



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN INSURANCE DIVISION

[Karachi]

Before Mr. Shahid Nasim, Executive Director (Insurance)

In the matter of

M/s EFU General Insurance Limited

Date of Show-Cause Notice: July 24, 2012

Date of Hearing: September 12, 2012

Attended by: Mr. Altaf Qamruddin Gokal
Chief Financial Officer & Company Secretary

Date of Order: September 28, 2012

ORDER

(Under Section 12 Read with Section 11(1)(f) and Section 156 of
The Insurance Ordinance, 2000)

This Order shall dispose of the proceedings initiated against M/s EFU General Insurance Limited (hereinafter referred to as ("the Company")) for making a default in complying with the requirements of Section 12 and Section 11(1)(f) of the Insurance Ordinance, 2000 ("the Ordinance").

Background Facts

The relevant facts for the disposal of this case are briefly stated as under:

1. Section 11(1)(f) of the Ordinance, states that:

"An insurer registered under this Ordinance shall at all times ensure that:

*...
(f) the insurer meets, and is likely to continue to meet, criteria for sound and prudent management including without limitation those set out in section 12;"*

2. The provisions of Section 12(1) of the Ordinance state that:

"Criteria for sound and prudent management.- (1) For the purposes of this Ordinance, the following shall, without limitation, be recognised as



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criteria for sound and prudent management of an insurer or applicant for registration as a person authorised to carry on insurance business:

(a) the business of the insurer or applicant is carried on with integrity, due care and the professional skills appropriate to the nature and scale of its activities;

...
(e) the insurer or applicant maintains adequate systems of control of its business and records."

3. The provisions of Section 12(2) to Section 12(5) of the Ordinance state that:

"(2) Accounting and other records shall not be regarded as adequate for the purposes of clause (d) of sub-section (1) unless they are such as:

(a) to enable the business of the insurer or applicant to be prudently managed;
and

(b) to enable the insurer or applicant to comply with the obligations imposed on it by or under this Ordinance.

(3) In determining whether any systems of control are adequate for the purposes of clause (e) of sub-section (1), the Commission shall have regard to the functions and responsibilities for those systems which are held by the persons who are responsible for the direction and management of the insurer or applicant and to whom clause (b) of subsection (1) applies.

(4) The insurer or applicant shall not be regarded as conducting its business in a sound and prudent manner if it fails to conduct its business with due regard to the interests of policy holders and potential policy holders.

(5) The insurer or applicant shall not be regarded as conducting its business in a sound and prudent manner if it:

(a) fails to satisfy an obligation to which it is subject by virtue of this Ordinance; or

(b) fails to supervise the activities of a subsidiary with due care and diligence and without detriment to the insurer's or applicant's business."

4. An onsite inspection of the Company was conducted under the Order of the Executive Director of the Insurance Division dated July 5, 2011, in exercise of the powers conferred under Section 59A of the Ordinance.

5. During the course of the said Onsite Inspection, it was noted that the Company neither has an investment policy nor is there any investment committee or department to make investment decision.



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Investment decisions are made by the Chief Financial Officer in consultation with the Chief Executive Officer. Further the inspection team was not provided with any research report or rationale on the basis of which investment decisions were made. This arrangement of investment decision making has resulted into loss on investment amounting to Rs. 357.955 million (including an impairment loss of Rs. 577.86 million) during the financial year ended December 31, 2010.

6. The inspection team also observed that on December 14, 2007, the Company sold 20,162,580 shares of EFU Life Assurance Limited in off market for an amount of Rs.10,578,639,675 to different parties (collectively referred to as counter parties) at the average price of Rs. 524.67 per share (net of brokerage).

The carrying cost of these shares at the time of disposal was Rs.181,866,472/- (Rs. 9.02 per share). On this transaction, the Company recorded a capital gain of Rs. 10,396,773,203/- in the financial statements for the period ended December 31, 2007. However, these shares were repurchased from the same parties on December 17, 2007 through off market for an amount of Rs. 10,600,437,436/- at an average price of Rs. 525.75 per share, translating into loss of Rs.21,797,761 on repurchase over sales.

The sale and repurchase transactions have been contemplated on the negotiated prices with the counter parties with sale price of Rs. 524.67 and repurchase price Rs.525.75, which in turn implies that Company had to incur the loss under the arrangement of sale over repurchase. In fact, the objective of the entire transaction was to translate the positive difference of current fair value and carrying cost of EFU Life's shares in the form of capital gain in the financial statements for the period ended December 31, 2007.

The subject transactions do not amount to sale and repurchase in substance, warranting any advantage or disadvantage of change in the price of these shares.

These shares should have been sold and repurchased at the same prices, keeping in view the objective and substance of the transaction at the cost of normal brokerage or nominal charges. The Company has incurred a loss of Rs. 21,797,761/- being the difference of repurchase over sales on total shares (loss of Rs. 1.08 per share), which reflects the actual cash outflow of the Company. In other words, the counter parties have earned the capital gain of Rs.21,797,761/- under the arrangement at the cost of stakeholders of the company.

In view of the above, it appeared that the above transaction has not been carried out with due care and professional skills, which gave a gain of Rs. 21.8 million to the counter parties at the cost of the Company.

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7. The inspection team observed that no policies and operational manual exist in the Company, and in this regard, the management is of the view that they have placed controls by building up controls in computer system. However, the inspection team is of the view that these built-in computer controls do not necessarily replace the requirement to have proper policies and manuals in order to strengthen the overall control environment of the Company, as policies and manual are sufficiently detailed in nature providing guidelines for business processes of a company, which are approved by the Board of Directors.

Further, the Company also appeared to have violated the provisions of the Code of Corporate Governance, which requires that the Board of Directors shall formulate significant policies and establish system of sound of internal control that are implemented effectively at all levels of the Company.

8. Additionally, it was noted that the Audit Committee has not paid proper attention towards the internal control system of the Company. The Company is operating without formally written down policies and manuals. Accordingly, the internal auditor has been unable to identify deviation from the standard policies and manuals.

The review of Internal Audit Report reveals that instead of submitting its report to the Audit Committee, the Internal Audit Function addresses its reports to the Managing Director (with a copy to Joint MD, Senior Deputy MD, Senior Executive Director, CFO and Company Secretary). In view of this, it appears that the reporting line of internal auditor to the executive management is bound to hamper the independence of the internal auditor which is also not in line with the international best practices.

9. In view of the abovementioned observations made by the Inspection Team, it, *prima facie*, appeared that the internal controls system of the Company are very weak particularly due to the absence of major policies, procedures and manuals that are vital for carrying out the operations of the Company.

This indicated that the business of the Company is not being carried out with due care and professional skills, as required by the abovementioned relevant provisions of Section 11 and Section 12.

Show-Cause Notice

10. On July 24, 2012, a Show-Cause Notice under Section 12 read with Section 11(1)(f) and Section 156 of the Ordinance was served to the Company, its Directors and Chief Executive, whereby they were asked to clarify their

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position as to why the penalty under Section 156 of the Ordinance may not be imposed on them for various negligence on part of the management of the Company in respect of inadequate internal control system of the Company and carrying out the business without due care and diligence, thereby contravening the provisions of Section 12 and Section 11(1)(f) of the Ordinance.

Company's Reply

11. The Company, in response to the Show-Cause Notice vide its letter of August 6, 2012, argued as under:

"We have a sound system of Internal controls backed by strong team of internal audit.

Investment decisions are taken mostly with long term view. It is our policy to invest in equities (including investment in related and associated companies). On the basis of the policy, the Chief Financial Officer in consultation with the CEO makes day to day investment decisions. Further with effect from 26 March 2011 a formal policy statement for investment was approved by the Board of Directors in their meeting on 26 March 2011, through which an investment committee was formed. Meetings of the investment committee are held quarterly and the proceedings of the meetings are minuted.

Regarding the issue that the research report to the rationale for making investments was not provided to the Inspection Team, we submit that we have a dedicated department which collects research documents from various sources which are used for making investment decisions. The stock market is highly volatile and moves upwards / downwards depending on the news on various political and economical factors. The return on investments is dependent on the performance of the stock market. All business decisions have element of gains / loss and the losses are not seen in isolation.

Please note that our Balance Sheet footing has increased from Rs. 7,286 million in 2005 to Rs. 24,378 million in 2011 (increase of 235 %) and Written Premium has increased from Rs. 6,644 million to Rs. 12,043 million (increase of 81 %) in the same period. These facts indicate that our Company on an overall basis has shown tremendous growth.

EFUG realized capital gains of Rs. 14,188 million in 2007 by selling various equity investments including shares of related parties where market prices were significantly higher than their holding costs. The objective of this exercise was to take advantage of tax exemption available on sale of shares originally scheduled to expire on 31 December 2007.

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Our total holding of EFU Life Assurance Ltd (EFUL) was sold and repurchased. The difference in these prices was due to brokerage charges and price differential (financing cost). The transaction size was Rs. 10,576 million and the transaction cost was Rs. 21 million i.e. 0.2% of the transaction size, which is normal. This cost included brokerage charges, counterparty brokerage charges and financing charges which amounted to Rs. 1.07 per share against market rate of Rs. 524.55 per share. These transactions were done consequent to the approval of shareholders at Extra Ordinary General Meeting held on December 14, 2007.

We have a strong system of internal controls which has been built in our computer operating systems. These controls are present in our system and are effectively working. Additionally we have a strong and experienced internal audit team headed by a chartered accountant and other officers having professional qualification such as MBA, CMA and CIA.

In the modern day and age there is more reliance on electronic aids and accordingly it is our view to concentrate on this aspect more and more. The company through the services of Ferguson Associates (Pvt) Limited carried out a business process documentation exercise which contain flow charting of policy and procedures of all the activities of Head Office and branches which include

- Property under writing (related to Branches)
 - Property new business
 - Renewals of property policies
 - Property policy endorsement
 - Premium recovery and out standing
- Complete policy processing (Property Department at Head Office)
- Facultative arrangements
- Risk management
- Monitoring of outstanding premiums
- Payment of claims
- Payroll processing
- Investments
- Management of moveable assets
- Corporate affairs, compliance and corporate governance
- Budget preparation and performance monitoring
- Cash and bank management

This process helped us in segregation of duties between our staff to minimize the risk and identify the critical stages of operation.

In addition to flow charts of policy and procedures we have placed controls in our operating computer system for better governance and effective implementation of the controls. Various MIS reports are also generated through our IT Systems.

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Further all our transactions at branches which include vouchers, underwriting records, claims payments etc are available for review at all respective departments of head office on the next working day through our IT System.

All financial transactions at branches are controlled through our authority matrix and the branch managers and underwriters have approval limits according to the volume of the branch and designation of the executives.

As regards Code of Corporate Governance of Pakistan (the Code) we would like to clarify that clause (viii) (c) of the Code requires the directors of the listed companies to establish and implement a sound system of internal controls at all levels of the Company which our directors have adequately implemented. Each operation of our Company is controlled with sound system of internal controls and documented. Therefore there is no violation of the Code.

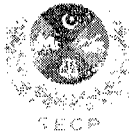
However, realizing the importance of documentation of policy and procedures we have started documenting the policies and procedures of the company. In the meeting held on 10 March 2012 our board approved the policies and procedures of Budgetary Controls and Capitalization of Fixed Assets. Going forward our management has decided to document all policies and procedure and prepare a complete policy and procedure manual of the company.

Regarding the reporting of the internal audit department, please note that our internal audit department is reporting to the Audit Committee as required under the code of corporate governance. However to ensure immediate corrective measures on the observations of the internal audit the reports are sent to Chief Executive and the related departments for information and necessary immediate remedial action from time to time. Material / significant matters are raised by the internal auditor at Audit Committee meetings which are held quarterly." (Underlined to put emphasis)

12. The reply of the Company revealed that the Chief Financial Officer in consultation with the CEO makes day to day investment decisions. A formal investment policy was approved by the Board on 26 March 2011, when the investment committee was formed. Prior to this, there was no formal policy of the Company for making investments.

13. However, the Company's management has decided to document all policies and procedure and prepare a complete policy and procedure manual of the Company, hence, it has started documenting the policies and procedures of the Company.

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14. The Company's reply also shows that the Company's internal audit department has been presenting the internal audit reports to the Chief Executive Officer and the related departments for quick remedial action(s), which may hamper the independence of the internal audit function of the Company, however, as per the Company's reply, the internal audit department reports directly to the Audit Committee.

15. The hearing in the matter was scheduled for September 12, 2012 at 03:00 p.m., which was communicated to the Company vide Commission's letter dated August 27, 2012.

Proceedings of the Hearing

16. At the commencement of the hearing (which was held on September 12, 2012), the Company's representatives presented a "General Power of Attorney" duly authorizing Mr. Altaf Qamruddin Gokal, the Chief Financial Officer & Company Secretary of the Company to be the true and lawful attorney of the Company in the name.

17. The Company vide their letter of September 10, 2012 authorized Mr. Altaf Qamruddin Gokal, Chief Financial Officer & Company Secretary of the Company to appear in person in the hearing in the matter before the Executive Director (Insurance).

18. Following arguments were made by the Company's representatives during the course of the hearing:

- a. The Company's representatives stated that the Company's growth in their premium over the past few years shows / guarantees that the management of the Company is sound, and that they are working in the principles that guarantee the growth of the Company.
- b. He further mentioned that each and every item / asset of the Company is being purchased with the approval of the Managing Director of the Company, and that there exist proper policies for purchasing every item. Similarly, investments are made after proper approval. With this, the Company's representative presented a copy of the Notice of the Extra Ordinary General Meeting, which was held on December 14, 2007, to accord approval from the shareholders of the Company for selling off 20,162,580 shares of M/s EFU Life Assurance Limited and repurchasing them, both on the prevailing market rates to realize capital gains and present these shares at the fair value on the face of the Balance Sheet of the Company.

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- c. The Company's representative further mentioned that the Company deals with some dedicated brokerage houses and the Company calls research reports from these brokerage houses, which are accounted for before making any investment.
- d. The Company's representative admitted that they did not have the investment committee, previously (i.e. till 2010). The investment decision making was centralized and was restricted to a single person.
- e. The Company's representative further mentioned that the horizon of the Company's investment policy portrays an idea of long term investment making.
- f. He also mentioned that in December 2007, exemption on capital gain was about to expire, so the Company preferred to sell off its shares in related parties on the prevailing market rates for which the broker charged them heavily for arranging buyers of this huge amount of shares. Then, subsequently after 2 or 3 days, the Company released an amount of Rs.10 billion to the brokerage house for making purchases of the shares.
- g. The Company's representative claimed that they have the best possible IT infrastructure and systems installed at their premises. The Company has acquired the IT systems 15 years ago, when there was no concept of computerized banking in Pakistan.
- h. He further mentioned that the Company had engaged M/s Fergusons to formulate operational processes' flowcharts, and, the Company had the flowcharts of each operation at the time of inspection.
- i. The Company's representative also mentioned and admitted that for the purpose of saving time and early action thereupon, the internal audit reports were presented to the Managing Director directly, however, the performance appraisals of the Chief Internal Auditor is done and finalized by the Audit Committee.

Consideration of the Submission

19. Before proceeding further, I find it relevant to discuss the duties of the Directors. The Directors, in addition to the day to day running of the company and the management of its business, also have some 'fiduciary' duties i.e. duties held in trust and some wider duties imposed by statute and breach of these statutory duties will usually be a criminal offence, punishable

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by fine or imprisonment. Hence the Directors are gauged against a higher standard of accountability which requires them to be vigilant and perform their duties with due care. In the instant case, however, the Directors have failed to perform their duties with due care and prudence. As the Directors are supposed to be well aware of their legal obligations in connection with the aforesaid statutory requirement of the Section 12 read with Section 11(1)(f) of the Ordinance i.e. the Directors of the Company were required to put in-place formal policies and procedures covering all the operational aspects and decision making, especially in the case of making investments, which was not done till March 2011, therefore, it could be legitimately inferred that the default was committed.

Conclusion

20. After carefully examining the arguments and studying the facts and findings of the case as mentioned in the above paras of this Order, the default of Section 12 read with Section 11(1)(f) of the Ordinance is established, and to a greater extent, the Company has also accepted its default. Therefore, the penalty as provided under Section 156 of the Ordinance can be imposed on the Company, which states that:

"Penalty for default in complying with, or acting in contravention of this Ordinance.- Except as otherwise provided in this Ordinance, any insurer who makes default in complying with or acts in contravention of any requirement of this Ordinance, and, where the insurer is a company, any director, or other officer of the company, who is knowingly a party to the default, shall be punishable with fine which may extend to one million rupees and, in the case of a continuing default, with an additional fine which may extend to ten thousand rupees for every day during which the default continues."

Order

21. In exercise of the power conferred on me under Section 156 of the Ordinance, instead of imposing the maximum penalty, take a lenient view, and thus, condone the Company due to the following reasons:

- a. The Company's management including its Directors have taken cognizance of the fact that they did not have proper policies and procedures, and they have initiated, and to some extent finalized, the formulation of policies and procedures;
- b. The Company has, on the net, gained from the transactions in the shares of M/s EFU Life Assurance Limited, and the loss on the

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repurchasing of the shares has not affected the Company's solvency position;

- c. The intention of sharing of the internal audit reports with the Chief Executive Officer and the relevant departments was to address the anomalies and shortcomings on immediate basis, and that the internal audit function reports to the Audit Committee; and
- d. The Company has in-built checks and controls in its IT systems, which may be revised on ongoing basis and especially upon the finalization of the policies and procedures.

Also, the Company is hereby issued a stern warning that in case of similar non-compliance in future a stronger action against the Company will be taken.

22. This Order is issued without prejudice to any other action that the Commission may initiate against the Company in accordance with the law on matters subsequently investigated or otherwise brought to the knowledge of the Commission.

Shahid Nasim
Executive Director