SECTOR UPDATE

Insurance Industry

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Insurance Sector Amid COVID

Insurance, in short, is a contract, represented by a policy, in which an individual or entity receives financial protection or reimbursement against losses from an insurance company. Insurance policies are used to hedge against the risk of financial losses, both big and small, that may result from damage to the insured or property, or from liability for damage or injury caused to a third party.

Insurance in Pakistan

Insurance is the second-largest sector in the financial industry and constitutes approximately 5% of Pakistan's total financial sector assets. According to Insurance Association of Pakistan, the sector's gross premiums/ takaful contributions underwritten by the industry grew by 10.5% (2018: 11.0%) in 2019 and amounted to Rs. 94.6b (2018: Rs. 85.6b). Insurance in Pakistan is broadly classified into three business areas including life, general insurance and health insurance.

The non-life insurance (including general and health policies) penetration in Pakistan, at <0.4%, is one of the lowest penetration percentages in the region; India's insurance penetration is close to 1.0%. The insurance penetration of a country represents the premium volume collected by the companies as a percentage of GDP. However, it also means that there is a tremendous potential to grow especially in personal products like personal motor, personal health, personal accident, home and travel. In developed countries, personal products represent almost 40-45% of total non-life premium whereas in Pakistan it contributes only 10-12% of total non-life premium. According to major non-life insurance products and recent trends of the insurance industry, fire and property, motor, health, marine and aviation have traditionally remained the major products of the general insurance industry. There are many reasons for low insurance penetration of personal insurance in Pakistan but a couple of reasons that are prominent include lack of awareness/availability of such products and limited digitalization. However, with the pandemic outbreak, improvements in technology and expanding communications have also encouraged the industry to become more operationally efficient. The regulator too has demonstrated a forward looking approach and has supported the technology led initiatives to expand the outreach beyond brick and mortar. Historical growth trajectory suggests that current products, processes and distribution channels alone cannot significantly outpace the GDP growth, thus reflecting any meaningful increase in penetration. Therefore, it is inevitable to embrace the digital revolution to reach out to vast underserved population. Digital channels such as the company's own online web store or third-party technology-based solutions are the distribution channels of future to effectively and efficiently serve the future consumer as well as underserved segments of the population.

A primary reason for lower penetration and density levels of insurance in Pakistan is also related to the unIslamic image associated with the products. In order to address this religious matter, a number of conventional insurers in Pakistan launched window operations for providing Islamic insurance coverage.

Moreover, insurance coverage in Pakistan is only bought when it is either mandatory by law or when it is a requirement by a specific lending institution. This is in vast contrast to other players on the global map who buy insurance as a necessity of life. Lower literacy rate has also contributed to negligible penetration levels in the region over the years as population based in rural areas still lack awareness of insurance products. Given the ongoing regulatory initiatives related to Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), several modifications have also been made to the insurance related regulatory framework including directives related to financial security and transparency, code of good governance and sound market practice.

The Pakistani insurance market has undergone major structural changes in last few years in line with the increased statutory requirement of minimum paid up capital. According to regulations issued in 2017, the regulator specified a minimum paid-up capital requirement of Rs. 500m for non-life insurers. Moreover, further changes in regulations also entail development of a risk management framework and maintenance of a risk based capital for insurance market players. General insurance market players will also need to abide by the new IFRS accounting standards which relate to booking losses related to all policies having a maturity of more than one year. As a result, there may be a greater impact on the company's underwriting liabilities with this standard. Going forward, there are plans to implement IFRS 17 across the industry, which will require additional provisioning. However, the industry-wide IFRS 17 implementation is scheduled for January 1' 2022 and there is no estimation of the related provisioning charge.

While all companies comply with the minimum paid up capital requirement issued by the regulator, a number of companies are still struggling with their leverage indicators where they have underwritten higher business on their net account in comparison to their equity base; this may impose a threat to such companies where they have lower levels of risk absorption capacities. Industry capitalization & liquidity are expected to persist at similar level, as no sizeable losses are expected in the coming year. Along with these metrics, a key factor in these challenging times is also the sponsor support that the companies receive. Given that some insurance companies have foreign backing or support from a commercial bank, such companies are expected to better tackle the challenge of business contraction and competition.

Repercussions of Coronavirus

The novel coronavirus outbreak, which started in December 2019, has developed into a world-wide pandemic, with the World Health Organization (WHO) officially recognizing the same as a pandemic in March 2020. Global economic activity was affected in Q1'20, albeit Q2'20 saw a complete lockdown across the globe with more than half the world's population effectively being asked to adhere to social distancing protocols. Pakistan's economy, which had been undergoing an adjustment phase, subsequent to experiencing an external account crisis in FY18, has been significantly impacted, as reflected from the GDP contraction in FY20 (GoP projects GDP to contract by 0.38%), which, although an anomaly in context of the long-term trend, is in line with the contraction in the global GDP. While there is a lot of negativity surrounding the novel coronavirus, it has had one influential impact on the insurance industry; more and more people are now becoming aware of the importance of having insurance especially health and life insurance. The insurance industry is set to recover faster than the wider economy in the wake of the global pandemic, despite the fact that the two generally move in parallel over the long term.

The COVID-19 pandemic and the measures taken to limit the spread of the disease have significantly disrupted economic activity in countries around the world, resulting in significant business interruption losses. The vast majority of these losses are likely to be absorbed by policyholders as, unless governments intervene, few companies have business interruption coverage that is likely to respond to these types of losses–exposing the existence of an important protection gap for some pandemic-related business interruption losses.

A few other business segments may also be impacted as a result of outbreak of novel coronavirus such as:

- The pandemic-related project delays are expected to impact premiums under fire & engineering segment, albeit this largely depends on the actual project delays.
- Given that non-life insurance is predominantly asset based, including long term assets like plant and machinery and short term assets like stocks and inventories, a slowdown in GDP growth may have its impact on the industry in terms of value of new policies business going forward.
- The reduced international trade will affect premiums in the marine line of business.
- As a result of the coronavirus public lock down in Q2'2020, the automobile sales have been notably impacted. Nonetheless, this indicator has started picking up in Q3'2020; reduced overall automobile sales may reduce motor premiums.
- The claims ratio for the health segment is expected to increase, albeit certain insurers that have specific reinsurance coverage in place for 'pandemic' will be able to avoid the same from reflecting on the net claims ratio.
- Ability to maintain performance metrics will remain a challenge given the prevalent competition faced by the industry players. Going forward, maintaining these profitability metrics will also be challenge on account of a lower interest rate prevailing. Given the sizable reduction in interest rates, the investment income, specifically for companies holding fixed rate PIBs, are expected to increase on account of capital gains on PIBs. This should have a positive impact on the net operating ratio.

- Amidst double digit inflation (Dec 2019: 12.6%), the underwriting expense ratio of the industry also increased, while a slight uptick was also noted in net claims ratio. While reduced economic activity is likely to have a positive impact on claims ratio, expenses are likely to remain sticky, which should resultantly increase underwriting expense ratio. Subsequently, the industry's combined ratio is likely to remain range bound. Results of this pandemic will be realized once the financial numbers for June 2020 are announced for the industry.

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