3.6 Risks to the Insurance Sector

The insurance industry's asset base has increased by 17.7 percent due to the improving economic and political environment, aggressive marketing and sales (including bancassurance), increasing consumer demand and wider use of technology. In addition, although still small, the Takaful segment has increased its market share due to greater consumer acceptability and the entrance of conventional insurers into the segment as Window Takaful Operators (WTOs); however, the rapid growth in the Takaful segment may lead to capacity constraints. Although there has been a slight increase in profitability, the accommodative monetary policy may dampen the industry's investment income which may contribute to financial risk. This, coupled with the increasing claims may decrease future income. Concentration of business remains with public sector players in the life, non-life, and reinsurance sectors, while penetration, though increasing, remains low. In addition, the increased usage of financial technology may contribute to operational risks.

The improving economic environment has helped facilitate the continued growth in the insurance industry. Both Life and Non-Life Insurance sectors have shown considerable growth (due to numerous factors like increase in bancassurance, aggressive marketing, greater consumer awareness, etc).[139] However, the most significant growth has been reported by the Takaful segment[140], due to the influx of conventional insurers in the Takaful market in the form of Window Takaful Operators (WTOs).

Public Sector insurers continue to dominate the industry as one of the public life insurers constitutes more than 60 percent of the insurance industry. Two of the other public insurers, one in life and one in non-life, are also big players in the industry. However, since their financials are not publically available, nothing substantive could be said about their contribution to the sector.

Emerging Markets and Developing Economies (EMDEs) facilitate Global insurance industry's growth

In real terms, global insurance premium volumes have been bolstered by strong growth in emerging markets.

Global life insurance premiums have been estimated to have grown by 5.4 percent in 2016 compared to 5 percent in 2015. In the AEs, life premium growth has slowed to 2 percent in 2016 (against 3.4 percent in 2015) while the life premium growth in EMDEs has been estimated to have increased to 20.1 percent in 2016 (against a 13.2 percent increase in 2015).

Global non-life premiums growth slowed down in 2016 to 2.4 percent (compared to 3 percent in 2015); in the AEs, premium growth has decelerated to 1.7 percent from 2.5 percent on the back of weaker economic growth and a softer pricing environment in commercial insurance. Non-life premiums grew by an estimated 5.3 percent in 2016 which is slightly higher than the previous year.[141]

Pakistan has an insurance penetration ratio of 0.84 percent in CY16[142] which, although higher than 0.77 percent in CY15, is below that of other countries in

139 The analysis is based on the data of 5 life insurers and 21 non-life insurers covering 98 percent and 82 percent of the life and non-life insurance sectors, respectively. The analysis covers data up to half-year ending June 30, 2016. The financial close for insurers is December of the corresponding year. All growth ratios are on year-on-year (YoY) basis.

140 It may be noted that Conventional insurers operating in the Family Takaful segment are not required to publish separate financial statements for their Window Takaful Operations.

141 Swiss Re's Global insurance review 2016 and outlook 2017/18

142 SECP Annual Report 2016

the region (India: 3.44 percent[143]; China 4.2 percent[144]). This means that there is vast potential for growth in the industry for which concerted efforts are needed.

The insurance industry has performed well …

Life Insurance sector has expanded with asset growth of 17.4 percent to PKR 792 billion in H1CY16 while gross premiums and net premiums have increased by 4.2 percent and 3.9 percent to reach PKR 65.7 billion and PKR 64.6 billion, respectively (YoY).

Non-life insurance sector has also shown an increase of 18.5 percent to reach PKR 145 billion while gross premiums and net premiums have increased by 17.8 percent and 10.9 percent to reach PKR 33.8 billion and PKR 16.6 billion, respectively (YoY).

The impressive growth in the insurance industry may, in part, be attributed to the improving political and economic environment, the adoption of modern distribution channels, innovative products, wider use of technology, etc.

Net claims have increased faster than net premium for the life insurance sector…

Life Insurance sector still has majority of its assets in the form of investments in government securities, though, it has begun decreasing them. However, the share of investments in equities and Sukuks in total assets has been increasing. **(Figure 3.6.1)**

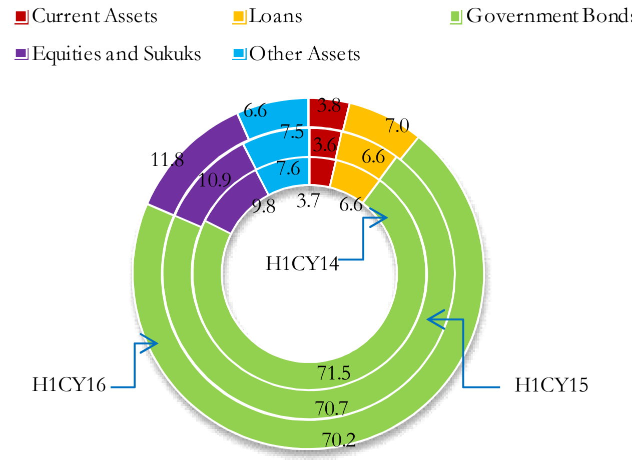
Generally, there is some seasonality in the net premiums as the industry increases its outreach efforts in the second half of a calendar year **(Figure 3.6.2)**. Net premiums have increased by 3.9 percent (YoY) during H1CY16 mainly due to 19.6 percent rise in "subsequent years" renewals over the same period.

Figure 3.6.1

Government securities continue to be the main investment avenue

Structure of Life Insurance

(percent)



Source: Unaudited published financial statments of life insurance companies.

Net claims have shown a marked increase due to the increase in surrender of claims in the "investment-linked business" statutory fund of a private life insurer.

Life insurance has registered an increase in profit (before tax) of 44 percent (YoY) in H1CY16, compared with H1CY15, mainly due to slight increases in premium and investment income. **(Figure 3.6.2)**

Increase in core activity of non-life insurer kept the decline in profits under check

The Non-Life Insurance sector has witnessed a decline of 7.3 percent in its profitability for the period ended H1CY16 mainly due to a decrease in investment income and increase in Underwriting and Management expenses as compared to the corresponding period of last year **(Figure 3.6.3).**

[143] https://www.irdai.gov.in/ADMINCMS/cms/frmGeneral_Layout.aspx?page=PageNo3021&flag=1
[144] https://www.munichre.com/en/reinsurance/magazine/topics-online/2017/01/insurance-market-china/index.html

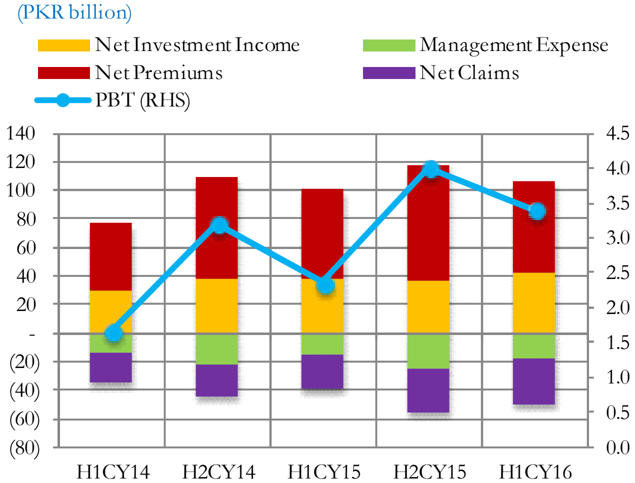
Net premiums have also increased while the claims ratio after decreasing at a rapid rate has started to stabilize around 48 percent. Motor business continues to dominate the non-life net premiums constituting about 47 percent of the total net premiums. **(Figure 3.6.4)**

Figure 3.6.2

Life insurance profitability

Life insurance profitability (flows)

(PKR billion)

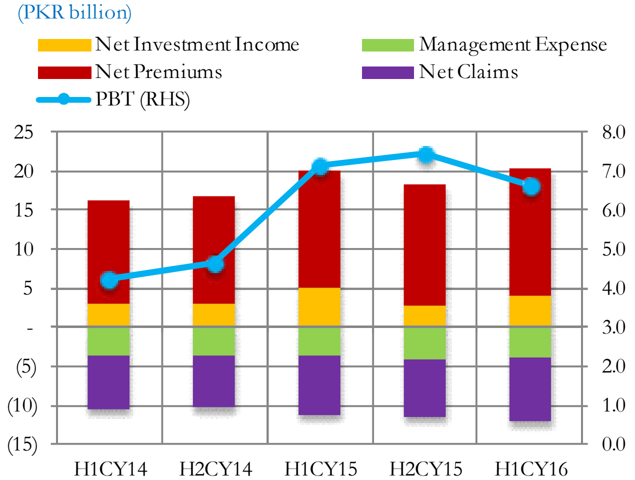


Source: Unaudited/Audited published financial statments of life insurance companies.

Figure 3.6.3

Non-Life insurance profitability (flows)

(PKR billion)



Source: Unaudited/Audited published financial statments of non-life insurance companies.

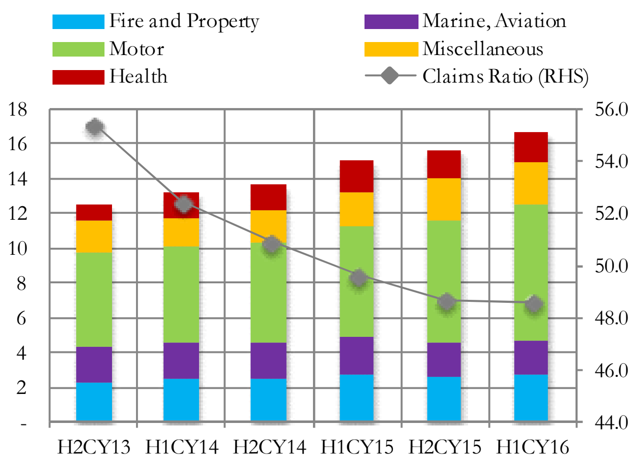
In addition, the claims ratio has gone down due, in part, to the adoption of technology to monitor insured assets and resolve claims. The claims ratio may further improve by the introduction of the SECP's guidelines for estimation of incurred but not reported (IBNR) claims reserve in 2016. The guidelines intend to ensure the adequacy of IBNR claims reserve and help bring standardization in the sector in respect of such estimation.[145]

Figure 3.6.4

Non-life net premiums flows and claims ratio

Non-life net premiums (flows)

(PKR billion)



Source: Unaudited/Audited published financial statments of non-life insurance companies.

Table 3.6.1

Soundness of Non-Life Insurance (percent)

	H1CY14	H2CY14	H1CY15	H2CY15	H1CY16
Capital to Assets	13.4	13.6	13.8	12.8	12.5
Claims Ratio	52.5	50.9	49.7	48.7	48.6
Expense Ratio	26.3	25.9	24.3	31.6	30.5
Combined Ratio	78.8	76.9	74.0	80.3	79.2
Premium Retention	51.3	51.5	52.1	53.0	49.1
ROA	3.2	3.4	5.0	5.2	3.4

Source: Unaudited/Audited published financial statments of non-life insurance companies.

145 See https://www.secp.gov.pk/document/circular-no-9-of-2016-sec-guidelines-for-estimation-of-incurred-but-not-reported-ibnr-claim-reserve-2016/

Barring the Claims ratio, the financial soundness indicators for the sector have seen some decline; the Combined ratio has increased from 74.0 percent in H1CY15 to 79.2 percent in H1CY16 while the Capital to Assets ratio has declined by 1.3 pps to 12.5 percent in H1CY16 (**Table 3.6.1**).

Rapid growth in the Takaful segment….

Family Takaful segment has increased its asset base by 39.3 percent to PKR 14.4 billion in CY15, while gross contribution written have increased from PKR 5.9 billion to PKR 7.8 billion. These may be conservative figures as conventional life insurers operating in the segment as WTOs are not required to publish separate financial statements, yet. This segment is expected to witness rapid growth after one of the public life insurers has been allowed to enter the Family Takaful segment in August 2016. **(Table 3.6.2)**

Table 3.6.2

Profile of Family Takaful Business

	CY12	CY13	CY14	CY15
	Amount in PKR million			
Net Investment Income	99.5	65.0	59.1	59.7
Surplus in shareholders' sub-fund - transferred to shareholders	267.4	340.0	(28.3)	43.7
Profitability (P.B.T)	(15.8)	(8.9)	16.9	96.0
Assets	5,001.1	7,541.2	10,352.9	14,397.4
	Percent			
Capital to Assets	29.2	19.4	14.1	10.1
Claims Ratio	36.4	32.4	37.3	42.7
Premium Retention	75.2	78.4	77.8	77.5

Source: Audited published financial statments of Family Takaful companies.

General Takaful segment has also increased its asset base substantially (26.6 percent) to reach PKR 3.7 billion as of December 31, 2015. The segment has written gross premium of PKR 3 billion for CY15 – a 38 percent increase over the previous year. This was, in part, due to the influx of conventional non-life insurers into the General Takaful segment in the form of WTOs and the SECP requirement that non-life insurers publish separate statements for their Window Takaful Operations. It is anticipated that the General Takaful segment will grow substantially over the coming years due to the economies of scale available to the WTOs' from the existing network of parent insurance companies.

However, the General Takaful segment registered an overall loss due to a restatement of financial statements by one of the full-fledged Takaful companies. If its accounts are excluded, the General segment posts a profit. **(Table 3.6.3)**

Table 3.6.3

Profile of General Takaful Business

	CY12	CY13	CY14	CY15
	Amount in PKR million			
Gross Premiums	932.6	2,029.8	2,144.8	2,959.6
Net Premiums	623.4	863.9	917.5	1,306.4
Net Claims	553.8	815.9	1,015.5	1,127.9
Expenses	337.3	462.1	579.8	720.5
Profitability	82.6	77.8	79.7	(342.2)
Assets	1,803.8	2,324.9	2,959.5	3,745.8
	Percent			
Capital to Assets	57.5	47.6	40.0	32.6
Claims Ratio	88.8	94.5	110.7	86.3

Source: Audited published financial statments of General Takaful

Nevertheless, both Family and General Takaful segments are expected to grow as the public becomes aware of an Islamic substitute to conventional insurance. This may also lead to some cannibalization as some conventional insurance contracts may be replaced with new Takaful contracts.

There is potential for risk buildup in the sector…

As highlighted in the previous FSR, one of the biggest risks that the insurance industry faces is **concentration risk**; one of the Public Life Insurer comprises more than 60 percent of the insurance industry's PKR 955 million asset base[146]. The financial information on its size or performance is not available for the other big public player in the life insurance sector. Even the Non-life insurance sector has a prominent public player. All these entities are significant state-owned market players which need to be brought under market discipline to improve their efficiencies.

In addition, the public non-life insurer has not published its financials since 2011 (reportedly, in part, due to alleged irregularities worth billions); nothing substantive can be said about its health. The possibility of its failure may lead to significant systemic risk buildup in the non-life sector.

As noted previously, the lack of reinsurers may also contribute to **reinsurance risk**. This is mitigated, to some extent, by insurers establishing reinsurance contracts with international reinsurers. Nevertheless, all general insurers are mandated to offer 35 percent of their surplus business to Pakistan Reinsurance Company[147] in the form of cession; thus, limiting the business which can be reinsured with international reinsurers and contributing to concentration of reinsurance risk. Being the only reinsurance company, the insurance industry may be susceptible to **reinsurance default risk**. As most local insurers have reinsurance arrangements with international reinsurers, this risk is partly mitigated.

In the Takaful segment, one of the Takaful companies (with a 12-13 percent share of the General Takaful segment asset base) has been involved in gross negligence and misstatement of financial statements, which may lead to substantial **systemic risk** build-up in the segment. However, due to the small share of the Takaful segment in the overall insurance industry (less than 5 percent of total insurance assets), it does not pose a significant risk to the overall industry.

In addition, this episode, coupled with the irregularities reported in the public non-life insurer[148], may indicate the presence of **misconduct risks** in the insurance industry.

The insurance industry has been registering double digit growth in various sectors due to factors such as bancassurance, greater awareness of Takaful business, etc.; this high growth rate may lead to **capacity constraints** (in particular, the risk-bearing, solvency, and shock absorption capacity) for insurers and Takaful companies.

The increasing use of financial technology to provide better customer services, expand outreach to uninsured areas, offer innovative products and services, etc. will also lead to increased operational risks, in particular, **cyber risks**. It is not only a growing concern for insurers but for other companies as well which in turn may imply increasing insurance risks as a cyber attack may lead to lost customer data, damage to a firm's reputation, business interruption, etc. This may also increase insurers' operational costs as they look to enhance their cyber security capabilities.

This may also provide insurers an opportunity to offer cyber insurance; however, due to the complex nature of cyber risks and the potential for significant losses, insurers need to be cautious regarding which (and to what extent) cyber events can be insured adequately.

146 The data covers insurers as of June 30, 2016 and Takaful companies as of December 31, 2015.

147 Pakistan Reinsurance Company Limited (PRCL) is a public sector reinsurer under the administrative control of the Ministry of Commerce.

148 See https://www.dawn.com/news/1246362

The operations and investment returns of the insurance industry are subject to market volatility and macro-economic factors. Investments constitute about 76 percent of total insurance industry assets as of June 30, 2016. Consequently, the insurance industry may face **financial risks** i.e. an adverse change in the capital markets or a "low for longer" interest rate environment. If there is a "low for longer" rate environment, insurers' investment income will suffer and they may invest in higher risk securities in search of greater profitability. In addition, while the low yields affect both sides of the balance sheet, they generally imply lower capital ratios for long-term business such as life insurance.

There is potential for **credit risk** for some insurers; as of June 30, 2016, the estimated carrying amount of financial assets representing the maximum credit exposure for life insurers and non-life insurers is PKR 222 billion (representing 28 percent of total life insurer assets) and PKR 67 billion (representing 47 percent of total non-life insurer assets), respectively. However, most insurers continually monitor credit exposure to mitigate this risk. In addition, insurers avoid any significant credit risk exposure to any single counterparty.

In addition, while bancassurance has helped insurers reach banks' customers through their large branch networks, there is potential for mis-selling which may lead to **compliance risks**. SECP and SBP have taken steps to mitigate these risks.[149]

Outlook

In 2017, global non-life insurers' premium growth will be modest while global life insurers are expected to have substantially higher premium growth. Insurance premium growth in emerging economies is expected to be robust due to improving commodity prices and increasing demand for insurance[150].

In Pakistan, the China-Pakistan Economic Corridor (CPEC) will provide new opportunities for the local insurance industry especially the non-life sector. Pakistan is expected to witness continued growth in almost all sectors of the insurance industry with significant growth expected in the Takaful segment.

[149] SECP has issued Bancassurance Regulations 2015 while SBP has issued a Circular on Sale of Third Party Products by Banks in 2012.

[150] Swiss Re's Global insurance review 2016 and outlook 2017/18