Chapter 7 Insurance Sector

The risks associated with the insurance sector have lessened barring few exceptions just as the coverage and size of the sector surged by 10.6 percent during H2-CY12 largely contributed by a robust 33.4 percent growth in life sector business. Though technical risk on motor coverage remained high, both life and nonlife providers benefited from lower claims ratio and improved earnings on investments in government securities as well as increased returns from the equity market. As a result, the insurance sector posted 304.1percent (YoY) higher profits during H2-CY12. Likewise, the nonlife reinsurance sector also continued to provide reinsurance coverage with higher accumulation of gross premiums during the period as well as reducing claims ratio and in-turn maintaining healthy profitability.

Figure 7.1

Life sector builds-up the size of the insurance industry

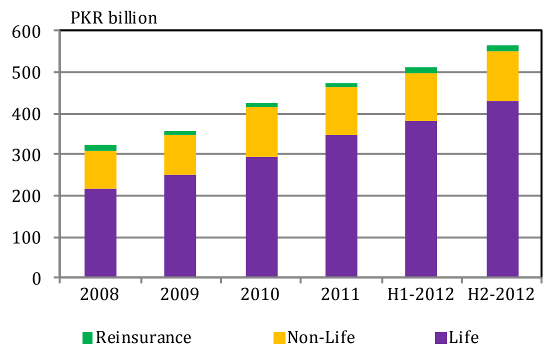
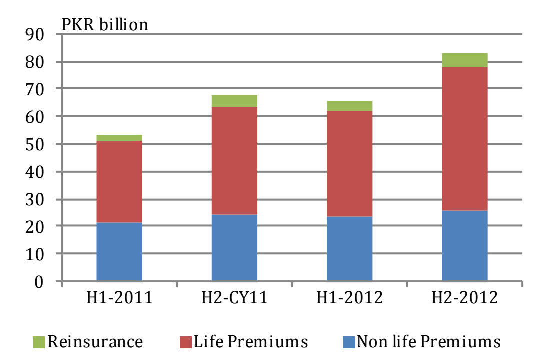


Figure 7.2

Insurance premium flows



Despite a challenging economic environment, risks associated with the insurance and reinsurance sector have lessened during the half year amid some exceptions in the nonlife insurance sector[87]. The size of the sector grew by 10.6 percent on half-yearly basis during H2-CY12 largely due to increased demand for life insurance in wake of attractive product offerings as well as concerns of deteriorating general law and order conditions in the country (**Figure 7.1**). Moreover, revival of consumer finance in segments of auto and personal loans during the period also enhanced the nonlife insurance business.

The insurance sector carried over the growth trend mainly on the back of continuous expansion in life insurance assets; 12.9 percent on half-yearly and 22.9 percent on yearly basis. Besides improvements in premium accumulation by 33.4 percent during the half year on account of attractive products, particularly, unit-linked policies[88], the life insurance business also benefited from improved return on investments as well as decreasing claims ratio. As a result, the life sector witnessed improved profitability during H2-CY12.

The non-life insurance assets also improved albeit modestly, i.e. 2.8 percent during H2-CY12 against 5.3 percent growth in the first half CY12. The deceleration in nonlife sector was attributed to already well-concentrated market with a number of service providers facing higher incidence of claims amid prevailing law and order and security situation. However, with some improvements in the consumer finance business particularly the auto finance, the gross nonlife premiums improved by 5.8

[87] The insurance sector faces four major types of risks that include technical risk, credit risk, market risk and operational risk. The higher claims ratio in motor insurance signifies technical risk.

[88] The unit-linked or investment-linked policies provide the policy holders with the benefits of insurance and investments in a single plan. As the investments benefits are determined on the return on investments, and since unit–linked policies consist of units invested in fixed income securities (money market) and / or in the equity market, the value of units' increases as the profits or return on investments increases. Hence unit-linked provide higher benefit to the insured against the conventional life insurance plan.

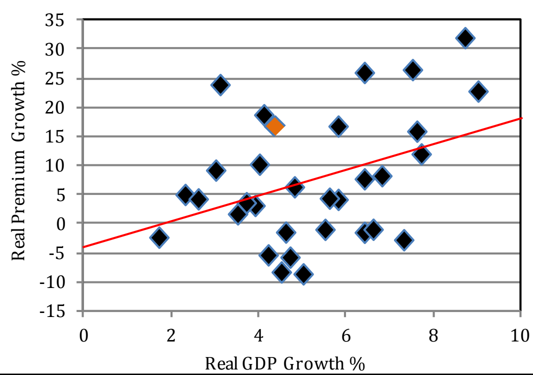
Table 7.1

Real Premium Growth Rates in 2012 (percent)

	Life	Nonlife	Total
Advanced Countries	1.8	1.5	1.7
Emerging Countries	4.9	8.6	6.8
Pakistan	-8.3	-8.3	-8.3
World	2.3	2.6	2.4

Figure 7.3

Insurance Premiums and GDP growth rates



percent (**Figure 7.2**). Meanwhile, the net premiums recorded a lower growth of 3.1 percent as the nonlife heavily resorted on reinsurance coverage. Owing to increased reinsurance coverage, the nonlife reinsurance sector posted 16 percent growth in its asset base while the premiums surged by 64.5 percent during H2-CY12.

While comparing the real premium growth rates[89] across countries, Pakistan witnessed a reasonably high growth during CY12 on account of surge in life premiums. While, the nonlife real premiums actually witnessed a decline of 1.8 percent (**Table 7.1**). A higher premium growth also had a favorable impact on the insurance penetration[90] in the country which improved marginally from 0.70 to 0.71 and the country ranking improved from 86 to 83 during 2011-12. Similarly, the insurance density also improved from 8.0 to 8.7 while it ranked lowest (87th) in the sample of countries[91].

While establishing a relationship between growth rates of real premium and the real GDP for the period 1975-2012, a causal relationship suggests that with an increase in the one-period lagged real GDP by 1 percent, the real premiums grew by an average of 2.3 percent during the period[92]. However, it is found that much of the observations fall in the region in which the average real premium growth was not achieved. Meanwhile, in recent years, as the life business picked up, the real insurance premium growth has surpassed the average trend line (**Figure 7.3**).

Though above mentioned relationship is weak, nonetheless, the insurance industry has been able to successfully manage indemnification of the financial risks of households and institutions and has remained largely healthy and profitable in its operations. During H2-CY12, the insurance (life and nonlife) posted a profit of PKR 5.86 billion reflecting a growth of 304.1 percent over H2-CY11. Further, as largest investor in the equity markets, the insurance sector played its meaningful role in deepening of financial markets despite its small share in the financial sectors' assets.

---

[89] Real premium growth rate is the premium growth rate minus inflation rate.

[90] Insurance penetration is defined as ratio of insurance premiums to GDP.

[91] Sigma – Swiss RE, various issues.

[92] Results were obtained from a simple regression equation in which real premium growth is dependent upon the lagged GDP growth rate.

Figure 7.4

Strucutre of Life Insurance

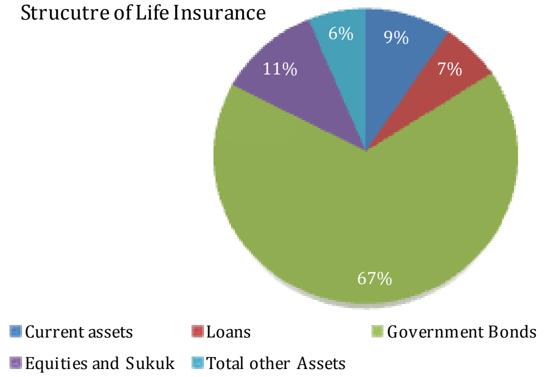


Figure 7.5

Life insurance premiums and claims ratio (flows)

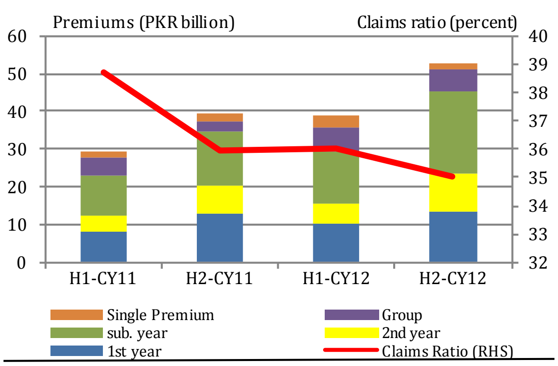
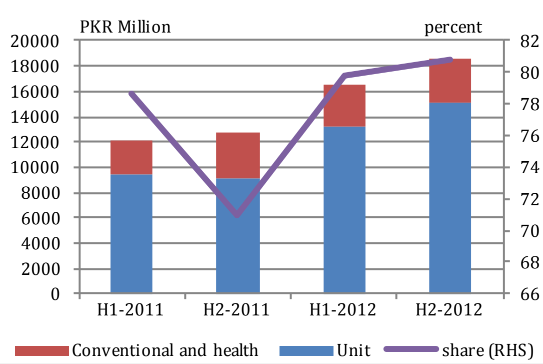


Figure 7.6

Rising trend of Unit linked policies



Life Insurance[93]

Life insurance is meant to indemnify the policy holders from adverse events and to provide an avenue for long terms savings. Given the large holding of financial assets in the form of government securities, the life insurance is critical from the perspective of ensuring supply of funding in the financial markets and maintaining financial stability. In this regard, the domestic life insurance sector has successfully been able to do just that during H2-CY12. Not only had the size of life sector increased by 12.9 percent on the back of 33.4 percent growth in premiums, the life sector remained the second largest buyer of government securities after the banks (**Figure 7.4**).

Generally, the second half of a calendar year tends to accumulate higher premiums compared with the first half. However, the surge of 33.4 percent in life premiums was exceptional. Similarly, in line with the prevailing trend, the share of subsequent premiums (sub year) remained the highest (41.4 percent) – an indication of preserving policy holders' interests. Meanwhile, the first year premiums (new business) though observed growth in rupee terms witnessed a decline in its share of premiums from 32.4 percent in H2-CY11 to 25.4 percent of gross premiums in H2-CY12.

However, the highlight has been a surge in group life premiums. Its share in gross premiums improved markedly from 6.3 percent in H2-CY11 to 10.4 percent in H2-CY12 (**Figure 7.5**). Increased group premiums reflect growing companies' interests in safeguarding the interests of its employees as well as reducing premium costs.

Another significant development in the life insurance business is the consistent reduction in the claims ratio. During H2-CY12, the claims ratio lowered further to 35.1 percent which was 35.9 percent a year earlier. Much of the claims were on account of maturity (34.1 percent) and events of death (32.3 percent) of the insured. However, the share of claims incurred on account of surrender of policies also remained significant to 29.9 percent.

Perhaps, one of the reasons for unprecedented growth in life premiums has been the introduction of unit-linked insurance policies (ULIP). They not only provide coverage but also an avenue for investments. During H2-CY12, the growth in the ULIP continued and its share in gross premiums improved to 80.8

[93] The life insurance market constitutes 9 companies. Out of which two are Family Takaful and seven are conventional. The share of Takaful contributions (premiums) improved from 3.1 percent to 4.6 percent (YoY).

Figure 7.7

PIB holdings by life insurance companies

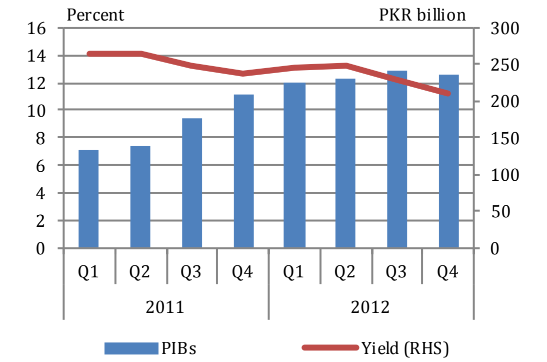


Figure 7.8

ROI of Life insurance companies

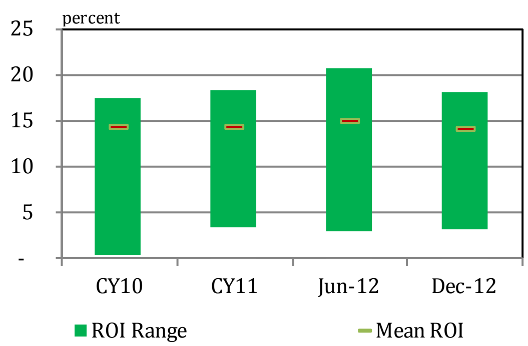


Figure 7.9

Life insurance profitability (PKR billion)

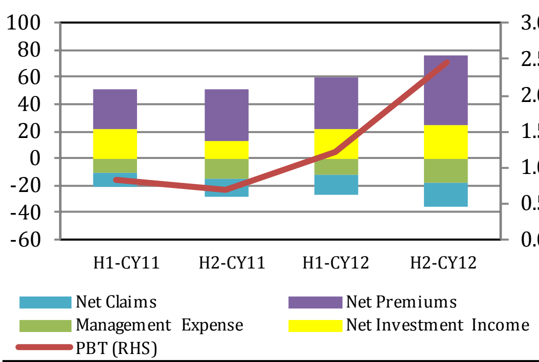


Table 7.2: Soundness of Life Insurance Companies

percent

	2010	2011	H1-CY12	H2-CY12
Capital to Assets	2.5	2.1	1.9	2.0
Claims to Capital	291.6	336.5	365.4	401.7
Claims Ratio	40.7	37.1	36.1	35.1
Expense Ratio	40.5	38.5	32.6	35.3
Combined Ratio	81.2	75.6	68.7	70.4
Premium Retention	97.6	96.9	97.1	98.1
Return on Inv.	13.4	13.2	14.0	14.2
ROA	0.3	0.4	0.3	0.9

percent. Increased concentration of ULIP though seems to attract prospective policy holders; it also poses market risks depending upon the composition of the units. During H2-CY12, units were largely composed of money market instruments that witnessed declining yields.

In addition to the improvements in life insurance coverage and business, the investment profile of the life providers also remained healthy during H2-CY12. The investment holdings of the life providers improved by 7.2 percent during the period. Due to long-term maturing liabilities, the asset concentration has also been in longer-term government securities. However, with a consistent decline in policy discount rates and subsequent effects translating a decline in the yield on longer term instruments, a marginal reduction was witnessed in the last quarter of CY12 (**Figure 7.7**). Despite this, the return on investments of life providers still managed to improve to 14.2 percent (an increase of 20 bps during the H2) largely on account of older contractual rates on securities and investments in the booming stock market (**Figure 7.8**).

As a result of lower claims ratio and improved investment earnings, a buildup of heavy profits for the life providers was eminent, though rising management expenses did affect the growth in profitability during H2-CY12. However, the management expenses were not alarming as they were incurred in underwriting premiums and running the businesses. The life insurance profitability improved from PKR 0.7 billion during H2-CY11 to PKR 2.5 billion in H2-CY12 showing an abnormal increase of 251 percent (**Figure 7.9**).

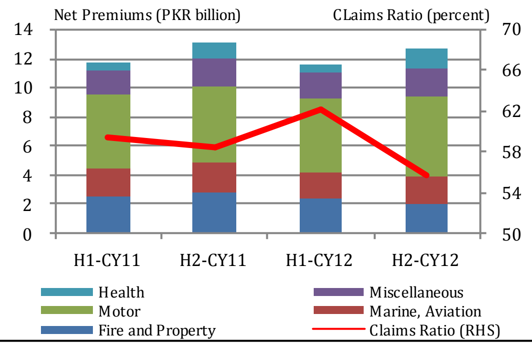
Furthermore, the ROA of the life sector also improved significantly to 0.9 percent during H2-CY12. In terms of financial soundness, the claims to capital ratio and the expense ratio worsened. On account of rather marginal equity positions and a stagnant capital requirements set by the regulator, the life service providers were left taking excessive risks on their capital profile. Though the current assets and investments are relatively liquid, a stress of claims can severely hit the solvency of the life sector (**Table 7.2**).

Non-Life Insurance

The nonlife insurance business also witnessed a 5.8 percent (YoY) improvement in gross premiums during the second half CY12. Though after reinsurance coverage, the growth in the net premiums remained modest at 3.1 percent. The segments of auto and health insurance contributed heavily in terms of growth in

Figure 7.10

Non-life net premiums and claims ratio



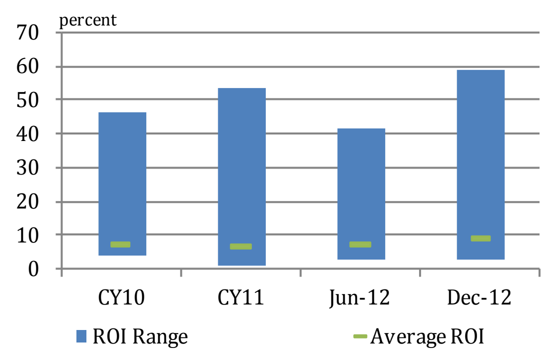
the nonlife premiums. Following the premium trends, the motor business remained dominant yet its share reduced slightly by 10 bps to 42.5 percent during H2-CY12 (**Figure 7.10**).

Another positive development in the nonlife sector besides increase in premium has been the reduction in claims; albeit a minimal. The claims ratio reduced to 55.6 percent during H2-CY12 against 62.1 percent in H2-CY11.The segments of fire, property, marine and aviation witnessed a declining claims ratio while that of auto and health coverage increased (YoY). The auto sector with its high claims ratio pose technical risk for the insurance providers which resulted in higher premium cost for the insured.

Unlike the life business, the nonlife insurance providers rely heavily on reinsurance coverage of their risks from domestic as well as foreign reinsurers. Though reinsurance reduces the net premiums significantly, the nonlife sectors' claims ratio would have gone much higher, otherwise. During H2-CY12, the premium retention further reduced to 49.5 percent against 52.7 percent in the last year implying a rather cautious approach opted by the nonlife companies.

Figure 7.11

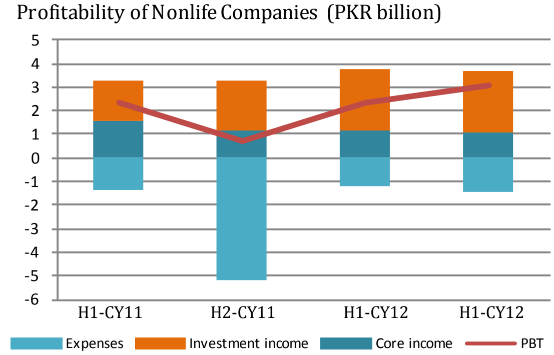
ROI of nonlife insurance companies



The improvements in the gross written premiums and claims ratio enabled the nonlife insurance companies to further accumulate investments and subsequently increase its prospects for returns. Likewise, the stock of investments improved by 7.3 percent during H2-CY12 and the investment income (RoI) also improved to 9.5 percent during the period (**Figure 7.11**). A reason for low investment return on nonlife verses life sector is because of the mix of investing instruments. Unlike the life insurance that primarily invests in government securities, the nonlife usually resorts to TFCs and short-term equities and mutual funds.

Figure 7.12

Profitability of Nonlife Companies (PKR billion)



While on the other hand, the underwriting / management expenses of the nonlife companies increased on account of rising operational costs and salaries. The expense ratio therefore deteriorated to 13.5 percent. This led to a sizeable reduction in the core income of the nonlife companies that witnessed a decline of 10.1 percent on annual basis. However, improvements in the RoI contributed significantly towards the profitability of the nonlife companies. The pretax profits of the nonlife companies improved by a massive 309 percent (YoY) to PKR 3.1 billions (**Figure 7.12**). Furthermore, the number of loss making companies also reduced slightly from 8 in CY11 to 7 in CY12.

Table 7.3: Soundness of Non-Life Insurance Companies				
				percent
	2010	2011	H1-CY12	H2-CY12
Capital to Assets	47.9	52.8	52.6	50.7
Claims Ratio	68.1	58.9	62.1	55.6
Expense Ratio	27.1	27.1	10.4	13.5
Combined Ratio	95.2	86.0	72.5	69.1
Premium Retention	54.8	52.7	51.9	49.5
Return on Inv.	6.6	6.8	9.3	9.8
ROA	3.0	2.7	3.9	4.9

In terms of financial soundness, the improvements in claims ratio and high profitability picked up the soundness profile of the nonlife sector. In addition to improvements in the RoI, the ROA also improved significantly to 4.9 percent during H2-CY12 (**Table 7.3**).

Reinsurance

As local nonlife reinsurance, the reinsurance sector has played a very meaningful role in spreading risks underwritten by the local nonlife companies. In fact, the stability in the nonlife sector on account of declining claims ratio and hence improved profitability materialized due to high reinsurance coverage. The reinsurance business gained further momentum during H2-CY12 and this not only improved the gross premiums accumulation but also lowered the claims ratio (**Table 7.4**). As a result, the reinsurance maintained its healthy profitability during the period.

Table 7.4: Profile of Reinsurance (PKR billion)				
	2010	2011	H1-CY12	H2-CY12
Equity	6.4	6.4	5.9	6.6
Investments	4.7	5.8	5.2	6.4
Gr. Premiums	6.6	6.9	3.1	8.1
Net. Premiums	2.9	3.5	2.1	4.1
Net Claims	1.7	2	1.0	2.2
Expenses	0.3	0.4	0.6	1.3
Profits (after tax)	0.5	0.8	0.6	1.1
Assets	12.5	12.9	12.5	14.6

Apart from financial health of the reinsurance, the sector has been prominent in consistent distribution of high dividends over the years to its shareholders (mainly the government) during the last two years. During CY12, PKR 900 million were distributed as cash dividend against post-tax profit of PKR 1.1 billion. Such an approach is limiting risk taking capacity and enhancement in premiums, that in case of increase in equity base would have a positive and direct bearing on policy holders' interests.