non-life companies was earlier set at Rs. 80 million, and Rs. 150 million for life insurance companies, which has recently been enhanced to Rs. 300 million and Rs. 500 million for non-life and life insurance companies respectively.[3] This enhanced paid up capital limit is set to be enforced gradually in a phased manner until 2010. Since the imposition of paid-up capital

[3] Source: SECP Circular 5 / 2007

requirements, most of the companies have increased their paid-up capital significantly. Those firms which are unable to meet this requirement are not allowed to undertake new insurance business by the SECP.[4] This puts pressure on smaller companies to either close down, or to merge with another company, resulting in a gradual consolidation of the sector. SECP's stringent requirements have strengthened the capital base of the sector and have paved the way for the implementation of new reforms and regulatory requirements.

The reinsurance sector consists of only one state-owned reinsurance company, i.e. Pakistan Reinsurance Corporation Ltd (PRCL). CY06 was a significant year for the reinsurance sector as it was the first year of operation subsequent to the abolition of the requirement for direct compulsory cession of all private non-life insurance companies with PRCL.[5]

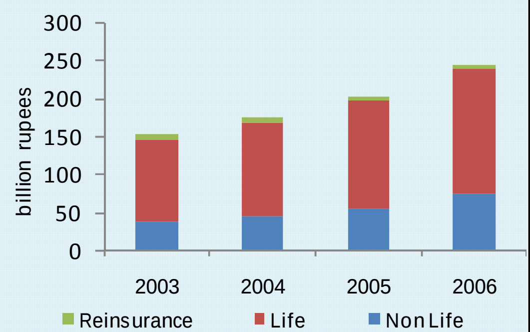
Table 10.2: Asset Structure of the Insurance and Reinsurance Industry
Share in percent, amount in billion Rupees

	2001	2002	2003	2004	2005	2006
Share of Life Insurance						
Public Sector	73.74	73.56	70.59	69.43	67.39	63.14
Private Domestic	1.24	1.55	2.50	2.70	3.19	3.39
Private Foreign	0.93	1.03	1.36	1.66	2.06	2.36
Share of Non-Life Insurance						
Public Sector	5.81	5.69	6.53	6.86	7.49	9.68
Private Domestic	17.21	16.97	17.77	18.52	19.00	20.59
Private Foreign	1.08	1.19	1.25	0.82	0.87	0.84
Share of Total Insurance	100	100	100	100	100	100
(1) Total Insurance Assets (Rs. Bn)	110.12	125.58	145.08	167.92	196.01	238.94
Share in Reinsurance						
Public Sector	100	100	100	100	100	100
(2) Total Reinsurance Assets (Rs. Bn.)	3.33	4.19	6.23	6.61	5.63	6.46
Insurance and Reinsurance						
(1+2) Total Assets (Rs. Bn)	113.45	129.77	151.31	174.53	201.64	245.40

Source: Annual Audited Accounts of Reinsurance and Insurance Companies

The total assets of the insurance industry increased by 21.9 percent in CY06 (**Figure 10.2**). This increase brought along with it some structural changes in the overall composition of the industry. Most notable is the increase in the share of the non-life sector in the overall assets, which for CY06 stood at 31.1 percent as compared to 27.7 percent in CY05[6] (**Table 10.2**). Furthermore, the share of foreign non-life companies has decreased from 0.87 percent in CY05 to 0.84 percent in CY06. In case of life insurance, this share has risen from 2.06 percent to 2.36 percent in CY06. The strong growth in the non-life sector is largely attributed to the rise in the demand for consumption goods financed by bank lending.

Figure 10.2: Assets of Insurance Sector



Source: Annual Audited Accounts of Insurance Companies

Furthermore, the financial health of the industry strengthened considerably with an enhanced amount of premiums. However, claims recorded a higher growth as the claim ratio for the overall industry including reinsurance, increased from 51.9 percent in CY05 to 53.4 percent in

[4] Six companies were ceased from undertaking new insurance business in CY06 by the SECP on account of their inability to meet minimum paid-up capital requirements.
[5] Detailed discussion of the Reinsurance sector is given in section 10.4.
[6] The sum of the shares of the public sector, private domestic sector and private foreign sector in the life and non-life categories is equivalent to the share of that particular sector in total insurance assets.

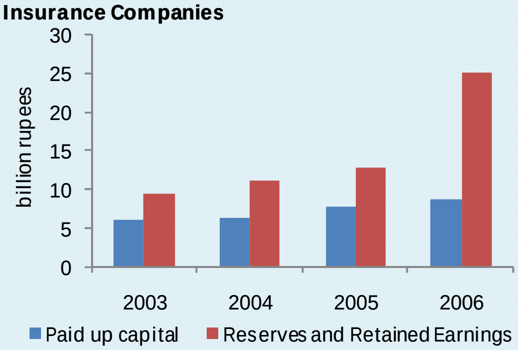
CY06. A high claim ratio reduces the profitability of the insurance companies, but on the other hand, also acts as a marketing tool in attracting insurance business.

10.2 Performance Review of Non Life Insurance Sector

10.2.1 Equity Structure of Non-Life Companies

Since the imposition of minimum paid-up capital requirements in the Insurance Ordinance 2000, non-life companies have enhanced their capital base substantially. The average paid-up capital of private companies was Rs 98 million in CY03, whereas 16 companies had a capital base less than the Rs 80 million level. The capital base in CY05 increased to Rs 158 million and then to Rs. 194 million in CY06. Moreover, the volume of reserves and retained earnings also improved considerably as shown in **Figure 10.3**.

Figure 10.3: Equity Structure of Non-Life Insurance Companies



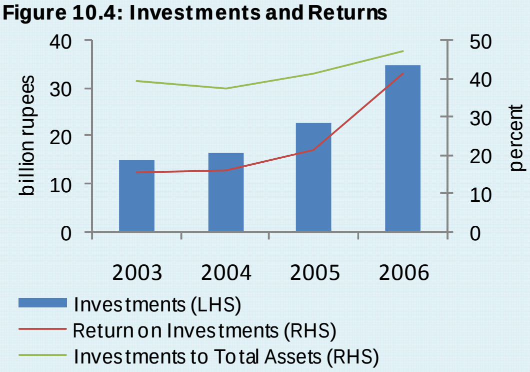
Source: Annual Audited Accounts of Insurance Companies

A large amount of reserves signifies the enhanced retention capability of an insurance company and its ability to absorb large unexpected shocks. The abolition of compulsory cession from PRCL, and SECP's requirement to obtain reinsurance only from 'A' rated international reinsurers, may affect the cost of reinsurance for the sector. Generally, the insurance companies reduce reinsurance cost by increasing their respective reserves, and retaining more of their risks in the business.

10.2.2 Investments of Non-Life Insurance Companies

Sustainability of the insurance business is strongly related to the investments made by the company. A firm with a large proportion of investments is expected to earn more investment income, which is utilized in honoring claims and other expenses. The investments of non-life insurance companies have grown by 135 percent over the period CY03-CY06. Investments constituted 41 percent of total assets in CY05, which further increased to 46 percent in CY06. Furthermore, the return on investments has also increased from 21 percent in CY05 to 41 percent in CY06 as shown in **Figure 10.4**. This huge increase in investment income is mainly derived from stock market investments. The share of investments in listed scrips is 22 percent of total investments of non-life companies in CY06.

Figure 10.4: Investments and Returns



Source: Annual Audited Accounts of Insurance Companies

Although the target market for state-owned and private sector non-life insurance companies is different, i.e. the state-owned company (NICL) insures only federal and provincial assets and it does not insure risks other than those of the government. However, if seen in share of total premiums and assets, **Table 10.3** highlights the robust growth in private sector entities as compared to NICL. This is an obvious consequence of the tremendous growth in private sector companies in recent years, and companies such as Adamjee Insurance and EFU General Insurance have witnessed greater increase in their asset base and gross premiums as compared to the state-owned NICL. **Table 10.3** also reveals another trend i.e. a high concentration of both assets and net premiums in the larger companies. This concentration is also decreasing albeit at a very slow pace. In terms of gross premiums, three companies had a 71 percent share in CY05 which declined to 62 percent in CY06.

Table 10.3 : Share in Non-Life Insurance Sector
percent

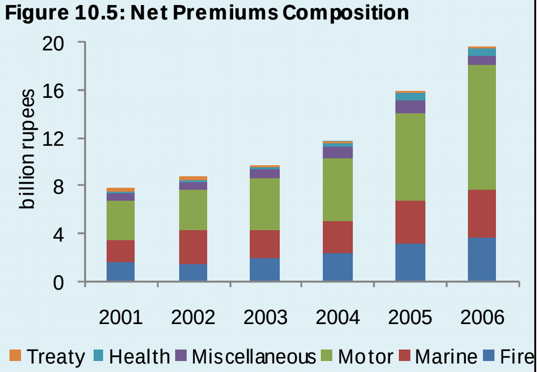
	State	Private	Foreign	Top Five	Top Ten	Overall
				Net Premium		
2002	23.3	72.3	4.4	79.4	88.6	100.0
2003	16.6	77.7	5.7	75.9	87.1	100.0
2004	13.5	86.5	3.3	75.1	86.4	100.0
2005	14.1	81.5	4.4	73.2	85.3	100.0
2006	10.5	85.1	4.3	73.4	82.6	100.0
				Assets		
2002	40.7	55.2	4.1	76.0	85.8	100.0
2003	37.8	58.0	4.2	73.9	84.6	100.0
2004	34.3	65.7	2.6	72.5	83.4	100.0
2005	31.6	65.5	2.9	71.1	82.8	100.0
2006	24.6	72.8	2.6	74.0	85.4	100.0

Source: Annual Audited Accounts of insurance Companies and SBP calculations

10.2.3 Premiums and Claims of Non-Life Insurance Companies

Insurance premiums are considered to be the critical factor in determining the performance of an insurance company. If the net premiums are more than the sum of net claims honored by the company and management expenses, the business is said to be making underwriting or operating profits. The non-life insurance business in the country is generally limited to conventional areas of auto, fire, marine, health, treaty[7] and miscellaneous insurance (**Figure 10.5**). However, the leading non-life insurance companies are also seeking new areas for insurance coverage such as agricultural and livestock insurance.

Figure 10.5: Net Premiums Composition



Source: Annual Audited Accounts of Insurance Companies

Net premiums for the non-life industry grew by 20.2 percent for the period CY01-06. Premiums for motor insurance grew by 26.1 percent in this period. Motor insurance accounted for 45.8 percent of the net premiums at end CY05, which has increased to 53.2 percent at end CY06. The main reason for this trend is the mandatory insurance cover needed for availing auto-finance from banks. In an era of constrained monetary conditions, this overwhelming reliance on motor insurance might become a problem for non-life insurance companies, as the main attraction in auto-finance was the relatively low financing rates, prevalent until recently.

Marine and fire insurance are the other two major contributors of premiums. Marine insurance premiums are strongly related with the volume of trade. The demand for fire insurance has also increased due to the expansion in industrial activities along with the construction boom in the country.

Health insurance has also gained considerable growth in recent years. However its share in net premiums has decreased from 4.5 percent in CY05 to 4.2 percent in CY06. Unlike other non-life products that gained considerable attention due to compulsory insurance to acquire

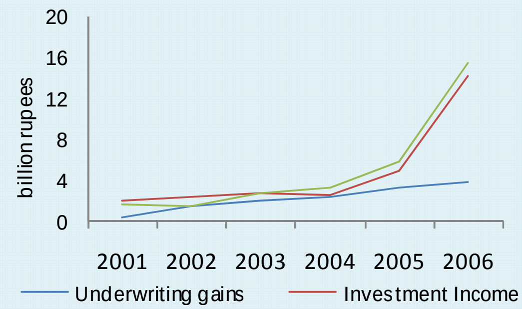
[7] Reinsurance arrangements with PRCL have two main classifications, direct compulsory cession and retrocession. With the abolition of direct compulsory cession, the premiums of treaty represent premiums of retrocession.

bank based financing, health insurance has largely remained ignored since banks generally do not provide financing of a nature which requires health insurance and hence its growth has reduced in comparison to other non-life products. In view of the importance of health insurance, the government has exempted the excise taxation on health insurance policy issuances by 5 percent in order to promote health insurance schemes. It is worthwhile to note that the life insurance companies were already exempted from excise taxation in CY04.

10.2.4 Profitability of Non-Life Insurance Companies

The non-life companies showed an astounding growth of 162 percent in profitability in CY06. A break-up of the statistic reveals that underwriting gains recorded a mere 13.4 percent increase over CY05, and that it was income from investments that formed the bulk of the increase, as net-investment income grew at 192 percent (**Figure 10.6**). This rise in investment income is not shared equitably across the industry, and 97 percent of the income was generated by the top ten companies. The distribution gets even further skewed, as one company posted a net income of Rs. 7.3 billion, which constitutes 48.3 percent of the net income posted by the non-life industry.

Figure 10.6: Major Sources of Profit



Source: Annual Audited Accounts of Insurance Companies

Another interesting pattern observed within this increase is that 79.9 percent of the total income came from realization of capital gains from stock market securities held by the non-life insurance companies.

This particular level of profitability cannot be sustained due to the volatile nature of stock markets, while also indicating that non-life companies need to look for other more permanent sources of income such as underwriting profits, which grew by 41.5 percent in CY05, but by only 13 percent in CY06.

Table 10.4: Financial Soundness Indicators for Non Life Insurance Sector
percent

Category	Indicator	2002	2003	2004	2005	2006
Capital Adequacy	Capital / Total Assets	0.17	0.15	0.15	0.12	0.11
	Paid-up Capital / Total Equity	40.6	37.6	36.1	32.5	32.0
	Growth rate of Equity	18.1	15.3	19.1	27.4	59.3
	Growth rate of Assets	18.7	13.8	45.8	22.1	34.8
Liquidity	Liquid Assets / Total Assets	24.1	17.1	19.4	20.1	17.8
Operating Ratio	Underwriting Expense / Gross Premium	14.2	13.3	11.7	11.3	15.6
	Claim Ratio	55.7	52.6	55.9	56.6	57.1
	Expense Ratio	0.08	0.09	0.11	0.24	0.08
	Combined Ratio	0.64	0.62	0.87	0.75	0.65
Earning and Profitability	Investment Income/ Net premiums	26.2	28.5	30.6	31.3	71.1
	Growth Rate of profits	-12.3	80.4	23.0	74.6	154.8
	ROA	5.7	9.3	7.6	10.9	20.6
Reinsurance and Actuarial	Retained Premium	0.51	0.52	0.54	0.64	0.68

Source: Annual Audited Accounts of insurance Companies and SBP calculations

10.2.5. Non-Life Insurance Financial Soundness Indicators

Table 10.4 highlights the financial stability indicators of the non-life insurance sector. The capital adequacy ratio relates to the regulatory aspect of the insurance business. The capital to assets ratio shows a declining trend as the growth in assets is much larger than the growth in the capital base. Regulatory developments under consideration by the SECP (**Box 10.2**) are aimed at strengthening the capital base of the industry and promotion of new insurance products.

BOX 10.2: Regulatory Developments

Successful regulatory changes in the banking sector and their impact on overall growth have emphasized the need for similar changes in other components of the financial sector. Insurance sector is no exception, and the regulators are striving to bring regulatory standards up to international best practices. Insurance Ordinance 2000 was a major landmark in the evolution of the Insurance business in Pakistan.

Seven years down the line, the impact of those changes is evident from the overall growth in the industry. The SECP is working on further refinement of regulatory framework. The following is a brief roundup of major developments during 2006.

- As stipulated in the Insurance Ordinance 2000, 2006 saw the creation of a "Federal Insurance Ombudsman." This office is created keeping in view the success of ombudsmen for tax as well as banking. The basic intuition behind this move is to provide the public an avenue for settling their grievances against insurance companies. In addition to that "Insurance Tribunals" have also been established in each of the four provinces. These developments will provide a timely and cost-effective alternative to the legal red tape that tarnishes the performance of Pakistan's judicial system. This in turn will go a long way in raising the overall confidence of general public in the practice of insurance.

- The SECP has set limits on "Maximum Management Expenses" on life insurance contracts. This move is aimed at limiting the amount of acquisition costs incurred by an insurer, as prescribed under section S.22 (9) and S.23 (9) of the Insurance Ordinance 2000. These limits were set by taking into account the types of life insurance policies, and are to be enforced in a phased manner starting from 2007, and then a gradual reduction of the limit till 2012 or beyond. The main motive behind this enforcement is to protect the policyholder's surplus on contracts.
- The solvency of firms is of the utmost importance when it comes to matters of risk management. Due to innovations in insurance products, the threat of contagion emanating from within the insurance industry is very real, where the insolvency of firms can spread to other firms in the industry as well as to other components of the financial sector. To ensure stability of players in the insurance industry, minimum paid-up capital requirements under revision for a gradual increase. **Table 10.5** lists the details of the planned increase.

- Foreign investment is playing a key role in the development as well as the transformation of insurance sectors across the developing world (See **Box 10.1**). In order to attract more foreign investment as well as to bring the rules governing the insurance sector, in line with those governing other service sectors, 100 percent foreign equity investment is permitted in the insurance sector. This ownership is subject to an investment of at least US$ 4 million, out of which a minimum of US$ 2 million will come from abroad. These rules for foreign ownership in the insurance industry are very flexible and accommodative when compared with other countries in the region.

Table 10.5: Minimum Paid up Capital Requirement
million Rupees

Takaful Operator	2007	2008	2009	2010	2011
Life Insurers/Family Takaful Operators	350	400	450	500	500
Non-Life Insurers/ General Takaful Operators	120	160	200	250	300

Source: SECP

The equity base has grown by 59.3 percent in CY06 as the reserves and retained earnings of the companies have increased as discussed in section **10.2.1.** The loss ratio or the net claim ratio has risen in CY06, and the combined ratio, which is the sum of the loss ratio and the expense ratio also shows a similar trend. Moreover, the earning and profitability ratios show a marked increase in the "investment income/ net premiums" ratio, which is primarily because of a substantial increase in investment income mainly from investments in the stock market. This led to an overall increase of 154.8 percent in the profitability of the non-life insurance companies.

10.3 Life Insurance Sector

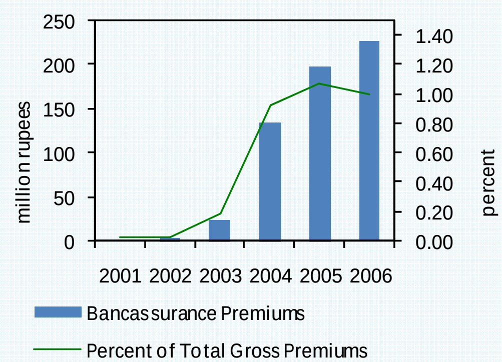
Unlike the non-life insurance sector which consists of 53 firms, the life insurance sector comprises of only 5 conventional life insurance firms. The largest company is owned by the Government i.e. State Life Insurance Company (SLIC). Two companies are foreign-owned and the remaining two are private domestic. Moreover, Pak Qatar Family Takaful has also acquired a license for conducting life and health insurance business in August CY07 and is the only shariah compliant company in the sector. The overwhelming size of SLIC dominates the industry; at the end of CY02, it accounted for 81.3 percent of the gross premiums written. However the private sector is enlarging its share of the market, and by CY06 the share of SLIC reduced to 71 percent. One of SLIC's biggest advantages is the size of its agency force, as it employs more than 50,000 personnel to sell its policies in the traditional manner i.e. convincing people in a face-to-face interaction. The private sector lags behind in comparison as the combined agency force of all four companies is around 6,000-7,000 personnel.

This restraint has led the private sector to look for other avenues of premium generation. One such source is "Bancassurance". The success of this particular distributive channel of insurance will not only be beneficial for the increase of insurance penetration but also in providing banks with a more lucrative avenue of raising profitability as experienced by the Indian insurance industry (**Box 10.3**).

BOX 10.3: Bancassurance in Pakistan

Bancassurance is an ingenious way of using the outreach of banks to sell insurance products. In this method a bank and an insurance company mutually agree to use a bank's distributive channels or branches to sell insurance products in collaboration with an insurance company. This agreement is mutually beneficial; for the bank, this rovides another avenue for generating profits, whereas, the insurance company benefits from the bank's established distribution channels.

Figure 1: Bancassurance Business in Pakistan



Source: Audited Annual Accounts of Insurance Companies

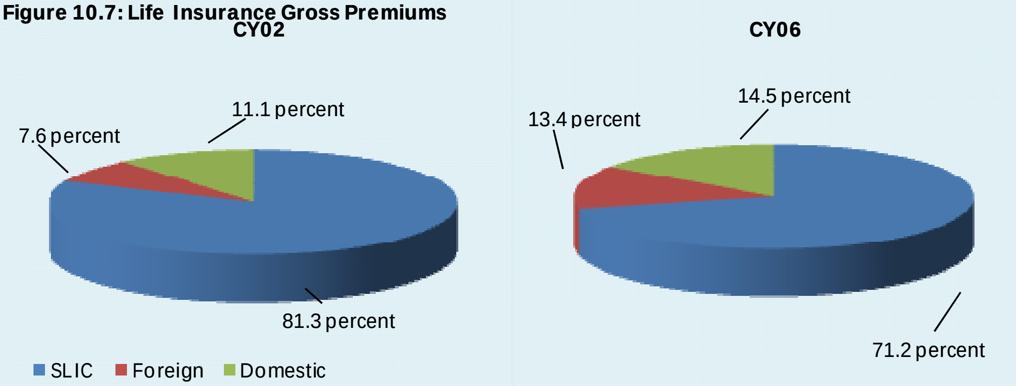
Figure 1 shows the growth of Bancassurance in Pakistan. Through Bancassurance, life insurance products are offered by the life insurance companies and the business is totally dominated by the private sector. This business segment has seen a tremendous growth since CY01, but it still accounts for less than one percent of the total premiums generated by the life insurance industry.

Source: Audited Annual Accounts of Insurance Companies

10.3.1 Structure of the Life Insurance Business

As evident from **Figure 10.7**, the share of SLIC has reduced from 81.3 percent in CY02 to 71.2 percent in CY06 on account of the growth of private life insurance companies. On a yearly basis, the overall gross premiums of the sector grew at an impressive rate of 21.7 percent, within which foreign companies showed a growth of 46.7 percent while domestic private companies and SLIC posted a growth of 34 and 16 percent respectively. One of the reasons behind this growing share of domestic private and foreign companies is the successful use of innovative products. The combined effect of an increase in paid-up capital requirements, coupled with the overwhelming size of SLIC's sales force has pushed the private sector to look beyond conventional methods of generating premiums.

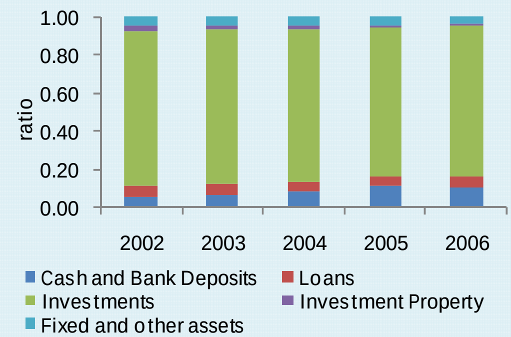
Figure 10.7: Life Insurance Gross Premiums



Source: Annual Audited Accounts of Insurance Companies

As a result, an interesting trend is starting to emerge in the composition of gross premiums. In terms of shares, conventional insurance plans still dominate the base of gross premiums. For CY06 these plans constituted 80.7 percent of the total base, but one popular alternative is the unit-linked insurance plan, the share of which increased from 14.4 percent in CY05 to 17.6 percent in CY06 (**Box 10.4**). **Figure 10.8** shows the consolidated assets position of life insurance companies. As can be seen, investments form the major bulk of assets.

Figure 10.8: Composition of Assets

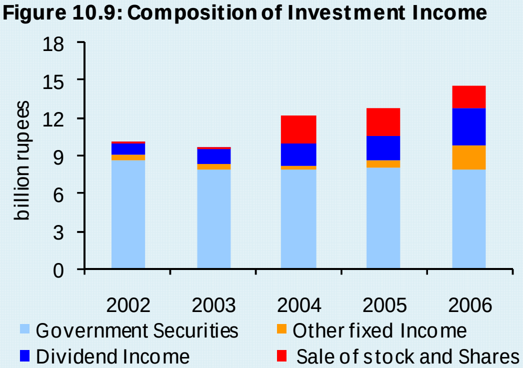


Source: Annual Audited Accounts of Insurance Companies

10.3.2 Investments of Life Insurance Companies

Investments constitute the major component of assets; at the end of CY01, investments formed 80 percent of total assets whereas for CY06 they constituted 78 percent of the total assets. But the composition of investments has changed considerably. This change is marked by an increase in the share of listed equities, and a decreasing share of government securities. In CY05, government securities formed 83 percent of the overall investment, but at the end of CY06, this share has been reduced to 80 percent as shown in **Figure 10.9**.

Figure 10.9: Composition of Investment Income



Source: Annual Audited Accounts of Insurance Companies

The increased share of investments in listed equities is basically due to the rising corporate profitability and distribution of dividends. Moreover, large fluctuations in the Karachi Stock Exchange also offer capital gains in shares trading. The low primary supply of Pakistan Investment Bonds (PIBs) coupled with relatively low interest rates in recent years also motivated the companies to seek higher returns elsewhere. In the existing scenario, even the fresh issuances of PIBs, resumed from May 2006, may not be able to reverse the trend towards holding more government securities, given that equity markets continue to provide higher yields on an annual basis. At the same time, there has been an increase of investments in fixed income securities, for instance Term Finance Certificates (TFCs). TFCs are preferred due to their tenor, which is usually of five years and more. Insurance companies used to invest in NSS instruments but since CY03, institutional investors were dis-allowed to roll-over existing investments or make fresh investments in NSS. Despite a policy-reversal on institutional investment in NSS in October FY07, insurance companies are still not allowed to invest in NSS instruments.

BOX 10.4: Unit-Linked Insurance Products

Unit-Linked insurance products have placed insurance companies in conjunction with mutual funds for asset management business. In a normal "with profits" insurance plan, the investment gains or profits are distributed to policyholders on an annual basis . These profits are determined after paying all the expenses as well as setting aside funds for risk premiums. In a Unit-Linked plan, the profits are determined in a similar manner, but instead of being distributed, these profits are pooled in a fund and then invested in stocks or bonds.

The total value of the fund is divided into identically sized units, and the share of a policyholder is measured in the number of units he possesses. It is for this reason that this particular plan is termed as Unit-Linked. Investment-linked policies are usually offered in a range of products that vary on the basis of risk. These include the all-equity, all-bond, or balance between equity and bond.

However, there are different benefits and costs associated with unit-linked products which are mentioned below:

Benefits

Unit-Linked Insurance Plans are transparent contracts in which policyholders know exactly where their funds are invested.

Policyholders can make investment decisions according to their risk-appetite.

These units can be sold to meet a premium installment, thus offering flexibility.

Partial withdrawals are possible.

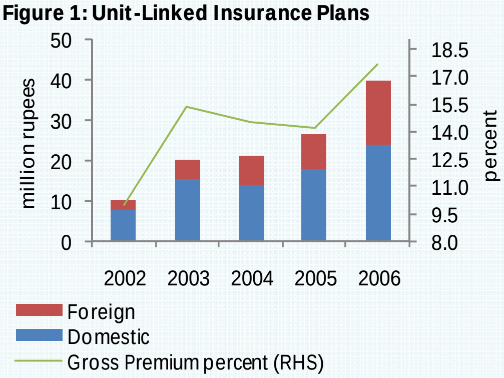
Costs

Higher charges in the first year make them a more expensive option than mutual funds.

Riskier than normal insurance plans.

In Pakistan this product is only being offered by the private sector. The annual average growth of premiums generated under this option for the period CY 02-06 is an astounding 31 percent. As evident from **Figure 1**, domestic companies have a larger share in the total premiums generated, the proportion of these premiums as a percent of overall premiums has also grown from 10 percent in CY02 to almost 18 percent in CY06. Furthermore, in order to increase the scope of unit link products, life insurance companies are exempt from the capital gains tax to promote their participation in the capital markets.

Figure 1: Unit-Linked Insurance Plans



Source: Audited Annual Accounts of Insurance Companies

10.3.3. Composition of Income from Investments

Income from investments showed a growth of 9.0 percent during CY02-06. One important factor regarding income from investment is its composition. Although government securities are still a major part of the income inflows, it is the investments in the equity market which is making an impact, both through trading, as well as dividend income. Dividend income grew by Rs 1.0 billion in CY06. These returns, along with income from TFCs, indicate the strong relationship between the stability of stock market performance and the return on investment for the insurance companies, and it further leads to increased reserves of the insurance companies and hence a higher retention ratio.

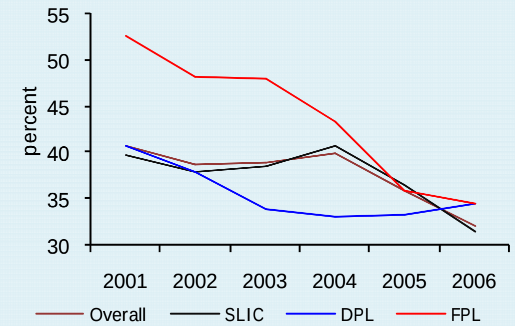
10.3.4. Operating Efficiency of Life Insurance Companies

The Management Expense Rate (MER) is generally used as a measure of the operating efficiency of insurance companies. The MER is a ratio of management expenses to gross premium. In case of the domestic life insurance industry, this ratio continues to show a promising trend, as it fell from 35.9 percent in CY05 to 34.4 percent in CY06 as shown in **Figure 10.10**.

This fall in MER can be further explained through the Agency Remuneration Rate (ARR) which is the agency remuneration expenditure relative to gross premiums, and also through the Administrative Expense Rate (Administrative Expenses/ Gross Premium). **Figure 10.11** shows the overall AER and ARR for the industry from CY01 to CY06.

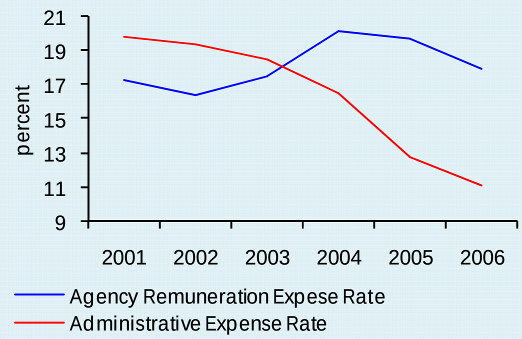
The fall in MER can be largely attributed to the falls in AER, from 20.6 percent in CY01 to 10.32 percent in CY06. During the same period ARR increased from 17.33 percent to 17.91 percent as the insurance companies continue to improve their compensation packages.

Figure: 10.10 Management Expense Rate



Source: Annual Audited Accounts of Insurance Companies

Figure 10.11: Overall ARR and AER

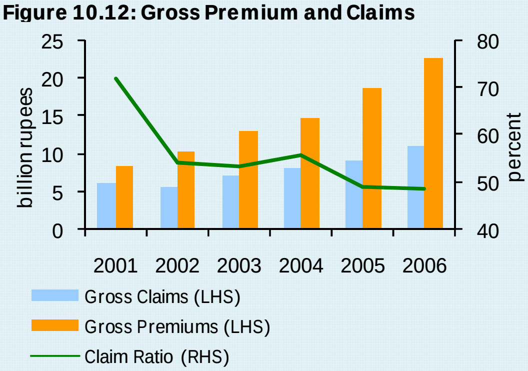


Source: Annual Audited Accounts of Insurance Companies

10.3.5. Claims

Honoring of claims has a very positive effect on the overall outlook of the insurance industry. Timely payment of claims assures the public in general that the companies operating in this business honor their obligations. From CY01 to CY06, gross claims grew at an average rate of 13 percent. To put things in perspective, this rise in claims should be seen relative to the rise in gross premiums, which shows that the generation of new premiums is taking place at a higher rate than the payment of claims, as shown in **Figure 10.12**.

Figure 10.12: Gross Premium and Claims



Source: Annual Audited Accounts of Insurance Companies

A. Life Insurance Claims (Individual)

Table 10.6 details the breakup of claims over the past four years. In terms of shares, claims by maturity and claims by surrender reflect most of the claims made on individual policies. In case of claims by maturity, the proportion is gradually increasing, reflecting the confidence of policy-holders in the industry as a whole as they are retaining their policies till

Table 10.6: Classification of Individual Life Insurance Claims

Percent share

	CY03	CY04	CY05	CY06
By Death	15.7	12.9	15	14.6
By Maturity	38.2	45.9	49.1	50.3
By Surrender	44.9	39.8	34.5	33.7
Others	1.2	1.4	1.3	1.4
Total Amount	**4,571**	**5,363**	**6,099**	**7,453**

maturity. On the other hand, the share of claims by surrender is decreasing; this is also a positive development as it indicates that fewer policy-holders are opting for the surrender option.

B - Life Insurance Claims (Group)

Group life insurance is dominated by claims from the "By Death" category, (**Table 10.7**). This is because these contracts are undertaken by organizations to provide coverage to a group of employees in case of death or injury. Another positive development is the rise of experience refunds. Experience refunds are distributed to principal policy-holders in the event of lower claims on group life policies. Moreover, life insurance companies also offer experience refunds in order to retain their clients and to be more competitive in the market.

Table 10.7: Classification of Group Life Insurance Claims

Share in percent

	CY03	CY04	CY05	CY06
By Death	79.9	85.7	92.9	86.8
By Maturity	0.3	0.6	0.5	0.0
By Surrender	0	0	0	0.6
Experience Refund	15	9.3	1.8	7.9
Others	4.8	4.4	4.8	4.7
Total Amount	**2,392**	**2,816**	**3,015**	**3,541**

10.3.6 Life Insurance Financial Soundness Indicators

Table 10.8 lists key indicators measuring the overall risk assessment of the Life Insurance industry. Capital adequacy holds the key to financial soundness; a strong capital base gives an insurer the endurance to sustain volatility in its underwriting business, in addition to having a direct bearing on the volume of business that can be booked.

Table 10.8: Financial Soundness Indicators for Life Insurance Sector

Percent

Category	Indicator	2002	2003	2004	2005	2006
Capital Adequacy	Capital / Total Assets	1.39	1.71	1.52	1.49	1.67
	Growth rate of Equity	18.6	20.2	37.6	31.5	28.9
	Growth rate of Assets	14.4	12.6	15.1	14.9	15.4
Liquidity	Current Assets / Current Liabilities	89.3	92.1	94.2	95.3	95.7
	Investments in Equity Markets	8.5	9.1	10.8	12.4	14.4
Operating Ratio	Claim Ratio	47.4	64	56.5	62.2	49.5
	Expense Ratio	113.6	93.2	90.8	95.6	85.6
	Combined Ratio	179.1	140.6	154.8	152.1	147.9
Asset Quality	Gross Premium/ number of employees	209.4	262.7	294.6	369.9	446.3
	Investment Income/ Net Premiums	113.7	82.5	98	78.9	76.4
Earning and Profitability	Total Assets/ number of employees	1939.9	2179.0	2486.4	2838.0	3247.5
	ROA	0.3	0.4	0.3	0.3	0.4
	Investment Income/ Investment Assets	15.2	12.6	14.4	13.5	12.6
Reinsurance and Actuarial	Retained Premium	97.22	97.65	96.86	97.12	97.85

Source: Annual Audited Accounts of insurance Companies and SBP calculations

The capital adequacy ratios have improved for the industry and are set to improve even further given the new requirements laid out by the SECP to enhance the paid-up capital level of the insurance companies. The quality of assets has a direct bearing upon the risk bearing capacity of the industry; from the investment pattern observed in the insurance sector, one important contributor of risk can be investments in the stock markets, as these expose individual companies to fluctuations inherent in stock market trading. The trend shows that equity investments have an increasing share in the overall assets of the industry. The strong performance of the Karachi Stock Exchange in recent years is one of the main reasons for this growing share.

The risk retention ratio indicates the reliance on reinsurance, i.e. how much of a risk is being passed on to the reinsurance companies. In case of the domestic life insurance sector, this ratio is quite high. This high reliance on re-insurers highlights the need for financially stable re-insurers. As reinsurance from foreign companies has now been allowed, this rather high risk retention ratio justifies SECP's requirement of getting re-insurance from highly reputed foreign re-insurers.

The industry is also showing remarkable improvements in its overall operations as shown in the three operating ratios in **Table 10.8** all of which indicate a considerable decline in the claims and other expenses.

Earnings and profitability ratios are the most important ratios when it comes to the long-term financial survival of a company. The decrease in expense ratio in CY06 shows that net premiums are increasing by a faster rate than increases in the expenses of the sector. The investment income to investment assets ratio indicates the asset management capabilities of the insurance companies. This ratio has shown a downward trend, indicating that the sector as a whole earns a lower investment income given the composition of its investment assets.

10.4 Takaful (Islamic Insurance)

Takaful is the Islamic mode of insurance based on the principle of cooperation among policy holders (participants). The participants or policy holders contribute towards a pool of funds to indemnify the losses of other participants or policy holders, making Takaful a compatible form of mutual insurance.[8] The difference between conventional insurance and Takaful lies in the investment of pool of funds. In conventional insurance, the premiums collected are invested in interest bearing bonds and stocks, whereas Takaful funds are invested in modaraba funds. Unlike conventional insurance, the objective of Takaful insurance is to improve solidarity and to create an atmosphere of brotherhood among the participants and hence the society.

The need for Takaful arises from the growing volume of shariah-compliant transactions in the country, with an associated need for hedging risks. The growth experienced by Islamic Financial Institutions globally and domestically has helped spur the development of the Takaful industry. Increasing volume of shariah based financial intermediation has created a need for shariah compatible risk mitigation, making Takaful operators central in the growth of the insurance industry. One of the reasons for low penetration of conventional insurance products in the country is faith-based considerations. With the introduction of Takaful, it is anticipated that there will be an overall increase in insurance penetration.

This expectation is supported by the global trends in the Takaful industry, which show that Takaful has grown at a rate much faster than the conventional insurance business, with most of the companies operating in Middle East, Far East, Sudan and Turkey. In CY00, the middle-eastern countries had 63 percent total insurance business in the form of Takaful, whereas Malaysia had a share of 27 percent in the same period. At present, around 60 companies are operating around the globe offering life and general insurance services in compliance with Shariah. According to IFSB, the estimated average annualized growth of the Takaful industry was around 63 percent in 1995-2000. Total insurance premium income of the world is US $2.4 trillion whereas in Takaful the total premium income is US $2.1 billion.[9]

Pakistan introduced Takaful products in the country in CY03. SECP issued detailed rules for Takaful companies in September 2005 and three Takaful companies i.e. Pak Kuwait Takaful Insurance Company Limited (2003), Pak Qatar General Takaful (2007) and Pakistan Takaful Limited (2007) are now operational in the non-life insurance sector of the country.

[8] In Mutual Insurance, the insured or the policy holders have ownership rights in the organization of the insurance company.

[9] Takaful premium is 0.8 percent of total Insurance premium income.

10.5 Reinsurance

Re-insurance provides insurance to the insurers. In providing insurance, an insurer is constrained by its own assets. These constraints are in place because of the potential risk that an insurer bears; the business of re-insurers is to spread the original risk taken by the insurers, thus giving the insurer more leverage for its asset base, while at the same time re-distributing risks.

At present, there is only one re-insurance company in the sector which is state owned i.e. Pakistan Reinsurance Co. Ltd. (PRCL). Until December CY04, it was mandatory for non-life insurance companies to seek at least 1.0 percent re-insurance for individual risks under the direct insurance business from PRCL, but in the ongoing wave of financial liberalization, this mandatory requirement was withdrawn in a phased manner. Since the policies issued in CY04 under compulsory cession expired in CY05, therefore CY06 marked the first year in which PRCL did not earn premium under compulsory cession. However, the treaty business still requires compulsory cession of 35 percent with PRCL. Furthermore, PRCL also insures the risks of non-life companies under facultative reinsurance.[10]

Table 10.9: Reinsurance Business in Pakistan

million Rupees

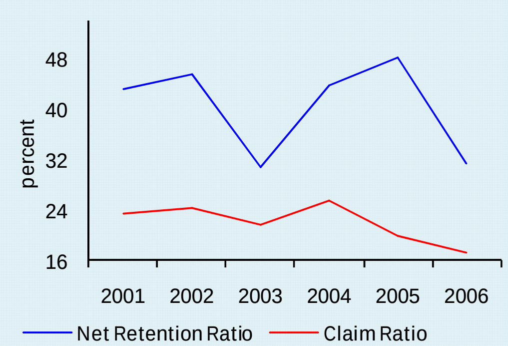
	CY01	CY02	CY03	CY04	CY05	CY06
Paid up Capital	50	450	450	450	450	450
Reserves and Retained Earnings	758	796	981	1306	1789	2280
Investments	1661	1905	1886	2719	2873	3588
Gross Premium	3045	3500	4697	5241	4160	4499
Net Premium	1312	1588	1447	2289	2005	1415
Net Claims incurred	709	848	1011	1329	823	777
Management Expenses	98	108	140	134	171	146
Net Profit after tax	67	297	333	325	594	672
Total Assets	3332	4192	6232	6613	5634	6464

Source: Balance Sheets of Pakistan Reinsurance Company Limited

In view of this development, the performance of PRCL during CY06 was commendable, with a growth of 8.0 percent in gross premiums. The assets of the company also grew by 14.7 percent in CY06 after showing a decline in the previous year (**Table 10.9**).

In terms of business, premiums worth Rs. 1,620 million were registered under the "Fire" category, accounting for 36 percent of the overall premiums generated by PRCL.

Figure 10.13 Reinsurance Retention



Source: Annual Audited Accounts of PRCL

An interesting feature of CY06 was the sharp fall in the retention ratio[11] indicating that the net premiums fell sharply as compared to gross premiums. **Table 10.9** shows that there has been a fall of 12.4 percent in net premiums in comparison with CY05, due to the increase in the cost of retrocession[12] by 12.1 percent in CY06. The overall profitability of PRCL increased by 13.0 percent during the

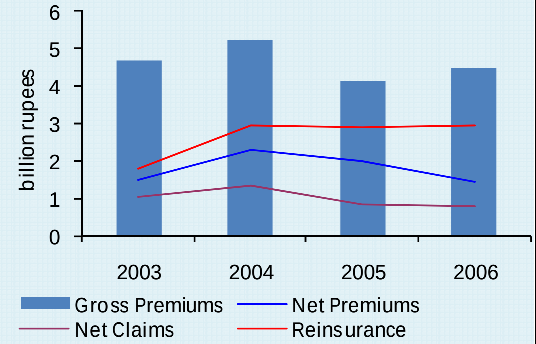
[10] Facultative reinsurance is the reinsurance of individual risks upon agreement between the reinsurance and the insurance company. On the other hand, treaty reinsurance refers to the coverage of certain proportion of the insurance business of the insurance company which is accepted by the reinsurance company.

[11] Retention ratio is Net Premium / Gross Premium.

[12] Retrocession is the process through which one reinsurance company insures the business of another reinsurance company.

year, which can only be attributed to the downward trend in net claims as indicated in **Figure 10.13** and **Figure 10.14**.

Figure 10.14: Reinsurance of PRCL Business

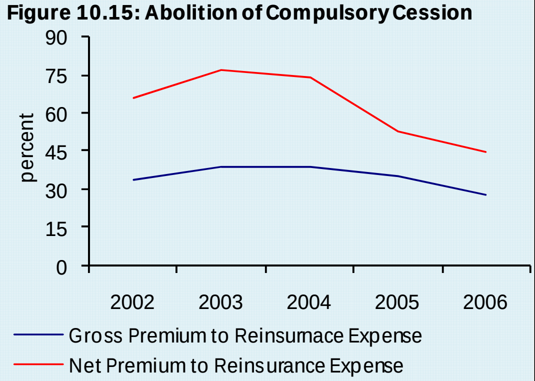


Source: Annual Audited Accounts of PRCL

The withdrawal of compulsory cession has given PRCL the option to select business transactions in line with its potential profitability, the effect of which is highlighted in the claim ratio which showed a decline of 17.0 percent for CY04-06, while after-tax profits showed a robust growth of 44.0 percent.

Meanwhile, the effect of abolition of compulsory cession on non-life companies has resulted in rising reinsurance expense. **Figure 10.15** shows the declining share of gross and net premiums in terms of reinsurance expense. This is probably because PRCL is not required anymore to accept the riskier business of various companies and therefore non-life companies are required to reinsure with "A" rated international insurers, which has led to an increase in the cost of reinsurance.

Figure 10.15: Abolition of Compulsory Cession



Source: Annual Audited Accounts of PRCL

10.6 Conclusion

Despite the fact that Insurance is still considered to be an involuntary expense, CY06 saw a substantial growth in the insurance industry of Pakistan. This trend is a reflection of the recent growth in the economy, prevailing economic stability, and innovative reforms which are bringing at par the regulatory environment with international standards. The growth in the insurance sector is reflected in the increase in premiums and profitability, as well as assets for both life and non-life insurance sectors.

The insurance industry is the only component of the financial sector which is still heavily dominated by state-owned entities, and there is a need to privatize the large state-owned organizations. It is expected that with the implementation of the planned reforms for the insurance sector, the overall efficiency and competitiveness of the industry will be enhanced. These efforts will also reduce the concentration of business in the sector, where only a few top 3-5 companies lead the market in asset size and premiums written. Not only do these companies have a very high equity structure but they also have very strong backward linkages as they are the part of leading industrial and banking groups in the country. In order for other companies to attract potential clients, it is necessary for them to go beyond conventional methods of insurance and to provide innovative products and improved service standards.

The concentration of non-life business in motor insurance, which accounts for 53.2 percent of overall net premiums, is also a cause for concern. The higher claim ratio of motor insurance (62 percent) as opposed to the overall claim ratio of 57.1 percent, indicates the vulnerability of the sustainability of underwriting profits from motor business. Insurance companies need to look for other avenues to extend their business, for instance, agriculture and crop insurance as initiated by one of the leading companies in the industry. Moreover, the proportion of investments made by the insurance companies in the stock market are also considered to be risky, given the inherent fluctuations in trading business. Insurance companies therefore need to manage their portfolios in a more balanced way to protect the quality of their asset portfolios.

The low share of Pakistan in the global insurance industry also highlights the need for concerted efforts to increase the competitiveness and outreach of Pakistan's insurance industry. Insurance sector reforms in the offing are expected to help promote the future growth of the industry; for instance, the increase in capital requirements will result in the emergence of stronger players in the industry. Appointment of the Insurance Ombudsman is another measure which would also go a long way in boosting the confidence of the public by settling complaints expeditiously.

One of the major reasons of the low share of insurance sector assets in total financial assets is general public awareness. There is a general dearth of information for prospective life insurance policy holders to use it as an investment instrument. The education of prospective insurance consumers would result in a rise in the demand for insurance products.