8 Insurance Sector Review

8.1 Overview of Recent Developments

The Insurance industry plays a significant role in a growing economy in terms of providing indemnification of risks faced by both individuals and companies, in addition to being an institutional investor (see **Box 8.1**). In the year 2004, the insurance industry continued to reap the benefits of sustained GDP growth and increased economic activities, especially in the industrial and consumer finance sectors. Moreover, the regulatory requirements set forth by the Securities and Exchange Commission of Pakistan (SECP)[1] also strengthened the financial soundness of the companies as reflected in the increased paid-up capital base. Six companies that were unable to meet the paid-up capital requirement continued to remain suspended from undertaking new insurance business, and three new companies started business in the non-life insurance sector. One of these companies offers Islamic insurance facilities.[2]

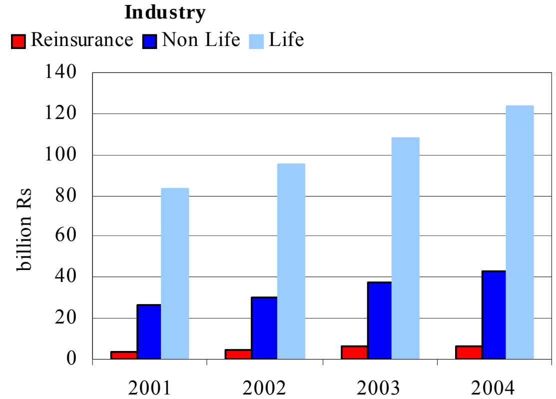
Box 8.1: Economic Benefits of Insurance

The most significant measure of an industry or an activity is its contribution towards employment generation, strengthening linkages with other sectors of the economy in promoting growth and stability, and creating a sizeable impact on the national income of a country. In developed countries, the Insurance industry is a necessary part of daily life and serves all the above mentioned purposes as opposed to developing countries where insurance is still dependent upon an individual's net disposable income, religious beliefs and government policies. Hence the economic significance of insurance as measured by the share of total gross premiums to GDP, is very high in developed countries in contrast to developing countries.

Generally, insurance companies help businesses and individuals in managing risks which can severely impact their economic well-being. Moreover, insurance companies are also termed as the largest investors in capital markets, in addition to being characterized as the sole suppliers of insurance business to reinsurance companies.

The total assets of insurance companies have seen a consistent improvement since CY01 with an average growth of over 14.5 percent in the last four years (see **Figure 8.1**). The non-life sector has shown a faster growth of 16.2 percent in CY04, as compared to 14.6 percent growth in life and a moderate 6.1 percent growth in reinsurance.[3] This growth in the assets of the insurance sector has primarily been due to the enhanced paid-up capital requirements which ultimately increased the risk management capacity of the insurance companies and enabled them to undertake increased insurance business with improved retention capabilities.

Figure 8.1: Assets of Insurance and Reinsurance Industry



As mentioned above, the asset structure of insurance companies shows that the assets of the non-life business are increasing at a faster pace than the life insurance business.

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[1] As specified in the Insurance Ordinance 2000. For details, please see "Pakistan: Financial Sector Assessment 2003", State Bank of Pakistan.

[2] For details, please see Chapter 4 : Islamic Financial Services.

[3] The analysis of the insurance industry is based on the number of available audited annual reports. Companies whose annual accounts were not published by July 20, 2005 have not been included in the analysis.

This is due to the increased activities in the areas of international trade and commerce and bank borrowing which also creates a sizeable demand for non-life insurance, whereas life insurance is either dependent on corporate management practices or on the preference of individuals. Moreover, the composition of assets shows a gradual shift in the ownership structure from state controlled to the domestic private market. As shown in **Table 8.1**,[4] the share of the state-owned life insurance company in the total assets of the insurance industry has decreased from 74.0 percent in CY01 to 70.0 percent in CY04. A similar pattern is observed in non-life insurance in which the share of the public sector has reduced from 10.3 percent in CY01 to 9.0 percent in CY04.

Table 8.1: Asset Structure of the Insurance Industry

percent share	CY01	CY02	CY03	CY04
Life	**75.8**	**76.0**	**74.3**	**74.1**
State owned	74.0	73.5	70.3	70.0
Private				
Domestic	1.0	1.4	2.4	2.5
Foreign	0.8	1.1	1.6	1.6
Non-Life	**24.2**	**24.0**	**25.7**	**25.9**
State owned	10.3	9.7	9.6	9.0
Private				
Domestic	13.3	13.3	15	16.2
Foreign	0.6	1.0	1.1	0.7
Total	**100.0**	**100.0**	**100.0**	**100.0**
Total Assets (million Rupees)	**110,081**	**125,604**	**145,124**	**166,919**

Source: Insurance companies' audited annual reports

8.1.1 International Perspective

On a global basis, insurance business which had undergone a major set back since CY01, made a come back in CY04 in terms of strengthening its profitability. The performance of the leading global insurance and reinsurance companies has been impressive since then, which is largely due to the robust growth rate of the world GDP and a low level of inflation prevalent in most of the countries.[5] **Table 8.2** shows two different measures of insurance penetration in national economies. It is evident that a country with a more developed financial system tends to accumulate more premiums.

Table 8.2: Cross-Country Insurance Premium Performance

US Dollars

	Gross Premium per Population		Gross Premium per GDP		Percent Share
	2002	**2003**	**2002**	**2003**	**2003**
Argentina	63.0	86.0	2.35	2.55	0.11
Bangladesh	1.6	2.1	0.46	0.57	0.01
Brazil	72.0	82.6	2.79	2.88	0.49
India	15.0	16.9	3.26	3.28	0.61
Indonesia	12.0	14.6	1.49	1.29	0.11
Kenya	12.0	12.1	3.09	2.81	0.01
Malaysia	198.0	226.4	4.91	5.27	0.19
Pakistan	**2.7**	**3.3**	**0.62**	**0.71**	**0.02**
Sri Lanka	11.0	13.0	1.3	1.37	0.01
Thailand	65.0	79.5	3.24	3.45	0.17
United Kingdom	3,879.0	3887.3	14.75	12.8	8.63
United States	3,462.0	3,651.1	9.58	9.62	35.91

Source: Sigma, world insurance in 2002, 2003

Pakistan's gross premium per capita has improved from US$ 2.7 in CY02 to US$ 3.3 in CY03 but it is still at the bottom of the list of the given sample of countries, better than Bangladesh only. More importantly, the share of gross premiums of the Pakistani market is only 0.02 percent of the global market whereas India accounts for 0.61 percent of global insurance premiums, USA has a hefty share of almost 36 percent and UK's share is 8.6 percent.

8.2 Non-Life Insurance Industry

With two new insurance companies having started business in 2005, the total number of non-life

[4] The Total Assets figure in Table 8.1 does not include the assets of reinsurance companies, which are discussed in Section 8.5. However the consolidated assets figure for the insurance industry in Chapter 1 includes reinsurance assets as well.

[5] A low level of inflation not only facilitates households and businesses to save and invest but it also increases their purchasing power, in addition to increasing the real return on investments.

Insurance companies operating in Pakistan has increased from 49 in CY03 to 51 by mid-CY05. However, technically there are 45 companies operating in the non-life insurance sector on account of the ceasing of operations of six insurance companies. As shown in **Table 8.3**, the assets of non-life insurance registered a growth of 16.2 percent in CY04. Net premiums, on the other hand, decreased by 12.0 percent during the year on account of the large number of provisions made on the basis of IBNR,[6] mainly in the categories of Fire and Marine Insurance.

Table 8.3: Non Life Insurance Business in Pakistan

million Rupees

	CY00	CY01	CY02	CY03	CY04
Paid up capital	2,947	5,005	5,477	5,965	6,300
Reserves and retained earnings	6,980	3,330	4,504	9,262	11,105
Investments	12,548	12,114	10,720	14,605	16,207
Gross premiums	11,713	12,643	15,221	19,571	17,163
Net premiums	8,038	7,835	8,810	9,740	8,567
Net claims incurred	3,965	5,088	4,949	5,266	6,563
Underwriting income[1]	-	426	1,574	1,970	2,380
Expenses	2,156	2,098	2,237	2,583	3,409
Net profit after tax	1,727	1,514	2,731	2,642	3,368
Total Assets	22,362	26,534	30,207	37,266	43,288

[1] Data not available for CY00

Source: Annual audited reports of non-life insurance companies.

The most significant feature in the financial figures of non-life insurance is the equity structure of the companies. Usually companies hold General and other reserves in order to meet contingencies. The combined Reserves and Retained Earnings of the companies saw a remarkable growth of 105.6 percent in CY03 which was further enhanced by almost 20 percent in CY04 due to relatively higher profitability in the preceding two years which eventually became a part of the reserves in the following years.

Furthermore, besides a decline in the amount of premiums, the gap between Gross and Net Premiums has also widened. Net premiums in CY00 were 68.6 percent of gross premiums which then became 57.9 percent in CY02, and in the last two years, net premiums have been around 50 percent of total gross premiums. This decline in net premiums as a percentage of gross premiums is mainly due to a large share of unearned premiums of the insurance companies with other insurance and reinsurance companies and business entities. Moreover, the insurance premium rates have declined considerably over time on account of competition in the non-life market, thus creating a decline in the overall premium amount.

8.2.1 Equity Structure of Non-Life Insurance Companies

There has been a considerable improvement in the equity structure of non-life insurance companies after the introduction of Insurance Ordinance 2000, followed by the Insurance Rules 2002.[7]

The total paid-up capital of non-life insurance companies increased from Rs 5,965 million in CY03 to Rs 6,300 million in CY04, a growth of 5.6 percent, whereas total equity has increased by 13.7 percent in CY04. **Table 8.4** shows the percent share of different categories

Table 8.4: Capitalization of Non-Life Insurance Companies

percent share

	CY01	CY02	CY03	CY04
Paid-Up Capital				
State owned	39.9	36.5	33.5	31.7
Domestic	57.7	60.9	60.1	65.3
Foreign	2.4	2.6	6.4	3.0
Total share	100	100	100	100
Total (million Rupees)	5,005	5,477	5,965	6,300
Equity				
State Owned	54.4	55.7	53	52.4
Domestic	42.9	40.8	42.7	44.4
Foreign	2.7	3.5	4.3	3.2
Total share	100	100	100	100
Total (million Rupees)	11,250	13,284	15,316	17,415

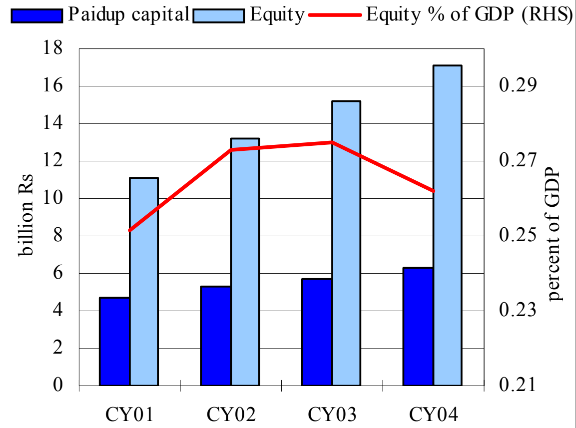
Source: Annual audited reports of non-life insurance companies

[6] Incurred but Not Reported: This is a loss reserve which is established on the insurer's books to account for losses that have already occurred but have not yet been reported to the company or directly recorded on its books.

[7] Issued by SECP in December 2002. For details, please see "Pakistan : Financial Sector Assessment 2003", State Bank of Pakistan. The minimum paid-up capital was required to be Rs. 80 million by end-CY04 for non-life insurance companies.

of companies in the total paid-up capital and equity. The share of the state-owned National Insurance Company has considerably decreased over the years, from 39.9 percent in CY01 to 31.7 percent in CY04. This is because of the fact that the paid-up capital of the company has remained at Rs 2,000 million whereas other private companies have increased their respective paid-up capital levels (see **Figure 8.2**).

Figure 8.2: Equity Structure of Non Life Companies



8.2.2 Composition of Assets and Investments

In addition to equity, the share of assets of domestic private companies in total non-life assets has also seen a considerable improvement from 54.9 percent in CY01 to 62.5 percent in CY04. Moreover, with the anticipated privatization of its state-owned clients, it is expected that the share of assets of the state-owned insurance company will decrease substantially in the coming years and this shift in demand will be met by the private insurance suppliers (see **Table 8.5**). The share of investments (excluding investments made in property) also shows a similar trend. Investments are generally the largest asset of an insurance company's balance sheet. The investment portfolio of insurance companies usually consists of listed shares, corporate debt bonds (TFCs) and money market instruments.

Table 8.5: Composition of Non-Life Insurance Investments and Assets

percent share

	CY01		CY02		CY03		CY04	
	Investments	Total Assets	Investments	Total Assets	Investments	Total Assets	Investments	Total Assets
State owned	58.9	42.5	48.7	40.4	54.1	37.5	43.7	34.9
Domestic	40.7	54.9	49.2	55.5	45.1	58.2	54.8	62.5
Foreign	0.4	2.6	2.1	4.1	0.8	4.3	1.5	2.6
Total share	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total (million Rupees)	12,114	26,534	10,720	30,207	14,605	37,266	16,207	43,288

Source: Annual audited reports of non-life insurance companies

8.2.3 Composition of Premiums and Claims

Premiums are considered to be the main indicator of an insurance company's performance. Usually, higher premium accumulation results not only in higher underwriting income but also leads to an addition in the investment stock and reserves of the company. Insurance premiums are classified as gross and net premiums. Premiums underwritten or gross premiums are net premiums plus reinsurance expenses and unearned premiums.

Table 8.6 highlights the composition of gross premiums among the various categories of insurance companies. With an increase in the assets of its current state-owned clients**,** the premiums accumulated by the state-owned insurance company have increased considerably.

In specific terms, the share increased from 19.1 percent in CY03 to 23.9 percent in CY04. Moreover, foreign insurance companies have also consistently managed to attract premiums over the last three years. The share of the domestic insurance companies, however, shows a decline mainly due to the higher provisioning of premiums as compared to other classes of insurance companies.

Table 8.6: Composition of Gross Premiums
percent share

	CY02	CY03	CY04
State owned	17.3	19.1	23.9
Domestic	78.4	76.7	71.7
Foreign	4.3	4.2	4.4
Total share	100	100.0	100.0
Amount in million rupees	15,221	19,571	17,163

8.2.4 Categories of Non-Life Insurance

There are four main classes of non-life insurance in the country: Fire, Marine, Motor and Miscellaneous, whereas Health insurance is a separate category. The Miscellaneous Insurance category includes hundreds of other prospective insurance classes such as Aviation, cash related insurance, travel insurance etc. Treaty insurance on the other hand is related to reinsurance.[8]

Table 8.7: Net Premiums and Claims
percent share

	CY01	CY02	CY03	CY04
Fire				
Share of net premiums	21.0	16.7	20.2	18.2
Share of net claims	11.8	14.3	12.8	26.4
Claim ratio	36.4	48.1	34.4	111.1
Marine				
Share of net premiums	22.6	32.5	23.0	20.9
Share of net claims	12.2	15.2	12.5	10.2
Claim ratio	35.0	26.2	29.4	37.5
Motor				
Share of net premiums	41.2	36.6	42.5	48.3
Share of net claims	62.1	52.6	56.1	53.9
Claim ratio	97.9	80.7	71.4	85.5
Miscellaneous				
Share of net premiums	8.5	7.2	8.3	6.4
Share of net claims	3.7	9.7	6.7	5.3
Claim ratio	28.6	75.4	43.8	60.0
Health				
Share of net premiums	2.3	3.2	3.2	5.4
Share of net claims	3.0	5.6	6.5	4.1
Claim ratio	82.3	98.1	108.6	57.7
Treaty				
Share of net premiums	4.5	3.8	2.9	0.8
Share of net claims	7.3	2.8	5.4	0.1
Claim ratio	106.1	40.2	101.4	6.8
Total Net Premiums (million Rs)	7,835	8,810	9,740	8,567
Total Net Claims (million Rs)	5,088	4,949	5,266	6,563
Claim ratio	64.9	56.2	54.1	76.6

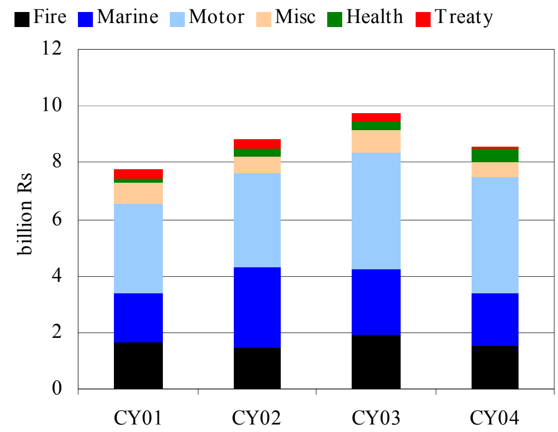
Fire insurance is mainly required by the construction and industrial sector. Higher the growth in industrial infrastructure, the more is the fire and allied insurance business for insurance companies. Similarly, Marine insurance is associated with trade of goods and services. Marine insurance usually increases with the increase in imports and exports of goods. Motor insurance on the other hand has two major sub-components: comprehensive motor insurance and third party or liability insurance. With the rapid growth in car loans in the recent past, Motor insurance premiums have also increased. **Table 8.7** shows the percent-wise contribution of each insurance class with respect to net insurance premiums.

Net Fire insurance premiums have declined in CY04 to 18.2 percent of total net premiums as shown in **Figure 8.3**. This has been due to large unearned provisions[9] in Fire insurance premiums. In CY03, the share was 20.2 percent. Similarly, Marine insurance also has a decreasing share in net premiums, whereas Motor insurance premiums have increased substantially primarily due to the easy availability of auto financing. Health insurance, which depends extensively on individuals' preferences, has attracted considerable attention in the recent past. Public awareness of

[8] There are two types of Reinsurance categories, Facultative and Treaty. Reinsurance coverage is detailed in **Box 8.2**.
[9] On unearned premiums.

Health insurance has also increased on account of the increasing cost of private medical treatment and the deteriorating state of public health facilities. All these factors have contributed in increasing the share of Health insurance premiums to 5.4 percent as compared to 3.2 percent in CY03. However, the share of net premiums of Treaty insurance has declined in CY04, which is mainly due to the increase in the capital base of the companies which provide Treaty insurance, which in turn has enabled them to manage their own risks and to increase their retention limits. This has not only helped these companies in reducing the outflow of their assets in the form of premium payments to reinsurance companies but has also enabled them to increase their remunerative asset base. This change in management policy has enabled these companies to post a 27.5 percent higher profit in CY04 as compared to CY03.

Figure 8.3: Composition of Net Premiums



Box 8.2: Reinsurance and its Types

Reinsurance is a transaction whereby a reinsurance company (reinsurer) indemnifies the risks underwritten by other insurance companies (insurers) by covering the entire risk or some part of it under different kinds of policies. The insurance company pays a premium for the services provided by a reinsurance company. Since the function of insurance is to spread risks, the reinsurance company further broadens the risk by extending its coverage to other reinsurance companies.

Traditionally, there are two types of reinsurance facilities, Facultative reinsurance and Treaty reinsurance.

Facultative: This mainly refers to large-scale risks. Insurance companies which originally underwrite the risks, offer to reinsure it. The reinsurance company after reviewing the associated risk may either accept or reject the proposed offer.

Treaty: In contrast to Facultative reinsurance, Treaty insurance covers the overall business of an insurance company. In this case, it is obligatory for the reinsurance company to accept all the risks that are present in the overall business offered by the insurance company. The benefit of Treaty insurance is that it reduces the cost of analyzing individual risks for the reinsurance company, due to which it is less costly than Facultative arrangements.

The claim ratio, which is the ratio of net claims to net premiums, also showed a tremendous increase (on an overall basis) of 76.6 percent in CY04 as compared to 54.1 percent in CY03. Most of the claims were related to Fire and Motor insurance, which also justifies the huge provisioning of premiums in these categories. In case of Fire insurance, total claims outweigh the net premiums (increase in claim ratio of 111.1 percent in CY04), which reflect a net loss to the insurance companies. Moreover, Motor claims were also on the rise during the year given that the claim ratio reached 85.5 percent in CY04 as opposed to 71.4 percent in CY03.

If it is assumed that the share of Motor premiums will continue to dominate the total premiums, in addition to the fact that Motor claims contribute significantly to the overall claim ratio, the core income of non-life insurance is expected to be vulnerable in the future, unless there is a drastic improvement in the law and order situation.

8.2.5 Performance Analysis of Non-Life Insurance Companies

Capital adequacy of non-life insurance firms has improved significantly due to enhanced paid-up capital requirements, however, a higher increase in the reserves and retained earnings served to decrease their paid-up capital to total equity ratio from 38.9 percent in CY03 to 36.2 percent in CY04.

Similarly, total assets also increased more than the equity, which slightly decreased the ratio of equity to total assets as shown in **Table 8.8**.

Table 8.8: Ratio Analysis of Non-Life Insurance Industry

percent share	CY01	CY02	CY03	CY04
Capital Adequacy				
Paid-up capital to total equity	44.5	41.2	38.9	36.2
Paid-up capital to total assets	18.9	18.1	16.0	14.6
Equity to total assets	42.4	44.0	41.1	40.2
Growth rate of equity	-	18.1	15.3	13.7
Growth rate of assets	18.7	13.8	23.4	16.2
Combined ratio	81.5	70.9	67.2	91.1
Liquidity				
Liquid assets to total assets	14.4	24.0	17.1	19.7
Operating Ratio				
Underwriting expense / gross premium (expense ratio)	16.6	14.7	13.2	14.4
Loss ratio	64.9	56.2	54.1	76.6
Operating ratio	54.3	43.6	38.3	61.0
Premiums to assets turnover ratio	29.5	29.2	26.1	19.8
Profitability Ratios				
Investment income to net premiums	27.2	27.3	28.9	30.1
Investment income to investment assets	16.2	20.6	17.8	15.9
Growth rate of profits	-12..3	80.4	-3.3	27.5

As firms take on more and more risks in the form of increased premiums, it becomes necessary to retain a significant portion of their assets in liquid form such as cash and bank deposits. This is reflected in the improved liquidity of the companies, from 17.1 percent in CY03 to 19.7 percent in CY04.

The operating ratio assesses the operational aspects of insurance companies and is defined as the combined ratio less net investment income ratio (the ratio of net investments to net premiums earned). In other words, it measures the profitability of the company from its core business after subtracting the net investment income. The operating ratio has improved considerably from 38.3 percent in CY03 to 61.0 percent in CY04. On the other hand, the expense ratio shows that the insurance companies employed 14.4 percent of gross premium on underwriting expenses, agents' commissions and advertising activities to promote their businesses in CY04 as compared to 13.2 percent in CY03.

The investment income, which is the return on investments in TFCs, equity and money market instruments, also witnessed a rise in CY04 on account of the booming stock market in Q2-FY05 and the higher return on money market instruments. This enabled the investment income to grow more proportionately than net premiums.

The combined ratio, defined as the sum of the loss ratio and the expense ratio (underwriting expense to net premium), deteriorated significantly in CY04. A higher ratio indicates that the company's expenses on claims and underwriting are increasing. In CY04 the loss ratio was 76.6 percent, considerably greater than 54.1 percent in CY03, which in turn increased the combined ratio from 67.2 percent in CY03 to 91.1 percent in CY04**.**

After a negative growth in profitability in CY03, profits of the non-life insurance sector grew by 27.5 percent in CY04, indicating that although the cost of doing business has increased during the year, as shown by the combined ratio, opportunities to provide insurance coverage have increased by a larger proportion.

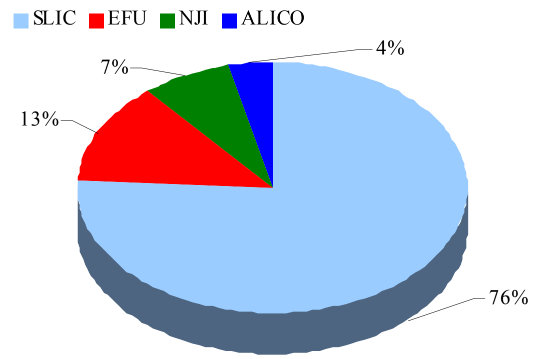
8.3 Life Insurance Products

The concept of life Insurance has evolved from a primary emphasis on conventional insurance protection to a relatively advanced form of a savings product. Life insurance products enhance the role of insurance in an economy by helping in the : (1) mobilization of savings; (2) development of capital markets; and (3) facilitation of the pension system. Specifically, by entering into life insurance contracts, individuals or groups of individuals are able to save and invest effectively for long periods of time. Life insurance companies pool the periodic premium payments into huge investment portfolios of long-term securities, which in turn provide a stimulus for the development of the capital market. Also, the introduction of attractive pension products partly shifts the role of the government for pension provision to the private insurance sector.

Traditionally, the life insurance industry in Pakistan has been characterized by an inadequate regulatory framework, few market players, limited types of business,[10] lack of innovative products, and the monopoly of State Life Insurance Corporation (SLIC).[11] While the insurance reforms in the 1990s began the process of development of the life insurance industry but the actual impetus to the development drive came with the promulgation of the Insurance Ordinance 2000. This was followed by the introduction of new insurance regulations by SECP in the form of Insurance Rules 2002 and the Code of Conduct for Surveyors and Loss adjusters. In CY05, SECP issued the Voluntary Pension System Rules,[12] which allow a life insurance company to register itself as a pension fund manager and also authorized such pension fund managers to offer annuity as a part of a pension plan.[13] Takaful Rules 2005, prepared by a task force constituted by the Securities and Exchange Commission of Pakistan, have also been issued in September 2005.

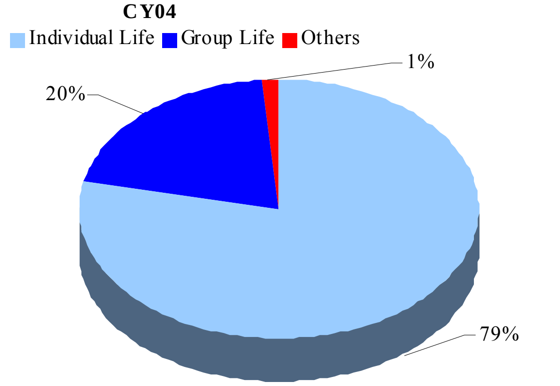
State Life Insurance Corporation (SLIC), which was created from the consolidation of 41 life insurance businesses during the nationalization process of the early 1970s, continued to be the dominant insurance company in CY04. In terms of gross premiums, SLIC's share is around 76 percent of the combined gross premium, while the shares of the rest of the companies range from 4 to 13 percent (see **Figure 8.4**). Due to the monopoly of SLIC, the number of life insurance companies has reduced from 9 in CY95 to 5 in CY03. Out of the currently operating 5 life insurance companies, one is state-owned, with two private domestic and two foreign life insurance companies.

Figure 8.4: Share of Life Insurance Companies during CY04



Life insurance business in Pakistan is concentrated in a few areas (see **Figure 8.5**). The combined share of individual life and group life business comprises 99 percent of the total gross premiums, whereas the other types of life insurance products such as pension, annuity, and accidental & health insurance are not so popular. Within the individual life and group life insurance businesses, conventional plans such as

Figure 8.5: Types of Life Insurance business during CY04

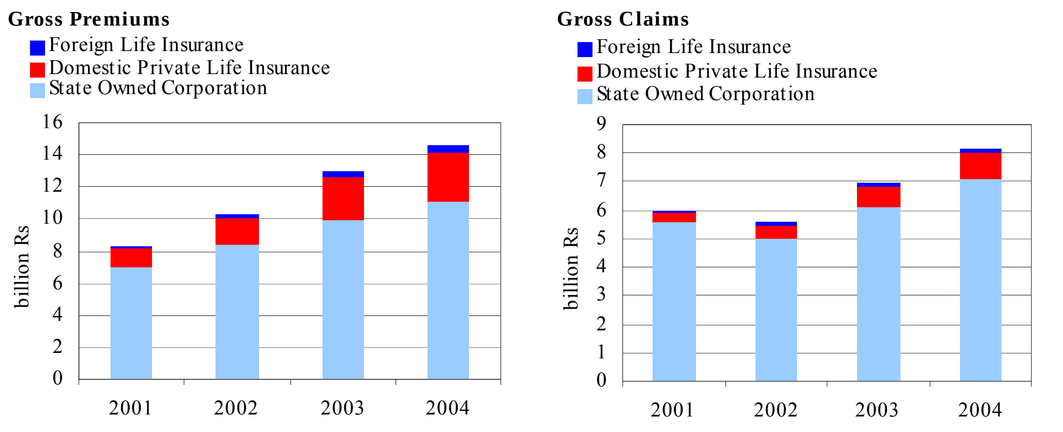


[10] Historically, life insurance companies in Pakistan mainly focused on individual life and group life business. The share of other types of businesses such as Pension, Accidental & Death, and Annuity insurance has remained almost negligible in the total business (see Figure 8.5).
[11] For a historical perspective, please see, "Pakistan : Financial Sector Assessment 2003", State Bank of Pakistan.
[12] For details, please see Chapter 2 : Financial Infrastructure : An Assessment.
[13] According to S.R.O. 87(I)/2005, Voluntary Pension System Rules, 2005 came into force w.e.f. January 27 2005.

endowment plan, term plan and whole life plan are the dominant products in the industry.[14] The product range expanded somewhat with the introduction of innovative products such as the investment linked[15] plans offered by a domestic private life insurance company in CY92.[16] As a result, the combined share of life insurance companies other than SLIC, has increased from 15.8 percent in CY01 to 24.0 percent in CY04.

The life insurance industry recorded a growth of 12.3 percent in combined gross premiums[17] to reach Rs. 14.6 billion in CY04 compared to Rs.13.0 billion in CY03 (see **Figure 8.6**).

Figure 8.6: Sector-wise Life Insurance Business



The gross claims paid by the life insurance sector increased at a slower rate of 17.6 percent to Rs 8.0 billion by end-CY04 against the rise of 24.7 percent to Rs 6.8 billion in CY03 (see **Figure 8.6** & **Table 8.9**). The prime sources of claims in CY04 were the higher maturity and surrender payments for individual life, and death benefits and experience refund[18] for group life.

Encouragingly, total assets of the life insurance sector expanded further to Rs 123.7 billion in CY04 compared to Rs 107.9 billion in CY03. Total investments grew by 13.3 percent in CY04 with higher investments in government securities and also relatively greater investments in listed equities to gain from the bullish trend of the stock market. Assets were allocated into various investments in accordance with the solvency requirements prescribed in the Insurance Rules.[19] The latest developments in the international arena on solvency issues are discussed in **Box 8.3**.

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[14] An Insurance policy which pays the sum assured only in case of death within a specified period called the 'term period' is called a term insurance policy. Insurance amount payable on death whenever this may occur is termed as a whole-life insurance policy, whereas an insurance amount which is payable either on death or survival to the maturity date stated in the policy is defined as an endowment insurance policy.

[15] Life insurance where the policy value at any time varies according to the value of the underlying assets is classified as an investment linked product.

[16] Investment linked plans are only offered by two life insurance companies and the share of these plans in the combined gross premiums is 14.5 percent at end-CY04.

[17] Combined total gross premiums include individual life, group life and other business types including pension, annuity and accidental & health insurance.

[18] Experience refund is the amount refunded to the master policy-holder as a share of profits in the business.

[19] For details, please see Rule 10 of Insurance Rules 2002.

Table 8.9: Snapshot of Life Insurance Business in Pakistan
Amount in million Rupees, growth in percent

	CY02		CY03		CY04	
	Amount	**Growth**	**Amount**	**Growth**	**Amount**	**Growth**
Minimum paid up capital requirement	100	-	100	-	150	50.0
Paid up capital	1,877	-	2,102	12.0	2,117	0.7
Gross premiums	10,277	24.0	12,978	26.3	14,632	12.7
Net premiums	9,956	24.0	12,625	26.8	14,207	12.5
Net investment income	11,361	27.6	10,445	-8.1	13,953	33.6
Gross claims incurred	5,485	-7.7	6,838	24.7	8,037	17.5
Net claims	5,377	-7.7	6,678	24.2	7,866	17.8
Net management expenses	3,893	16.7	4,750	22.0	5,664	19.3
Net profit after tax	233	-22.5	385	64.9	311	-19.1
Total assets	95,419	14.4	107,889	13.1	123,676	14.6
Total investments	77,250	15.7	87,049	12.7	98,584	13.3
Total equity	1,249	13.1	1,760	40.9	1,750	-0.6

Source: Annual audited reports of life insurance companies

The life insurance sector is expected to develop in tandem with the positive outlook of the economy. With increasing competition, improved client services, increased marketing to promote consumer awareness and introduction of new products, the life insurance industry will continue to expand in the foreseeable future. In this regard, the introduction of the Voluntary Pension System Rules, establishment of a *Takaful* company and development of bancassurance[20] are all expected to bring forth substantial growth in business for life insurance companies.

8.3.1 Performance of Life Insurance Companies

The overall performance of the life insurance industry can be gauged by using different methods. For instance, the International Association of Insurance Supervisors (IAIS) has developed the core principles for insurance companies.[21] The basic purpose of these core principles is to measure the status of insurance regulations and also to gauge the performance of insurance companies around the world. The status of core principles for Pakistan insurance companies is summarized in **Box 8.4**. Another methodology proposed by the IMF is based on Financial Soundness Indicators (see **Box 8.5**). Some of these indicators are discussed below.

One of the most important indicators for assessing the financial health of the life insurance sector is the capital adequacy ratio which indicates the capacity of the life insurance companies to bear the burden of unexpected financial obligations. The capital adequacy indicators are shown in **Table 8.10.**

Specifically, paid-up capital as a percent of total equity has improved in CY04. This improvement is due to an increase in the paid up capital base of the domestic private life companies, and the slight decrease in SLIC's equity due to a low accumulated surplus during CY04.

The ratio of paid-up capital to total assets has declined in CY04. This was because the growth in assets was much more pronounced than the growth of paid-up capital during the year. Similarly, equity as a percentage of total assets declined in CY04. The decline in both these ratios may not

[20] A combination of banking and insurance business is termed as bancassurance. Some life insurance companies are also using bank branches for selling products such as loan protection plans.
[21] IAIS is an apex regulatory body which supervises regulators of insurance companies around the world.

necessarily be an unhealthy sign because the assets of life insurance companies are largely composed of investments in risk-free government securities.

With respect to liquidity, the life insurance sector increased its holdings of cash and bank deposits in CY04 as reflected in the relatively higher liquidity ratio.

The loss ratio declined significantly in CY04, which suggests that: (1) the life insurance industry as a whole followed more prudent underwriting practices in addition to appropriately pricing its policy-risks and (2) the renewal persistency of the insurance policies is improving, which is reflected in higher net premiums.

In contrast, the expense ratio, which is the underwriting expense as a percent of net premiums, increased in CY04, indicating that expenses related to underwriting increased during the year. The combined ratio, which is the combination of the loss and expense ratios, has declined in CY04, which signifies an improvement in the performance of the underwriting operations of the life insurance industry.

Table 8.10: Ratio Analysis of the Life Insurance Sector

Percent

	CY01	CY02	CY03	CY04
Capital Adequacy				
Paid-up capital to total equity	170.1	150.3	119.5	121.0
Paid-up capital to total assets	2.2	2.0	1.9	1.7
Equity to total assets	1.3	1.3	1.6	1.4
Growth rate of equity		13.1	40.9	-0.6
Growth rate of assets		14.4	13.1	14.6
Combined ratio	73.0	54.4	67.4	56.1
Liquidity				
Liquid assets to total assets	4.2	5.6	7.0	8.5
Operating Ratio				
Underwriting expense to gross premiums	0.4	0.4	0.4	0.7
Underwriting expense to net premiums (Expense ratio)	0.4	0.4	0.5	0.8
Loss ratio	72.6	54.0	67.1	55.4
Operating ratio	60.3	40.1	55.8	42.3
Total assets turnover ratio	9.9	10.8	12.0	11.8
Profitability Ratios				
Investment income to net premiums	109.2	114.1	82.7	98.2
Investment income to investment assets	12.6	14.2	11.7	13.8
Return on assets	0.4	0.2	0.4	0.3
Growth rate of profits		-22.5	64.9	-19.1

Source: Annual reports of life insurance companies

As far as profitability ratios are concerned, the growth rate of profits has declined in CY04, particularly due to a one-off gain on sale of investments in CY03 in case of SLIC, which contributed to the overall growth in profits. On the other hand, investment income has increased, indicating higher returns mainly due to a relatively diversified investment portfolio in both government securities and equities (see **section 8.3.3**).

8.3.2 Classification of Life Insurance Business

8.3.2.1 Individual Life Business

An Individual life insurance plan is a contract which covers the life of an individual (either single or joint life) up to a specified amount called the sum assured. These plans can be classified according to the process of business as follows:

New Business

All the new policies issued are part of the new business process of the company. Life insurance companies in Pakistan are growing in terms of the new business premium. The share of new business premiums in total gross premiums has increased from 17.6 percent in CY01 to 23.6 percent in CY04. It should be noted though that after exhibiting exceptional growth in CY03, the total gross new business premium has declined marginally in CY04.

Although annual premium plans remained the main source of contribution in new business gross premiums, single premium plans offered by both the domestic and the foreign life insurance companies contributed significantly in accumulating the total gross new business premium in CY03. The single premium plan initially gained attention due to the low interest rate environment as these plans were issued at competitive rates. However, as the interest rates started rising in CY04, these plans lost their appeal. This pattern is also reflected in the number of issued policies, sum assured coverage and total gross premiums (see **Table 8.11**).

Table 8.11: Overall Individual Life New Business

Amount in million Rupees, growth in percent

	CY02		CY03		CY04	
	Amount	**Growth**	**Amount**	**Growth**	**Amount**	**Growth**
No of policies issued ('000s)	160.2	13.7	197.6	23.4	239.7	21.3
Sum assured	33,145	28.0	45,404	37.0	57,839	27.4
Single premium plans	182	217.4	713	291.2	321	-55.0
Annual premium plans	1,760	25.0	2,412	37.0	3,134	29.9
Total gross premiums	1,942	32.5	3,125	60.9	3,454	10.6
Average premium ('000s)	12.1	16.6	15.8	30.4	14.4	-8.9
Average sum assured ('000s)	206.9	12.6	229.8	11.0	241.3	5.0
New business premium/Total premium	18.9	11.2	24.1	27.4	23.6	-1.9

Source: Annual audited reports of life insurance companies

Interestingly, the average premium per policy of the foreign life insurance companies is the highest in the life insurance industry, followed by domestic life insurance and then the state- owned corporation.[22] This pattern of average premium indicates that SLIC's business policy is targeted towards the low-income group.[23]

Business In-force

The financial strength of an insurance company depends on its ability to retain the business. This ability can be gauged from the amount of the 'in-force' business and the renewal persistency level maintained by a life insurance company over the years. Consistent renewal premium of individual

Table 8.12: Individual Life In-Force Business

Amount in million Rupees, growth in percent

	CY02		CY03		CY04	
	Amount	**Growth**	**Amount**	**Growth**	**Amount**	**Growth**
No of policies in-force ('000s)	1,874.0	0.6	1,941.3	3.6	2,040.3	5.1
Sum assured	134,458.1	11.0	164,273.2	22.2	203,896.0	24.1
Second year renewal premiums	1,041.6	53.5	1,391.0	33.5	1,974.2	41.9
Subsequent year renewal premiums	5,084.1	16.8	5,357.8	5.4	6,090.9	13.7
Total gross renewal premiums	6,125.7	21.7	6,748.8	10.2	8,065.1	19.5
Average premium ('000s)	3.3	21.0	3.5	6.4	4.0	13.7
Average sum assured ('000s)	71.8	10.3	84.6	17.9	99.9	18.1
Second year renewal premium	10.1	23.8	10.7	5.8	13.5	25.9
Subsequent year renewal premium	49.5	-5.8	41.3	-16.5	41.6	0.8
Renewal premium to total premium	59.6	-1.8	52.0	-12.8	55.1	6.0

Source: Annual audited reports of life insurance companies

[22] In CY04, the average premium per policy was Rs.10, 509, Rs.31,720 and Rs.35,735 for SLIC, domestic life insurance companies and the foreign life insurance companies, respectively.

[23] The difference between the average premium of SLIC and other life insurance companies highlights the former company's policy of accepting low premium amounts.

life insurance is a source of long-term profitability for a company. All those policies which are renewed due to the regular payment of premiums, or reinstated from a lapsed status, are classified as the *in-force* business.

The total gross renewal premium of the life insurance industry showed an impressive performance during CY04. In specific terms, the total gross renewal premium increased by 19.5 percent to Rs 8.1 billion in CY04 compared to Rs 6.7 billion during CY03 (see **Table 8.12**). Both the rise in the second year renewal premiums and the subsequent year renewal premiums contributed to the growth of the gross renewal premiums. Importantly, the share of renewal premiums in total gross premiums has increased from 52.0 percent in CY03 to 55.1 percent in CY04. This suggests that the ability of the life insurance industry in retaining individual life business has improved in CY04.

Individual claims

In CY04, the gross claims paid by the life insurance industry for individual life increased by 17.2 percent to Rs 5.3 billion compared to gross claims of Rs 4.5 billion registered in CY03 (see **Table 8.13**). A large portion of gross claims was paid on account of the maturity and surrender of the policies.[24] Specifically, the amount paid on account of maturity increased by 41.0 percent to Rs. 2.4 billion in CY04 against Rs.1.7 billion paid in CY03. The higher amount of claims on account of maturity is a good sign for the reputation of a company, as it shows that the company retained the client for the term period of the policy. Moreover, retention of a policy until maturity is also financially favorable for the company given that the company continues to earn the expected gains over the life of the policy. The amount paid against the surrender of policies has also increased marginally by 3.9 percent to Rs 2.1 billion compared to Rs 2.0 billion in CY03. A high surrender value signifies the lack of confidence of the policy holder in continuing the policy. Life insurance companies incur losses if the policy is terminated prior to the term period, especially in the early period of issuance. On the other hand, the amount paid on account of death claims has declined by 4.1 percent to Rs 0.68 billion as compared to Rs 0.71 billion paid in CY03.

Table 8.13: Composition of Individual Life Claims

Amount in million Rupees, share in percent

	CY01		CY02		CY03		CY04	
	Amount	**Share**	**Amount**	**Share**	**Amount**	**Share**	**Amount**	**Share**
By death	632.4	15.2	619.8	13.8	718.4	15.7	688.7	12.9
Insured event other than death	37.8	0.9	52.0	1.2	48.0	1.1	63.1	1.2
By maturity	1,322.6	31.7	1,592.7	35.5	1,745.3	38.2	2,461.9	46.0
By surrender	2,168.3	52.0	2,211.6	49.3	2,051.7	44.8	2,133.1	39.7
Annuity payment	6.9	0.2	9.5	0.2	7.8	0.2	9.4	0.2
Bonus in cash	0.0	0.0	0.2	0.0	0.1	0.0	0.1	0.0
Total Gross individual policy claims	4,168.1	100.0	4,485.7	100.0	4,571.3	100.0	5,356.3	100.0
Net claims	4,128.8		4,447.0		4,519.2		5,258.1	

Source: Annual audited reports of life insurance companies

8.3.2.2 Group Life Insurance

Generally, group life insurance is a term assurance plan which covers the lives of several people as a group (usually employees of a company), written under one contract called the 'master policy'. The premiums can be paid by the employer, the employee or both. Also, the premium amount is usually

[24] Collectively, almost 85.8 percent of individual gross claims were paid on maturity of polices and as a cash value against surrender of policies during CY04.

lower than for individual life policies because the administrative expenses per person usually decrease in group insurance.

The group gross premiums constituted (on average) almost 22.0 percent of the combined gross premiums between CY01 and CY04. The overall group insurance business remained roughly the same in CY04 after exhibiting an exceptional performance in CY03. The overall group gross premium (GGP) decreased marginally by 0.7 percent to Rs.3.1 billion in CY04 as compared to an increase of 40.8 percent (Rs 3.09 billion) in CY03 (see **Table 8.14**). During CY03, the exceptional growth in group gross premium was due to: (1) the *one-off* enhancement of sum assured by government departments in their group contract with SLIC, and (2) the advance premium paid by these government departments to SLIC. Due to these two factors, the growth of gross premiums for group business during CY04 seems unusually low.

Table 8.14: Structure of Group Life Insurance

Amount in million Rupees, growth in percent

	CY02		CY03		CY04	
	Amount	Growth	Amount	Growth	Amount	Growth
No of policies	2896	9.7	3113	7.5	3250	4.4
Lives insured (million numbers)	4	7.1	4.4	10.5	4.8	8.4
Sum assured	593,200	32.9	730,100	23.1	828,900	13.5
Group gross premium (GGP)	2,203	23.3	3,097	40.8	3,103	-0.7
Group net premium (GNP)	2,000	22.2	2,900	45.9	2,800	-0.6
Group premium to total premium (percent)	21.4	-0.7	23.9	11.6	21.2	-11.3

Source: Annual audited reports of life insurance companies

Group Claims

In CY04, the group claims of the life insurance industry in gross terms increased by 17.4 percent to reach Rs 2.7 billion compared to Rs 2.3 billion in CY03. Unlike individual life, group life claims largely arise on account of death benefits as reflected in the 85.7 percent share of this category in CY04 (see **Table 8.15**). A smaller share of 9.3 percent was also paid as experience refunds in CY04. A higher proportion of experience refunds indicate a healthy business during the year.

Table 8.15: Composition of Group Life Claims

Amount in million Rupees, share in percent

	CY01		CY02		CY03		CY04	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share
By death	1,521.5	83.3	829.6	75.7	1,910.7	79.9	2,391.9	85.7
Insured event other than death	94.0	5.1	62.5	5.7	114.8	4.8	120.5	4.3
By maturity	1.5	0.1	2.1	0.2	7.5	0.3	16.1	0.6
By surrender	22.3	1.2	12.0	1.1	0.0	0.0	0.0	0
Annuity payment	0.1	0.0	0.1	0.0	0.6	0	0.7	0
Experience refund	187.0	10.2	189.4	17.3	357.9	15	260.6	9.3
Total gross claims	1,826.5	100	1,095.8	100	2,391.5	100	2,789.8	100
Net claims	1,703.6		930.5		2,173.2		2,603.1	

Source: Annual audited reports of life insurance companies

8.3.3 Investment Income of Life Insurance Companies

The net amount earned by a company on financial investments is classified as the net investment income during the year. Because of the very nature of life insurance policies, companies undertake investments of longer durations.[25] Specifically, insurance companies are one of the largest investors of long term government securities and other capital market instruments as it provides them an assured rate of return to meet their financial obligations arising from claims and other liabilities (see **Box 8.6)**.

Government securities dominate the investment portfolio of life insurance companies. However, the share has declined in CY04 due to the low rate of return on government securities in the last three years (see **Table 8.16)**. Moreover, the net income received against loans to policy holder[26] and gains earned on the sale of investments in both fixed income securities and equities also increased in CY04. In addition, dividend income also helped in accumulating net income in CY04.

Table 8.16: Statement of Investment Income of Life Insurance Companies

Amount in million Rupees, share in percent

	CY03		CY04	
	Amount	**Share**	**Amount**	**Share**
On government securities	7,843.1	75.1	7,830.2	56.1
On other fixed income securities and deposits	425.0	4.0	408.2	2.9
Dividend income	1,368.6	13.1	1,755.3	12.6
On loan to policy holders	566.0	5.4	1,527.0	10.9
On loan to employees	6.4	0.1	3.3	0.0
Amortization of premium relative to par	-4.0	0.0	-6.6	0.0
Other	-1.6	0.0	234.8	1.7
Gain on sale of investment	53.3	0.5	2,231.9	16.0
Provisions for impairment of investments	208.8	2.0	-8.4	-0.1
Investment related expenses	20.9	0.2	22.1	0.2
Net investment income	10,442.6	100.0	13,948.4	100.0

Source: Annual audited reports of life insurance companies

8.4 Postal Life Insurance

There are several features of the Postal Life Insurance business which distinguish it from other life insurance organizations. Some of these are as follows: (1) Postal Life Insurance (PLI) has an extensive outreach to far flung areas due to its wide-raging network of post offices across the country, especially in the rural areas; (2) Postal life insurance is exempt from corporate and income tax; (3) due to the government guaranteed insurance business, Postal Life Insurance does not require reinsurance; and (4) Postal life insurance offers products at a low premium.

New business activities of postal life insurance have improved during CY04. The gross premiums increased by 63.8 percent to Rs 181.4 million (see **Table 8.17**). This pushed up the average premium per policy for new business to Rs 5,494 in CY04 from Rs 4,434 in CY03.

Table 8.17: New Business of Postal Life Business

Amount in million Rupees, average amounts in '000s

	No. of Policies	Premium	Sum Assured	Average Premium	Average Sum Assured
CY01	19,332	69.297	2,324	3,585	120,226
CY02	19,448	74.041	2,505	3,807	128,790
CY03	24,983	110.772	3,369	4,434	134,840
CY04	33,029	181.462	5,161	5,494	156,254

However, the in-force business of postal life insurance only increased marginally in CY04 as compared to CY03. Both the number of policies and total sum assured increased in CY04 at an almost similar growth rate as CY03 (see **Table 8.18**). This signifies the lack of interest of individuals in renewing their policies. The potential impact of this on the growth of the Postal Life Insurance Fund is discussed below.

[25] Other than financial investments, SLIC also earns a huge amount on investments in property, in the form of rental income.
[26] Loans in cash against the security of life insurance policies may be extended to the policy-holders to the extent of a partial amount of the policy value provided the policy has been in-force for over two years.

Total claims in CY04 rose by 27.72 percent to reach Rs 326.44 million, due to larger maturities as well an increase in surrendered value of policies (see **Table 8.19**).

Table 8.18: Business In-force of PLI

million Rupees

	No. of Policies	Sum Assured
CY01	226,464	14,930.39
CY02	228,714	15,878.87
CY03	239,272	18,051.69
CY04	252,810	20,847.65

Table 8.19: Claims of Postal Life Insurance

million Rupees

	Maturity	Death	Surrender	Total
CY01	67.11	24.84	162.94	254.90
CY02	79.16	31.06	144.51	254.73
CY03	83.25	37.43	134.91	255.59
CY04	134.52	41.56	150.36	326.44

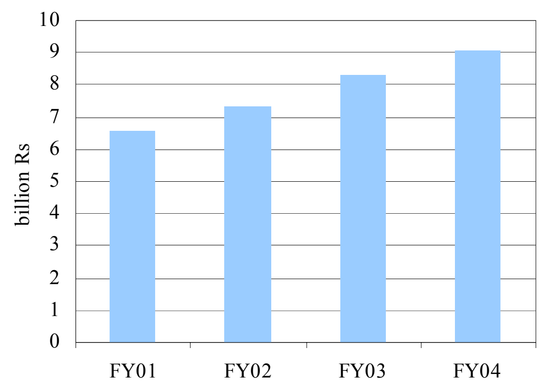
The net balance of premiums accumulated by the Post Life business is invested in the Postal Life Insurance Fund (PLIF), which is controlled by the Ministry of Finance. PLIF ensures that the organization is able to meet its contingency claims and other liabilities. A healthy investment fund builds the confidence of the policy-holders and also yields attractive returns on the maturity of insurance policies.

Noticeably, in relative terms, the growth rate of PLIF was only 8.6 percent in CY04 compared to 13.8 percent in CY03. This lower growth was due to the lower returns on government investments in CY04 (see **Figure 8.7**).

8.5 Review of Reinsurance

The only reinsurance company in Pakistan, which deals in non-life insurance products, Pakistan Reinsurance Company Ltd (PRCL), continued to perform well in CY04. Overall, the company has been successful in making substantial profits in recent years. One of the major concerns of the company however is the fact that the compulsory cession for domestic non-life companies which used to be 5 percent in CY03, was decreased to just 1 percent in CY04, and then completely abolished by the end of CY04. The implications of the abolition of the compulsory cession will reflect in the overall change in premium amounts underwritten by the company in the coming years.

Figure 8.7: Postal Life Insurance Fund



In case of life insurance, there is no domestic arrangement for reinsurance and all the life insurance business is reinsured by foreign insurance companies.

Table 8.20 Reinsurance Business in Pakistan

million Rupees

	CY01	CY02	CY03	CY04
Paid up capital	50	450	450	450
Reserves and retained earnings	758	796	981	1306
Investments	1,661	1,905	1,886	2,719
Gross premiums	3,045	3,500	4,697	5,241
Net premiums	1,312	1,588	1,447	2,289
Net claims incurred	709	848	1,011	1,329
Management expenses	98	108	140	134
Net profit after tax	67	297	333	325
Total Assets	3,332	4,192	6,232	6,613

Source: Annual audited reports of life insurance companies.

Just like the non-life insurance companies, PRCL also focused on increasing its reserves and retained earnings to strengthen its ability to sustain major financial risks in CY04. This increase in reserves has enabled the company to accept greater premiums. The gross premiums witnessed an increase of 11.6 percent in CY04 (see **Table 8.20**). Moreover, net premiums witnessed an exceptional growth of 58.2 percent in CY04. The claim amount also witnessed a growth of 31.4 percent in CY04. Interestingly, the claim ratio which was 70 percent in CY03 reduced drastically to 58.1 percent in CY04. Investments of PRCL which had declined in CY03, picked up pace again in CY04 as the reinsurance company once again started to accumulate more and more investments which grew by over 44 percent in CY04.

8.6 Conclusion

In sum, in CY04 the insurance industry continued to develop on account of a conducive regulatory environment, introduction of new products and a favorable macroeconomic environment.

The overall growth of assets of insurance companies signifies the growing importance of insurance business in the country. Moreover, a robust increase in the health insurance business (a growth of 48.1 percent in net health premiums) also highlights the increased awareness of the necessity and benefits of insurance.

Despite the fact that non-life insurance premiums showed a decline of 9.8 percent on account of huge provisioning in Fire premiums, the overall performance of the non-life companies has improved as measured by an increase in their profitability. On the other hand, the growth momentum of the life insurance industry moderated in CY04, after exhibiting an exceptional growth in CY03.

It is expected that with the continued implementation of economic reforms, the insurance industry will continue to grow and play a meaningful role in the overall development of the economy. However, consistently high claims and expenses of non-life insurance companies, and lack of proactive management in preventing surrender of policies by life insurance companies, may be potential impediments in the growth momentum of the insurance industry.

Box 8.3: Solvency II Framework
The latest developments in the areas of insurance, risk management, financing techniques and financial reporting have paved the way for reforms in the European solvency system. The European Commission's Financial Services Action Plan (FSAP) has proposed revisions in the solvency regime of insurance companies. As a result, the Solvency II project was initiated as an extension of Solvency I. The overriding objective of Solvency II is to establish a solvency system that prudently deals with the risks of an insurance company.

Harmonization with Basel II
The integration of international financial systems has increased the need for convergence of the regulatory environment. Since the consolidation in the range of products offered by insurance companies and banks is growing, therefore there was a need to harmonize banking and insurance rules. In a recent development, consensus has been achieved to develop Solvency II on the "three pillar" approach similar to the Basel II regulations that the Basel Committee has initiated for the banking industry.

The main features of each pillar are presented as:

Pillar I: Minimum Capital Requirements
The provisions regarding insurers' solvency capital will become stringent. In fact, there will be both a minimum solvency capital and a target solvency capital requirement. The minimum solvency capital will rely on the amount of business that the insurer underwrites. The target solvency capital will be based on the economic risk capital that a company should have in case of unforeseen circumstances. There will be a European standard model available for the calculation of the target solvency capital. However member states can also develop their own internal models according to certain requirements.

Pillar II: Supervisory Review Process
The supervisors will be responsible for monitoring the amount of the existing capital. The level of international cooperation between the supervisory authorities in each member state, particularly between the supervisory authorities for banks and insurers, needs to be enhanced. The audit process should also be coordinated and standardized according to requirement.

Pillar III: Enhanced Disclosure
The public will have greater access to information about the financial stability of insurers. The European Commission is putting in efforts to ensure that competition resulting from Solvency II will force insurers to comply with quality and security standards.

In the second phase of the Solvency II project these three pillars will be further developed from a healthy exchange of ideas and consensus-building, which in turn would lead to the establishment of the framework directive. In this regard, discussion paper (MARKT/2507/05-EN) has already been circulated on 23rd March 2005 containing the proposed structure of a future Solvency II directive.

It is expected that the conclusion of the European Commission's Solvency II project will result in a positive reform of the solvency regime for insurance companies. The Solvency II project has prompted European insurers in altering risk management strategies, processes and systems. Moreover, Solvency II provides an opportunity to insurers to adopt techniques which could improve the methodology of managing risks.

Box 8.4 : IAIS Insurance Core Principles

Background
The wave of financial globalization has accelerated the development of insurance markets around the world. The development, though encouraging, has also brought about many challenges and risks for the countries involved in insurance business. Specifically, many insurance companies increasingly focus on operations beyond their national boundaries. However, regulatory and supervisory systems were still sheltered within the domestic zone. In order to address this issue, the International Association of Insurance Supervisors (IAIS) was established in 1994. Since its foundation, IAIS has been involved in the development of insurance mandates and fundamental activities that helped in strengthening the regulatory infrastructure of insurance markets. Most importantly, in 2003, IAIS developed the essential regulatory and supervisory framework, the Insurance Core Principles (1CP) and several key principles, standards and notes for guidance. The development of core principles is aimed at enforcing regulatory and supervisory standards around the world in order to face the challenges due to increasingly globalized insurance and financial markets.

Methodology
The insurance core principles, standards and guidelines are set and defined by IAIS. These are also available in detail at www.iaisweb.org. The insurance core principles are evaluated through self-assessment programs where members can gauge their observance of ICP. This practice helps members in identifying strength and weakness in their regulatory and supervisory systems and also provides an opportunity to undertake remedial and preventive measures.

Implementation of IAIS Standards
The IAIS provides guidance and assistance to its members in meeting the Insurance Core Principle Standards. Moreover, IAIS also facilitates the ICP exercise through the Financial Sector Assessment Program (FSAP) conducted by IMF and World Bank. The Security and Exchange Commission of Pakistan joined membership of IAIS in CY03 and is compliant with the principles and standards set forth by IAIS. The level of observance of ICP by the Pakistan insurance industry is presented in **Table 1**.

Table 1: Insurance Core Principles Summary Self-Assessment - Pakistan

Core Principle	Classification	No. of Criteria	Level of Observance [1]				
			O	LO	MNO	NO	NA
Principle 1	Organization of a Supervisory Body	12	7	3			2
Principle 2	Licensing	25	13	6	2		4
Principle 3	Change in Control	5	3	2			
Principle 4	Corporate Governance	16	7	2	3		4
Principle 5	Internal Controls	14	7	3			4
Principle 6	Assets	10	8	1	1		
Principle 7	Liabilities	6	2	1	2	1	
Principle 8	Capital Adequacy and Solvency	11	2	5			4
Principle 9	Derivatives and 'Off-balance sheet' items	9	9				
Principle 10	Reinsurance	5	4				1
Principle 11	Market Conduct	10	7	3			
Principle 12	Financial Reporting	11	9	1			1
Principle 13	On-site Inspection	6	6				
Principle 14	Sanction	13	13				
Principle 15	Cross-border Business Operations	10	5				5
Principle 16	Coordination and Cooperation	11					11
Principle 17	Confidentiality	3					3

[1] O = Observed; LO= Largely Observed; MNO = Materially Non-Observed; NO=Non-Observed; NA =Not Applicable

Source: "Questionnaire 2: IAIS Self Assessment Questionnaire on Implementation of IAIS Insurance Core Principles", IMF-World Bank, Financial Sector Assessment Program of Pakistan, 2004.

Box 8.5: Insurance Financial Soundness Indicators:

Introduction

The growing role of the insurance sector in the financial system cannot be ignored in many developing countries including Pakistan. A stable insurance sector not only mobilizes long term savings but also optimally allocates the various risks. However, the risk profile of insurers' investments (in particular life insurers) is highly exposed to the movements in equity and real estate prices which may potentially lead to the failure of insurance companies. Moreover, the uncertain nature of insurance business also intensifies the risk profile of insurance companies. These possibilities emphasize the need for effective monitoring and surveillance of insurance companies. In this regard, Insurance Financial Soundness Indicators (FSI) developed by IMF are useful quantitative tools for gauging the performance of the insurance sector.

Structure of Indicators[1]

The IMF proposed financial soundness indicators can be classified into two sets of indicators. These include: (1) the core set of essential FSI for regular monitoring of insurance companies; and (2) an encouraged set of indicators for assessing more specific areas of vulnerabilities. Most of the indicators are commonly used for life and non-life insurers in addition to re-insurers. The major highlight of FSI indicators is their usage in peer group analysis because of standardized definitions of indicators. However, FSI indicators are analyzed based on business and product type and the degree of development. For example, the focus of regulators should be on stress testing in case of life insurance business. These indicators are developed within the CARAMELS framework, which includes Capital Adequacy, Asset Quality, Reinsurer Issues, Actuarial Issues, Management Soundness, Earning and Profitability, Liquidity, and Sensitivity to Market Risk. The core set of indicators are presented in **Table 2**.

Table 2: Insurance Financial Soundness Indicator - Core Set

Category	**Indicators Classification**	**Usefulness**	
		Non-Life	**Life**
Capital Adequacy	Net premium/Capital	▲	
	Capital/Total assets	▲	▲
	Capital/Technical reserves		▲
Asset Quality	(Real estate + unquoted equities+ debtors)/ Total assets	▲	▲
	Debtors/ (Gross premium + reinsurance recoveries)	▲	▲
	Equities/Total assets	▲	▲
	Nonperforming loans to total gross loans		▲
Reinsurance and Actuarial Issues	Risk retention ratio (net premiums/ gross premiums)	▲	▲
	Net technical reserves/average of net claims paid in last three years	▲	
	Net technical reserves/average of net premium received in last three years		▲
Management Soundness	Gross premium/number of employees	▲	▲
	Assets per employee (total assets/ number of employees)	▲	▲
Earnings and Profitability	Loss ratio (net claims/net premium)	▲	
	Expense ratio (expenses/net premium)	▲	▲
	Combined ratio = loss ratio + expense ratio	▲	
	Revisions to technical reserves/technical reserves		▲
	Investment income/Net premiums	▲	
	Investment income/Investment assets		▲
	Return on equity (ROE)	▲	▲
Liquidity	Liquidity assets/Current liabilities	▲	▲
Sensitivity to market Risk	Net open foreign exchange position/capital	▲	▲
	Duration of assets and liabilities		▲

[1] Source: Das, Davies, and Podpiera (2003), "Insurance and Issues in Financial Soundness", IMF working paper, WP/03/138.

Contd... Insurance Financial Soundness Indicators:
The encouraged set of indicators is developed to provide additional information on insurers depending on the degree of openness that insurance regulation requires. The encouraged set of indicators is listed as follows:

Table 3: Insurance Financial Soundness Indicator - Encouraged Set

Category	Indicators Classification	Usefulness Non-Life	Usefulness Life
Capital Adequacy	Cover of solvency margin	▲	▲
	Risk-based capital adequacy ratios	▲	▲
Asset Quality	Asset/liability position in financial derivatives to total capital	▲	▲
	Investments; geographical distribution	▲	▲
	Investments; sector distribution	▲	▲
Reinsurance and Actuarial Issues	Underwritten business; geographical distribution	▲	▲
	Underwritten business; sector distribution	▲	▲
	Underwritten business; distribution by main business	▲	▲
Management Soundness	Operating expenses/ gross premium	▲	▲
	Personal expenses/ gross premium	▲	▲
Earnings and Profitability	Earning per employee (Net profit/ number of employees)	▲	▲
	Return on Assets	▲	▲
	Return on Revenue	▲	
Liquidity	Liquid assets/ Total assets	▲	▲
	Liquid Liabilities/ Total liabilities		▲
Market based Indicators	Market/Book value	▲	▲
	Price/Earning ratio	▲	▲
	Price/Gross premium	▲	▲
Group Exposure	Group debtors/total assets	▲	▲
	Group (premium claims)/Total (premium + claims)	▲	▲

Box 8.6: Asset Allocation of Selected Insurance Market

Asset allocation is a critical decision for any life insurance industry. Other than Hong Kong, South Africa and Singapore, almost all the other countries have a strong tendency for investment in fixed income securities (see **Table 4**). A higher percentage of asset allocation for bonds was due to the restrictions imposed by regulators in tapping other alternative investment avenues. Such restrictions in the form of investment guidelines augment the insurance cost because a well-diversified portfolio helps in reducing interest rate and market risk. In certain countries, lack of alternative avenues and the existence of a shallow capital market, prevent life insurance companies to allocate funds in a diversified manner.

Sometimes regulators alter the product design and pricing by dictating a minimum guaranteed return on insurance products. Countries like Thailand, Croatia and Korea artificially keep the guaranteed rate higher than the market. Moreover, competitive pressure in some countries has led to the under-pricing of insurance products to generate a return above the required minimum to gain market share. As a result, life insurance companies are biased towards investments in bonds market.

Notably, a similar trend is observed in Pakistan, where a much larger portion of assets is allocated to government securities. The share of bonds in total assets has reduced slightly in CY04 due to the stock market boom.

Table 4: Asset Allocation of Life Insurers (as of end of 2002 unless otherwise noted)

in percent of total assets

	Cash & Deposits	Equities	Bonds	Foreign Securities	Loans	Real Estate	Other	Total
Asia								
Pakistan	6	8	72	0	6	3	5	100
Pakistan (2004)	9	11	68	0	5	2	5	100
Hong Kong SAR (2001)	7	35	38	0	0	0	20	100
Korea	2	7.5	29.8	6.2	26.5	5.5	22.5	100
Malaysia	29	0	54	0	9	4	4	100
Philippines	12	16	51	0	4	16	1	100
Singapore (overall)	8	3	52	21	10	5	1	100
Singapore (unit-linked)	6	62	30	0	0	0	2	100
Thailand	8	9	64	0	11	3	5	100
Eastern Europe, Middle East, Africa								
Hungary	3	6	91	0	0	0	0	100
Poland	4	12	83	0	0	1	0	100
South Africa	7	49	15	14	0	5	10	100
Latin America								
Argentina	22	9	61	0	1	4	3	100
Brazil	1	6	64	0	6	5	18	100
Chile	3	15	51	2	20	7	2	100
Colombia	3	11	68	7	8	3	0	100
Mexico	2	5	80	0	3	7	3	100
Peru	21	17	43	0	0	0	19	100

Source: Manmohan and Janet 2005, "Insurance Companies in Emerging Markets", IMF Working Paper No. 05/88.