11 RISK ASSESSMENT OF THE INSURANCE SECTOR

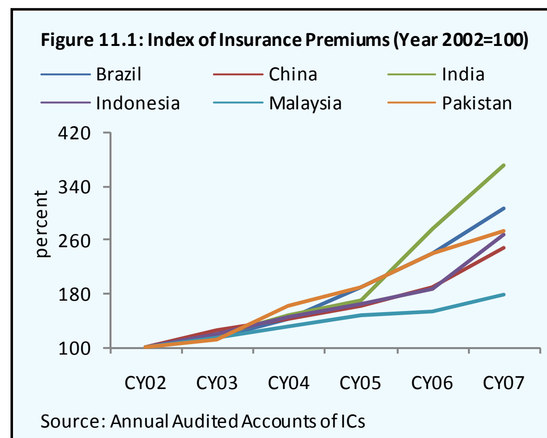
11.1 Introduction

In assessing the role of the insurance sector in fostering financial stability, it is obvious that it does so by enabling economic agents (households and corporates) to implement economic transactions by providing transfer and dispersion of risks. In its role as a financial intermediary and a crucial component of the financial sector, the insurance sector faces four types of risks, i.e. technical risk, credit risk, market risk and operational risk. The technical risk, associated with the inaccurate estimation (probability of occurrence) of the risk event, is the main risk factor for an insurance company, given that the inaccurate estimation of risk leads to inaccurate calculation of the premium rates. The non-payment of premiums is also included in the technical risk. Credit risk is associated with loans extended by an insurance company to its policy holders or to its subsidiaries. Generally, such loans are fully secured against the underlying policy. The market risk or the systemic risk is related mostly with the investments made by the insurance companies. Riskier investments can potentially affect the claim repayment ability of an insurance company. Similarly, the insurance company faces operational risk in the course of its business, which arises from different factors such as business practice, fraud (moral hazards) and business disruption and / or system failure. In order to play its due role in the financial sector and in the economy, insurance companies are required to optimally manage these risks.

11.1.1 Global Perspective

CY07 was an eventful year for the insurance sector, in particular for the general and mono-line insurance companies (**Box 11.1**). However, the insurance sector of Pakistan, being small and with little correlation with the developments of the international insurance market, managed to perform reasonably well in CY07. Notwithstanding the improvement in operating dynamics in the last few years, Pakistan's insurance industry continues to lag behind some of the developing countries in terms of the penetration of insurance services in the economy, and share of insurance premiums in comparison with emerging markets' premiums. Insurance penetration in Pakistan is estimated to be 0.8 for CY07, which is significantly less than other developing countries. **Figure 11.1** shows the premium index of selected developing countries. While taking the index of the premium amount at market prices, it is evident that the incentive mechanism for insurance services in Pakistan needs to be reassessed, and the insurance sector needs to bolster its marketing practices to encourage more insurance coverage in general.

Figure 11.1: Index of Insurance Premiums (Year 2002=100)



Source: Annual Audited Accounts of ICs

11.2 Overview of the Insurance Sector

The insurance sector in Pakistan comprises of 1 general reinsurance company, 5 life insurance companies, 52 non-life or general insurance companies and 3 Takaful companies. Since CY03, the number of foreign companies in both life and general insurance has decreased sharply. SECP, in its capacity as the regulator of the insurance sector, has devised a strategy to promote foreign investment in the insurance sector which is aimed at increasing the number of foreign companies

to promote competition and introduce new innovative products in the insurance market and this is expected to bear fruit in the near future.[1]

Box 11.1: Sub-Prime Crisis and its Impact on the Insurance Industry

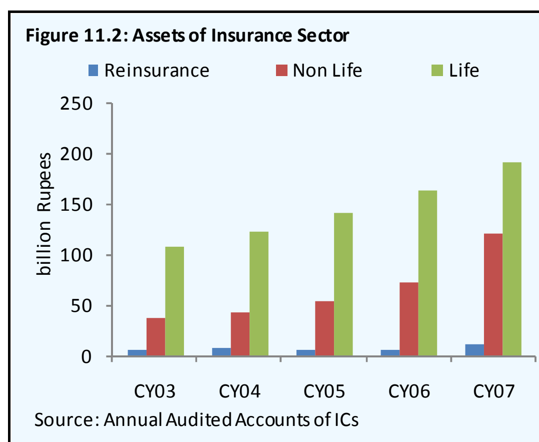
The global financial crisis that originated from the housing market bubble has emerged as one of the most severe financial crisis in recent times. The severity of the crisis was due to its contagion effect. Virtually every component of the financial sectors suffered from the spill-over effects of the crisis. From households' perspective, the resetting of mortgage rates to a higher level augmented the default rates on mortgage loans, leading to foreclosures and in some cases, loan readjustments. From financial institutions' perspective, the bankruptcy of weak lenders led to rising credit risk and stock price reductions that eventually led to the erosion of the capital base of weak financial institutions. Similarly, supervisors of the financial system that earlier had limited regulations on non-bank based lending were forced to come up with new regulations aimed at enhancing and enforcing strict guidelines for housing finance market in particular, and the financial sector in general.

The insurance industry which was not really directly affected by the financial crisis of the '90s, suffered a major blow as the sub-prime crisis continued to unravel. Besides companies which had to deal with increasing incidence of arson (voluntary damage to property in order to claim compensation from insurance companies), the most difficult environment was faced by the mono-line insurance companies. The mono-line insurance business generally insures municipal bonds issued by public sector organizations. The purpose of insuring these bonds is to attract prospective investors and to secure higher debt ratings. Mono-line insurance guarantees the investors timely payment of principal and interest on the bond. In case of default of the bond issuing organization, the insuring mono-line company has to honor its commitment equivalent to the value of the issued bonds. Besides insuring municipal bonds, mono-line insurance companies also insure mortgage backed structured products. With the incidence of the sub-prime crisis, claims against insuring municipal bonds, CDOs and mortgage products hit the mono-line insurance business, as a result of which the leading mono-line insurance companies' equity was wiped out and some were even delisted.

Besides the direct effect of the sub-prime crisis on the insurance companies, there was also a substantial indirect impact on the overall financial base of these companies. This included a reduction in gross premiums accumulation coupled with a rising claims ratio, and a reduction in investment income mainly resulting from declining stock movements.

Over the years, in response to regulatory requirements, the insurance sector has significantly improved its capital adequacy and risk bearing capacity in general, and its overall profitability in particular.

Figure 11.2: Assets of Insurance Sector



Source: Annual Audited Accounts of ICs

11.2.1 Significant Developments

In CY07, the insurance sector continued to consolidate its position by enhancing its capital base. The capital requirements imposed by the SECP require the general insurance companies (conventional and Islamic) to gradually enhance their paid-up capital from Rs. 120 million (at end CY07) to Rs. 300 million by 2011. The life insurance companies are also required to enhance their paid-up capital from the earlier requirement of Rs. 300 million to Rs. 500 million by the end of 2011.[2] The overall response of the insurance sector has been very encouraging to this directive and most of the insurance companies are progressing towards strengthening their capital base. Furthermore, the asset base of the insurance companies has also been increasing on account of the enhanced capital base (**Figure 11.2**). The total assets of the insurance sector have increased by 32.1 percent in CY07 (**Table 11.1**), as compared with growth of 18.8 percent in the assets of commercial banks over the same period. However, this robust growth in insurance sector assets has been on

[1] SECP Circular No. 5 dated May 28, 2007.

[2] SECP Circular No. 3 dated April 10, 2007.

account of the quantum of loans extended by the banking sector which necessitated insurance coverage and in turn enhanced the share of general insurance more substantially in CY07. Moreover, the overall law and order situation in the country also led to a significant increase in the demand for insurance coverage.

Table 11.1: Asset Structure of the Insurance Industry

Share in percent, amount in billion Rupees

	2001	2002	2003	2004	2005	2006	2007
Shares							
Life	73.7	73.7	71.4	71	70.6	67.1	59.0
State Owned	71.6	71.2	67.7	66.8	65.5	61.5	52.2
Domestic	1.2	1.5	2.4	2.6	3.1	3.3	4.3
Foreign	0.9	1.0	1.3	1.6	2.0	2.3	0.8
General	23.4	23.1	24.5	25.2	26.6	30.2	37.3
State Owned	9.9	9.4	9.3	8.6	8.4	7.4	6.6
Domestic	12.7	12.8	14.2	15.9	17.4	22	30.0
Foreign	0.8	0.9	1.0	0.7	0.8	0.8	0.8
Reinsurance							
State Owned	2.9	3.2	4.1	3.8	2.8	2.6	3.2
Takaful	…	…	…	…	…	0.3	0.5
Total Assets	113.41	129.73	151.28	174.55	201.66	246.08	325.06

Source: Annual Audited Accounts of insurance companies

While the assets of the general insurance companies have increased by 32.1 percent in CY07, the distribution and pattern of assets show a skewed trend towards a few leading companies. **Table 11.2** shows the share of assets among the insurance companies. The share of the top ten companies which was 85.8 percent in CY02, showed a declining trend until CY05, and subsequently started to increase in CY06 and CY07. This is probably due to the fact that the general insurance companies that are part of large financial groups are more equipped to grow than other small isolated companies. This is generally because of the fact that they get business references from their associates. Moreover, over time, these companies have also strengthened their financial position and acquired the reputations of reliable insurers, for instance in terms of honoring claims.

11.2.2 Performance Review of the General Insurance Sector

Table 11.2 : Asset Share in General Insurance Sector

	State	Private	Foreign	Top Five	Top Ten	Overall
2002	40.7	55.2	4.1	76.0	85.8	100
2003	37.8	58.0	4.2	73.9	84.6	100
2004	34.3	65.7	2.6	72.5	83.4	100
2005	31.6	65.5	2.9	71.1	82.8	100
2006	24.6	72.8	2.6	74.0	85.4	100
2007	17.8	80.5	2.1	73.5	87.8	100

Source: Annual Audited Accounts of Insurance Companies

Capital Structure

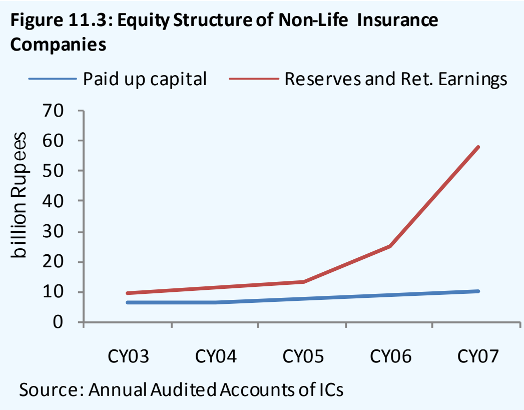
The average paid up capital of the Non-life insurance companies increased to Rs. 301 million during CY07, as compared to Rs. 252 million in CY06. However, there are six companies that fall short of minimum paid-up capital requirements. The operations of these companies have been suspended by the SECP from conducting any new insurance business. **Figure 11.3** shows the level of paid-up capital and reserves of the overall general insurance sector. Interestingly, the level of reserves and the retained earnings have increased much significantly as compared to the increase in the paid-up capital. The rising amount of reserves and retained earnings is linked with the overall rising profitability of the sector during CY07. The higher retention of profits and

reserves is also one of the indicators of the sector's solvency and shock absorption capacity. Further, the Insurance Ordinance 2000[3] requires all insurance companies to place a maximum amount of Rs. 10.0 million with the State Bank of Pakistan (SBP) as statuary deposits. SECP in a recent circular[4] reduced the amount to Rs. 5.0 million. Since the SBP does not offer any remuneration on the statutory deposits, the reduction in this amount is intended to increase the return on investments made by the insurance companies.[5]

Investments

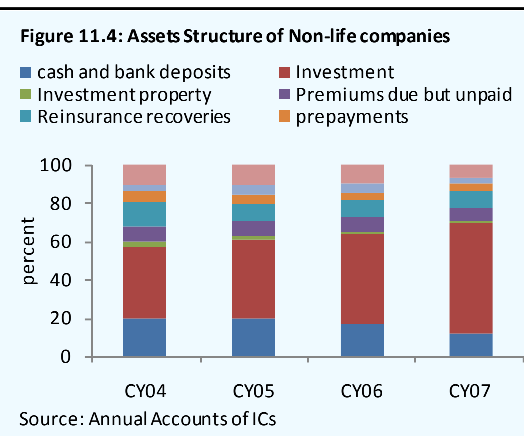
The investments of general insurance companies, excluding investments in property, grew by 78.0 percent in CY07 (Rs 69.6 billion). Investments constituted 57.0 percent of the total assets of the general insurance companies during CY07 (**Figure 11.4**). The income that is generated through investments plays an important role in meeting the companies' claims and other expenses. Moreover, cash and deposits held with banks also form a sizeable portion of the sector's assets. The rise in investment income remained significant during CY05-CY07. Correspondingly, there was a similar rise observed in the return on investments (ROI) as shown in **Figure 11.5**. The rising return on investment, especially after CY05, is linked with the performance of the stock market and consequently higher capital gains from the investments made in leading scrips. Unlike the regulations on stock market investments given in the Prudential Regulations' Framework for banks, the Insurance Ordinance does not provide a ceiling on insurance companies' investments in the equity market.

Figure 11.3: Equity Structure of Non-Life Insurance Companies



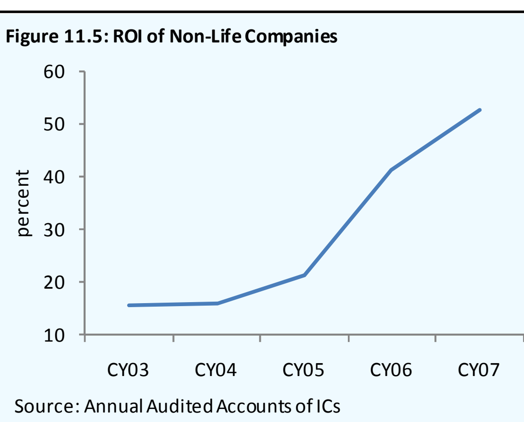
Source: Annual Audited Accounts of ICs

Figure 11.4: Assets Structure of Non-life companies



Source: Annual Accounts of ICs

Figure 11.5: ROI of Non-Life Companies



Source: Annual Audited Accounts of ICs

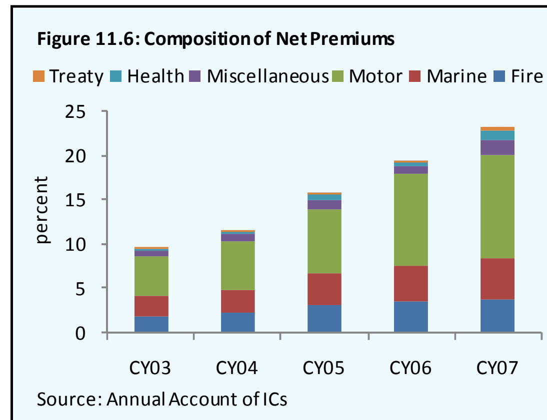
While considering the market risk on investments, most of the companies have opted to invest in government securities such as Pakistan Investment Bonds and T-Bills. However, some companies have made investments in ordinary shares of listed companies and listed TFCs. The investment made in ordinary shares is very sensitive to market risk. However, the insurance companies have constructed various risk management systems that allow them to carefully monitor market developments and

[3] Section 29, Insurance Ordinance 2000.
[4] SECP Circular No. 14 dated November 20th, 2007.
[5] Statutory deposits serve the purpose of reducing uncertainty. Placing statutory deposits with the central bank ensures that in case of failure of an insurance company, creditors with the highest charge will be honored first.

to take actions against early warning signals. This includes regular monitoring of the stock indices as well as various sectors and macroeconomic events that may affect the performance of the stock market.

Premiums and Claims Composition

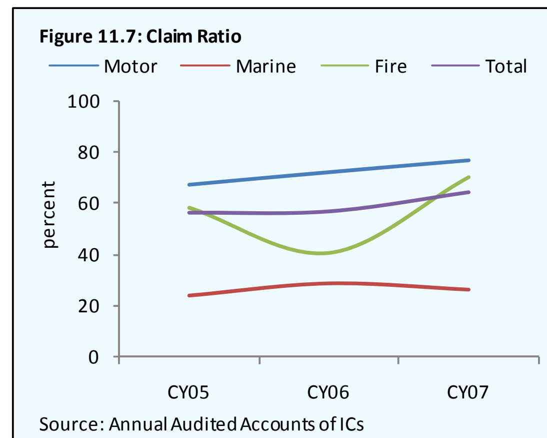
The business of general insurance companies constitutes fire, marine, motor, health, treaty and miscellaneous insurance. The fire, marine and motor categories constituted 87.0 percent of the net premiums of the general companies in CY07, while health, treaty and miscellaneous insurance premium formed 13.0 percent of total net premiums (**Figure 11.6**).



The net premiums in the general insurance sector witnessed a sizeable growth of 20.0 percent during the period from CY02-CY07, from a meager amount of Rs. 8.8 billion in CY02 to Rs. 23.2 billion in CY07. The premiums for motor insurance, which alone constitutes 50.0 percent of the total premiums, recorded a remarkable growth of 12.0 percent, against a 24.0 percent average growth in CY02-07. As compared to CY06, the net motor premiums grew by 14.5 percent in CY07. The rise in motor premiums is largely attributed to the car financing products offered by different banks. However, given the hike in interest rates and the continued monetary tightening stance of the central bank, the sales of (leased) automobiles has declined considerably, which may result in a reduction in motor premiums in CY08.

Similarly, premiums for the marine sector also posted a healthy growth of 11.0 percent during CY07. The consistent rise in the premium is linked with the sizeable rise in trade activities during the last few years. Premiums from fire insurance, which is the third largest source of premium accumulation (16.4 percent of total premiums), witnessed 8.0 percent growth during CY07. Fire insurance premiums generally include insurance of construction projects, industries and other businesses largely in the urban areas. The health, treaty and miscellaneous premiums, together accounting for 13.6 percent of the net premiums, also enhanced the total net premiums accumulated by the insurance companies in CY07.

As the majority share of total assets detailed in **Table 11.2 is** attributed to the robust growth in assets of a small number of insurance companies, the distribution of the premiums is also skewed as shown in **Table 11.3.**



Turning to the claims ratio, the general sector witnessed a very high claim ratio in CY07 (64.4 percent) as compared to 57.1 percent in CY06 (**Figure 11.7**). Much of the increase in claims has been due to motor and fire insurance. The claim ratio for motor insurance stood at 76.6 percent in CY07, which is rather high. Given the law and order situation prevailing in the country, riots in Karachi in the post 27th December period, and the fact that most of the insurance companies are not inclined to reinsure the motor

insure business with reinsurers on account of high reinsurance premiums, the claim ratio might increase in the future. This risk of increase in the claims ratio can potentially erode the reserves which the companies have managed to accumulate in a period when the claim ratio was low.[6]

Table 11.3 : Premiums Share in General Insurance Sector
percent

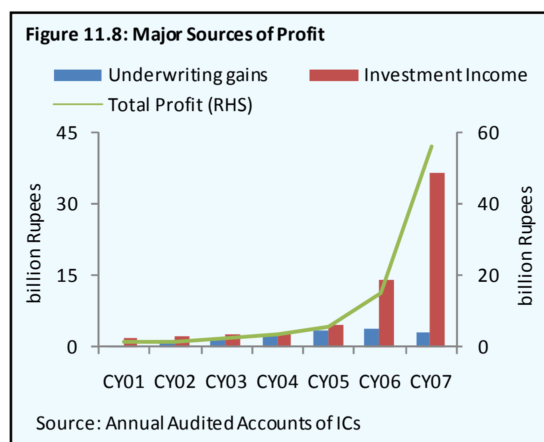
	State	Private	Foreign	Top Five	Top Ten	Overall
2002	23.3	72.3	4.4	79.4	88.6	100
2003	16.6	77.7	5.7	75.9	87.1	100
2004	13.5	86.5	3.3	75.1	86.4	100
2005	14.1	81.5	4.4	73.2	85.3	100
2006	10.5	85.1	4.3	73.4	82.6	100
2007	10.5	85.6	4.2	72.4	84.0	100

Source: Annual Audited Accounts of Insurance Companies

Profitability

The profitability of the general insurance sector increased to Rs 56 billion in CY07, which was considerably high compared to Rs. 15 billion in CY06. By looking at the various sources of the profit, investment income is observed to be the overwhelming contributor in total profits (**Figure 11.8**). On the other hand, underwriting gains declined by 18.0 percent during CY07 on account of higher claims in motor insurance and management expenses.

Figure 11.8: Major Sources of Profit



Source: Annual Audited Accounts of ICs

The significant rise in the profitability of the general insurance companies mainly originated from the dividend earnings and capital gains made in the stock market. Moreover, given the rising interest rates, the return on investments in government securities has also been enhanced, and is expected to form a significant portion of the investment income of the general insurance companies in CY08.

General Insurance Financial Soundness Indicators

The financial soundness of the general insurance companies has been analyzed on the basis of the financial soundness indicators (**Table 11.4**).

The analysis of the capital adequacy indicators illustrates the sound performance of the general insurance companies in recent years. For instance, the capital/total assets ratio, growth rate of equity and growth rate of assets portray a favorable picture. This is due to the fact that the companies are progressively enhancing their capital base, reserves, asset and equity structure in order to improve their solvency position and resilience to extreme financial shocks.

Moreover, the operating ratios show a significant increase as depicted in the claims ratio and combined ratio, which reflect a higher volume of claims for the industry. However, the expense

[6] The torching of several hundred vehicles, buildings, factories and bank branches throughout the country after the riots that broke out after the assassination of the former Primer Minister, Ms. Bhutto, will appear as losses / claims incurred by the insurance companies more prominently in the financial statements for CY08. This is due to the fact that the majority of these claims were reported in January CY08.

ratio has not changed much. Underwriting expenses as a proportion of gross premiums have recorded improvement, as the gross premiums witnessed a significant increase in CY07.

Table 11.4: Financial Soundness Indicators for Non Life Insurance Sector

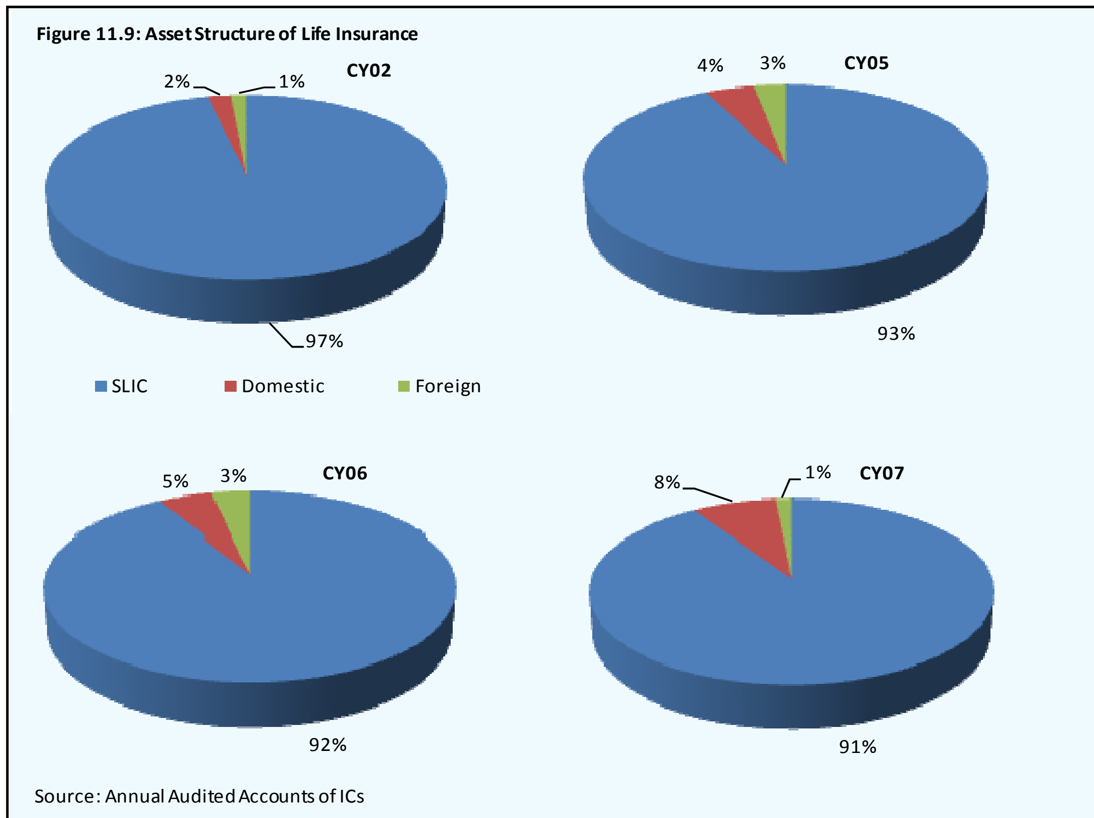
percent

Category	Indicator	2002	2003	2004	2005	2006	2007
Capital Adequacy	Capital / Total Assets	17.0	15.0	15.0	12.0	11.0	17.5
	Paid-up Capital / Total Equity	40.6	37.6	36.1	32.5	32.0	14.1
	Growth rate of Equity	18.1	15.3	19.1	27.4	59.3	72.2
	Growth rate of Assets	18.7	13.8	45.8	22.1	34.8	53.5
Operating Ratio	Underwriting Expense / Gross Prem	14.3	13.4	14.4	15.4	15.6	12.9
	Claim Ratio	55.7	52.6	55.9	56.6	57.1	64.4
	Expense Ratio	8.0	9.0	11.0	24.0	8.0	8.2
	Combined Ratio	63.7	61.6	66.9	80.6	65.1	72.6
Earning and Profitability	Investment Income/ Net Premiums	26	28	30	31	71	158
	Growth Rate of Profits	-12.3	80.4	23	74.6	154.8	229.6
	ROA	5.7	9.0	7.6	10.9	20.6	46.3
Reinsurance and Actuarial	Risk Retention Ratio	60	50	50	70	50	52

Source: Annual Audited Accounts of Insurance Companies

The earning and profitability indicators saw a substantial improvement in all the representative categories such as investment income to net premiums ratio, growth rate of profits and return on assets. The risk retention ratio in case of general insurance companies is not very high: insurance companies are generally shifting approximately 53.0 percent of the risk to the reinsurance companies, while 47.0 percent of the risk is retained by these companies themselves. Retaining risk is useful only when the cost of reinsurance is more than the cost of claims incurred. Further, with companies increasing their capital base and reserves, retaining the entire premium amount

Figure 11.9: Asset Structure of Life Insurance



Source: Annual Audited Accounts of ICs

and investing it in different avenues may be more beneficial for the companies than to reinsure its business and share the premiums with the reinsurance company.

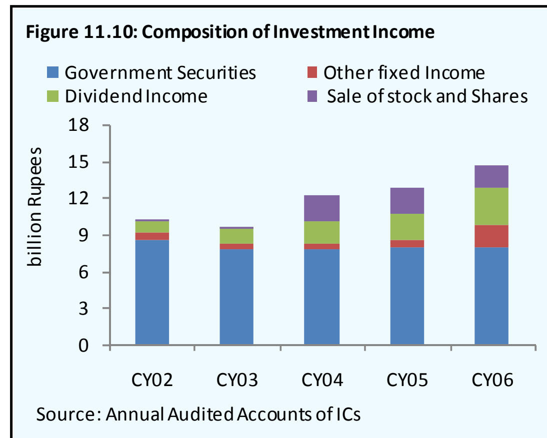
11.2.3 Life Insurance Companies

Life insurance companies had a 59.0 percent share in the total assets of the insurance industry in CY07. Currently, there are 5 such companies operating in the insurance industry, out of which one is state-owned, two are domestic and two are foreign companies. Although the share of the state-owned company is declining gradually as shown in **Figure 11.9** compared to the domestic and foreign companies, yet it still holds 91.0 percent of the total life insurance assets and 52.2 percent of total insurance (life and general) assets. However, with a rising share of domestic companies, it is expected to that the life insurance business will expand further and the private and foreign companies will bring efficiency and better management practices to the market.

Investments

The composition of the investment portfolio of life insurance companies indicates that government securities constitute the key portion (79.0 percent) of the investment income (**Figure 11.10**). Despite such a huge share in total investments, the ratio in the total earnings from Government securities witnessed a lower yield as compared to the returns from the stock market in CY07.

Figure 11.10: Composition of Investment Income

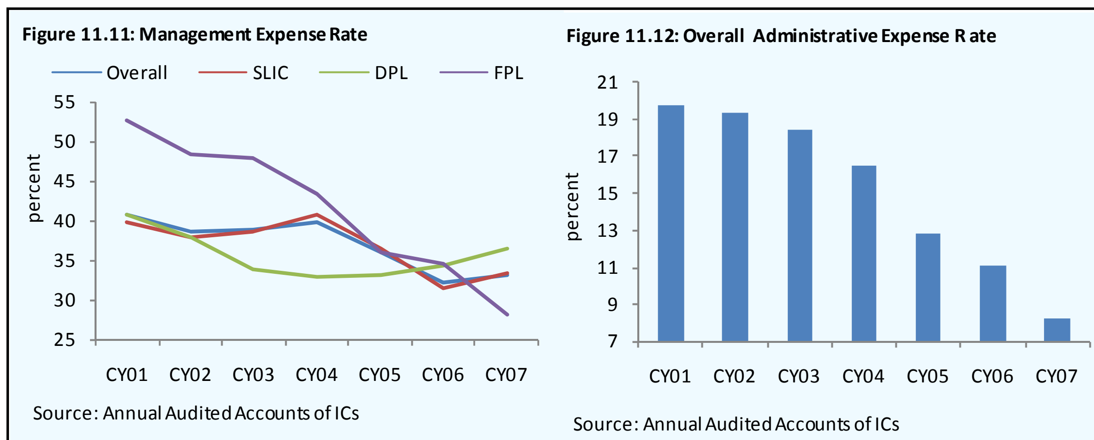


Source: Annual Audited Accounts of ICs

Operating Efficiency of Life Insurance Companies

The Management Expense Rate (MER), which is one of the indicators of efficiency, has shown a declining trend during the last couple of years (**Figure 11.11**). This ratio remains favorable for the foreign private companies. However, for domestic private companies, the state-owned company and also for the overall ratio, there is an increasing trend for CY07. The overall administrative expenses rate (administrative expenses/gross premium) has also declined substantially over the years as shown in **Figure 11.12**. This decline in the administrative expense rate is an encouraging sign, as in a way it indicates the presence of economies of scale by bringing more efficiency in their operations.

Figure 11.11: Management Expense Rate | **Figure 11.12: Overall Administrative Expense Rate**



Source: Annual Audited Accounts of ICs

Source: Annual Audited Accounts of ICs

Claims and Premiums

Claims and premiums are important constituents of the insurance business, given that premiums are one of the important sources of revenue for an insurance company, while the honoring of claims provides a cushion to the customers against any unforeseeable loss. Thus the insurance business provides hedging against potential risks and paves the way for a smooth business environment.

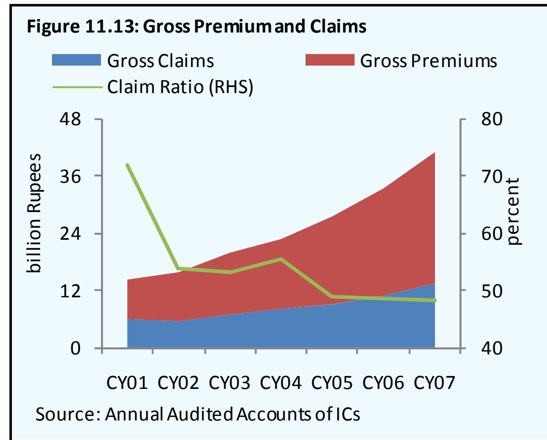


Figure 11.13: Gross Premium and Claims

Source: Annual Audited Accounts of ICs

The claims ratio (net claims/net premium) for the life insurance companies was 48.5 percent during CY07, much lower than the 64.4 percent claims recorded by the general insurance companies during the same period. Lower life insurance claims compared to general may be linked with the lower occurrence of associated events. Life insurance claims are relatively longer term in nature, and materialize in case of death, or the maturity or surrender of the life insurance policy. Another reason for the lower claim ratio is the much rapid increase in premiums in comparison with claims (**Figure 11.13**).

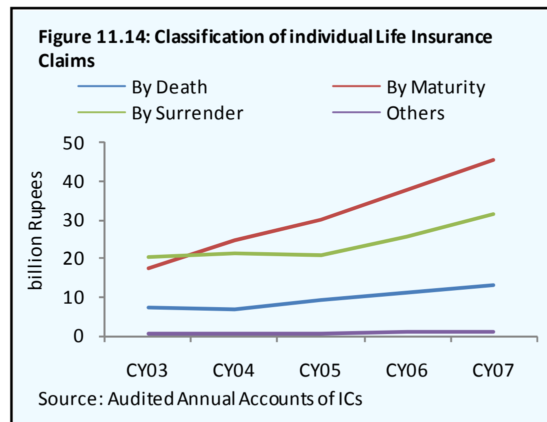


Figure 11.14: Classification of individual Life Insurance Claims

Source: Audited Annual Accounts of ICs

Life Insurance Individual Claims

The amount of the individual life insurance claims increased to Rs.9.1 billion during CY07 compared to Rs.7.6 billion in CY06 as shown in **Figure 11.14**.

Claims of the individual life insurance companies suggest that the major portion of claims (50.3 percent during CY07) comes at the time of maturity of the insurance policy. This is a positive sign that the share of the maturity claims is rising (**Figure 11.14**), implying that a larger number of people hold on to their policies until maturity.

On the other hand, the number of people who withdraw their insurance policies is also still sizeable. Though the share of claims by surrender was 44.9 in CY03, yet it declined to 34.4 percent in CY07. Claims by death stand at Rs.1.3 billion (14.3 percent) during CY07 compared to Rs.718 million (15.7 percent) during CY03. These claims do not form a very high portion of the total claims categories.

Table 11.5: Classification of Group Life Insurance Claims

	2004	2005	2006	2007
By Death	84.7	92.9	86.8	82.1
By Maturity	0.6	0.5	0.0	0.1
By Surrender	0.0	0.0	0.6	1.2
Experience Refund	9.1	1.8	7.9	9.2
Others	5.6	4.8	4.7	7.4
Total (million Rupees)	**2,850**	**3,015**	**3,541**	**4,321**

Source: Annual Audited Accounts of insurance companies

Life Insurance Group Claims

Classification of the Group Life Insurance claims reflect that claims by death are the most predominant, as these constitute 82.0 percent of the total group claims during CY07. Group claims are primarily subscribed by various companies for the benefit of their employees (**Table**

11.5). Other than the group claims by death, claims from experience refund form the second biggest portion in total group claims.

Life insurance Financial Soundness Indicators

For an assessment of the financial health of life insurance companies, this section analyzes the financial soundness indicators as detailed in **Table 11.6**.

Table 11.6: Financial Soundness Indicators for Life Insurance Sector

percent

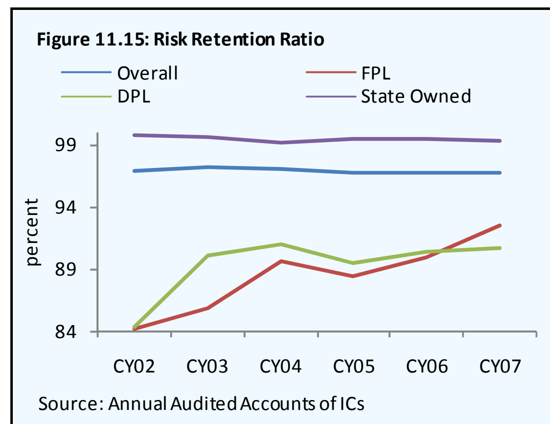
Category	Formula	2002	2003	2004	2005	2006	2007
Capital Adequacy	Capital/Total Assets	1.4	1.7	1.5	1.5	1.7	2.1
	Growth Rate of Equity	18.6	20.2	37.6	31.5	28.9	40.4
	Growth Rate of Assets	14.4	12.6	15.1	14.9	15.4	16.8
Asset Quality	Gross premium/number of employees	209.4	262.8	294.6	369.9	446.3	540.6
	Investment income/net Premiums	113.7	82.5	98.0	78.9	73.1	78.3
Operating Ratio	Claim Ratio = Net claims/Net Premium	47.4	64.0	56.5	62.2	49.5	48.5
	Expense Ratio = Management expenses/Net premium	39.3	38.1	40.5	36.7	32.1	34.2
	Combined Ratio = Loss Ratio + Expense Ratio	86.7	102.1	97.0	98.9	81.6	82.7
Earning and Profitability	Total Assets/ number of employees	1940.0	2179.0	2486.4	2838.1	3247.5	3742.8
	ROA = profit/total assets	0.3	0.4	0.3	0.3	0.4	0.9
	Investment Income/Investment assets	15.2	12.6	14.4	13.5	12.6	9.7
Reinsurance and Actuarial Issues	Risk Retention Ratio =Net premium\gross premium	96.9	97.2	97.0	96.8	96.8	96.8

Source: Annual Audited Accounts of Insurance Companies

The analysis of the life insurance companies indicate that the capital adequacy indicators such as capital/total assets, growth rate of equity and growth rate of assets have improved during the last two years. This indicates the improved financial cost/risk bearing capacity of the life insurance companies.

Operating ratios are also one of the other set of indicators used to gauge financial soundness. The claim ratio has improved considerably compared to previous years. The expense ratio has worsened a bit during CY07 and as a result the combined ratio has also deteriorated slightly compared to CY06. As a whole, these ratios have improved to a larger extent during previous years.

Figure 11.15: Risk Retention Ratio



Source: Annual Audited Accounts of ICs

The overall risk retention ratio in case of life insurance companies is quite high, which implies a higher dependence on the re-insurance companies (**Figure 11.15**).

The state owned company, given its predominant share, influences the overall retention ratio (96.8 percent during CY07), as its risk retention ratio is also very high (99.0 percent during CY07) compared to the foreign and domestic private life companies. This ratio for the foreign private life companies and domestic private life companies was 92.6 percent and 90.7 percent in CY07,

respectively. The lower risk retention ratio suggests that both the foreign and domestic private life companies are relatively less dependent on reinsurance companies.

The earning and profitability ratios such as total assets to the number of employees and Return on Assets (RoA) have also improved to a greater extent which is a positive development for the life insurance industry. Furthermore, there is also improvement in the asset quality indicators such as the ratios for Gross premium to the number of employees and Investment income to net premiums.

11.3 Reinsurance

There is only one reinsurance company in Pakistan (Pakistan Re-insurance Co. Ltd.or Pak Re), which is state-owned. In terms of assets, it constitutes 3.2 percent of the total insurance sector assets. The total assets of the reinsurance company were Rs. 10.4 billion during CY07, compared to Rs. 6.4 billion in CY06, a robust growth of 62.0 percent which seems to be consistent with the overall strong 32.1 percent growth in assets during CY07 (**Table 11.7**).

Table 11.7: Reinsurance Business in Pakistan

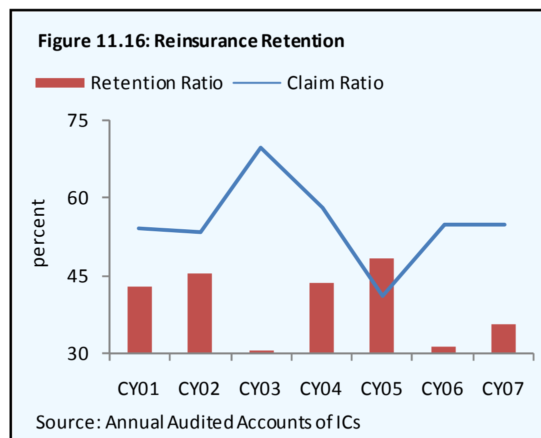
amount in million Rupees

	CY01	CY02	CY03	CY04	CY05	CY06	CY07
Paid up Capital	50	450	450	450	450	450	540
Reserves and Retained Earnings	758	796	981	1,306	1,789	2,280	5,827
Investments	1,661	1,905	1,886	2,719	2,873	3,588	6,412
Gross Premium	3,045	3,500	4,697	5,241	4,160	4,499	4,731
Net Premium	1,312	1,588	1,447	2,289	2,005	1,415	1,695
Net Claims incurred	709	848	1,011	1,329	823	777	931
Management Expenses	98	108	140	134	171	146	158
Net Profit after tax	67	297	333	325	594	672	3,727
Total Assets	3,332	4,192	6,232	6,613	5,634	6,464	10,447

Source: Annual Audited Accounts of Pakistan Reinsurance Company Limited

The claim ratio of Pak Re has been maintained at 55.0 percent for CY06 as well as CY07. It should be noted that the general insurance claim rate was 64.4 percent for CY07. The lower claim ratio for reinsurance is purely on the basis of retention of motor business by the leading general insurance companies instead of taking reinsurance cover.

Similarly, the risk retention ratio is 35.0 percent as shown in **Figure 11.16** for the reinsurance sector, which means than the majority of the risk is being shared with other international re-insurance companies. The gross premium and net premiums have also increased modestly.



The profit after tax of the reinsurance sector enhanced to Rs.3.7 billion during CY07 compared to Rs.672 million in the preceding year. This higher rise in the profitability is linked with the exceptional rise in the investment income.

11.4 Conclusion

In summary, despite its continued small size and low penetration level, the insurance industry performed well in CY07 by posting strong growth, with rising reserves and enhanced equity base,

indicating its growing financial strength. The profitability of the general insurance companies increased further on account of higher returns on investments. However, the rising claim ratio in the general insurance sector raises some concerns. Furthermore, the concentration of general insurance premiums in motor insurance also signifies concentration risk. With rising interest rates and lower demand for auto finance, dependence on the motor insurance business would need to be reassessed.

The Life insurance sector also posted strong gains on account of handsome gains on investments. However, in contrast with general insurance, the claim ratio in life insurance has decreased marginally. In the reinsurance sector, Pak Re has also performed well and has posted a strong growth in its profits in CY07.

There are currently 3 General Takaful and 2 Family Takaful operators which have been issued licenses by the SECP. SECP is working to formulate a robust regulatory framework for Takaful business in Pakistan. Going forward, concerted efforts are being made to increase the availability of insurance protection to the less privileged segments of the society, and introduce innovative products which facilitate stakeholders in the financial sector, for instance the Crop Loan Insurance Scheme (**Box 11.2**) which was launched in August, 2008. Encouragingly, contribution of bancassurance as a distribution channel continues to gain ground with the passage of time. Other initiatives such as micro-insurance have also been taken, and SECP is in the process of formulating a regulatory framework for the provision of micro insurance for both public and private sector insurers. All these measures are expected to bear fruit in the near future.

Box 11.2 Crop Loan Insurance Framework

The Agriculture sector serves as the backbone of Pakistan's economy. Not only does it serve as the largest employer of labor, it also provides strong backward and forward linkages to the industrial sector of the country. The majority of the industrial base entirely depends on agricultural output such as cotton, rice and sugarcane. Furthermore, the agriculture sector is also a large recipient of bank credit. Given its significance importance, it is imperative to consider the risks in the agriculture sector and the ways to mitigate those risks.

In terms of risks, agriculture output is very sensitive to the changes in the overall climate. Another factor which also severely affects the agricultural output is the spreading of crop diseases and infestations. These risks not only affect farmers but also the banks that have provided credit to the famers for the purpose of crop cultivation. The purpose of crop insurance is to mitigate certain risks associated with the agricultural sector that enable the farmers to have a sustainable level of income, while protecting banks' interest.

There are mainly two types of crop insurance policies used worldwide: 1) Classical crop insurance, and 2) New Crop Insurance Products

Classical crop insurance is based on the damage the crop suffers on account of different risk factors / perils. In this way, a total sum assured is decided between the insured and insurer. Another type of classical crop insurance considers yield of crop as a measure of risk.

With innovations in insurance products, new crop insurance schemes were introduced in different countries. This includes crop insurance while considering the price risk with damage based insurance. In this way, the supply shocks of agricultural products are also accounted for. Similarly, another type of insurance policy includes the whole farm rather than just a few crops.

Like many developing countries, Pakistan has also been planning to implement a crop insurance scheme. These schemes were not implemented successfully on account of technical and financial constraints. Moreover, the schemes considered too few crops to be insured and in selected areas. While having no reinsurance cover, the premium rates were also very high as compared to conventional general insurance rates. However, recently the state owned general insurance company has initiated different types of crop insurance schemes that will be compulsory for farmers availing credit from the National Bank of Pakistan and Zarai Taraqiati Bank Ltd. In view of the significance of the crop insurance scheme, SBP formulated a task force in 2006 which has formulated a commercially viable and sustainable crop loan insurance scheme.[1]

The salient features of the framework are:

The present crop loan insurance scheme will not depend on government subsidies in form of risk sharing or premium reductions.
The scheme shall include all cultivated regions of the country covering all crops that are cultivated.
All the insurance companies that are registered with the SECP and all the banks that extend loans towards the agriculture sector will participate in this scheme.
The maximum sum assured is set at Rs 2.0 million per farmer per crop per season.
The premium is set at maximum 2.0 percent of the amount insured. It is the responsibility of the banks to collect the premium amount and other associated taxes.
The crop loan insurance scheme does not cover price fluctuations.
Insurance is compulsory for all agricultural related bank borrowers.

Source:
1. Quarterly Report on the State of the Economy, Q3-FY08 pp. 18,
2. SBP Task Force Report on Crop Loan Insurance Framework, August 2008.