



SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN INSURANCE DIVISION

[Karachi]

Before Ms. Nasreen Rashid, Executive Director (Insurance)

In the matter of

M/s East West Insurance Company Limited

Date of Show-Cause Notice: November 15, 2010
Date of Hearing: January 17, 2011
Attended by: (1) Mr. Naved K. Yunus, Managing Director & Chief Executive
(2) Mr. Kazim Raza, Director (Operations)
Date of Order: January 20, 2011

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 East West Insurance Company 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 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



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. An onsite inspection of the Company was conducted under the Order of the Executive Director of the Insurance Division dated June 23, 2010, in exercise of the powers conferred under Section 59A(1) of the Ordinance.

4. During the course of the said Onsite Inspection, it was noted that there is no policy, manual (except accounting manual) and/or standard operating procedures in the Company to provide guidelines and framework for carrying out the operations of the Company with efficiency and effectiveness. The Company has not adopted a proper system of internal control which can prevent or detect and correct the error on timely basis. The software application/modules being used by the Company are obsolete and lack proper built-in controls. The scope given to the internal audit is very limited and does not cover the areas relating to the control issues. The weakness in internal control system as noted in the inspection report has resulted in various irregularities and discrepancies, including but not limited to, the following:

"a) During the review of Reinsurance Facultative Register some instances have been noted by the inspection team where sum insured was in excess of treaty capacity. However, the excess amount was not reinsured adequately and hence retained by the Company.

b) The Company has paid Federal Excise Duty (FED) to Federal Board of Revenue (FBR) short by an amount of Rs.3.8 million for the year ended December 31, 2009. An amount of Rs.26.606 million has been paid/adjusted against total liabilities of Rs.30.501 million which was received from policyholders in full. Further, the Company has not recorded any liability in this regard in financial statements for the year ended December 31, 2009. Accordingly, the loss before tax for the said year has been understated by Rs.3.8 million.

c) As on December 31, 2008, EWCL carried an investment in 2.6 million shares of Jahangir Siddiqui & Company Limited (JSCL) amounting to Rs.607.95 million (cost). The total assets stood at Rs.1,273.324 million on that date. It is also notable JSCL is an associate company by virtue of common directorship held by Mr. Mian Mahboob Ahmad. It is beyond understanding of the inspection team that 47.75% of total assets were invested in single scrip



on December 31, 2008 without any prudent commercial logic. This concentration of investment was not considered at the time of approval and even subsequently, by the Board of Directors, Audit Committee and Internal Auditors. It is also pertinent to mention that on December 31, 2009, the Company has provided a provision of impairment in the value of investment amounting to Rs.554.93 million on account of this investment. In nutshell, the entire transaction has been carried out without due care and professional skills and to the detriment of shareholders of EWICL."

Show-Cause Notice

5. On November 15, 2010, a Show-Cause Notice under Section 12 read with Section 11(1)(f) and Section 156 of the Ordinance was served to the Directors and Chief Executive of the Company, whereby the Company was asked to clarify their 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 the loose internal control system of the Company, thereby making contraventions of the provisions of Section 12 and Section 11(1)(f) of the Ordinance.

Company's Reply

6. The Company, in response to the Show-Cause Notice vide its letter of December 3, 2010, argued as under:

"At the outset, it is submitted that we understand the importance and values of policies and manuals in running the affairs of the Company. Therefore, we already have proper accounting manual duly approved by the Board of Directors. Further we have already prepared a draft manual for underwriting which will be placed before next Board meeting for approval. This manual can be shown to inspection team at their request. Moreover, we are in process of preparation of other policies/manuals for standard operating procedures in the Company to cover the functional areas of claims, re-insurance, internal audit and risk management etc. We hope that these will be prepared soon after consideration of the Board of Directors. Further, in order to strengthen and develop our software system, we have engaged a vendor for preparation of modules with the programming language of Visual Basic. The vendor is expected to complete assignment by June, 2011. We assure you that our Board of Directors as well as management is committed to improve the overall control environment and procedures as all level.

Below is point-wise clarification for the discrepancies mentioned in the subject show cause:-

a) As already mentioned vide our reply to the observations that our re-insurance program has limitation with regard to control over processing of data, and therefore, minor errors likely to be encountered. The excess amount



which us bit re-insured is extremely small i.e. less than 5% of total quantum in respect of facultative placement. Nonetheless you would appreciate that in all these cases the risks were facultatively placed which proves bonafide of our intensions.

Further large projects can also be re-insured on PML basis, i.e. probable maximum loss in which risks are re-insured on the maximum loss value rather than sum insured. Hence, we would have retained excess amount to our retention on the recommendations of surveyors/inspectors.

Simultaneously, it may also be mentioned that reinsurance arrangements as per Section 41(1) of the Insurance Ordinance 2000, is the prerogative of the Directors/management of the insurance company and they are the best judge to maintain suitable reinsurance protection for the company to maintain its solvency.

b) The software we are running to calculate the excisable premium upon feeding the premium register and we deposit the FED in accordance with that calculation. The deficit of Rs.3.8 million is due to the system error. Moreover, we have already provided the same in the half yearly account ending 30th June, 2010.

c) In regard to investment in 2.6 million shares of Jahangir Siddiqui and Company Limited (JSCL) we would like to submit that the capital gains booked in our investment portfolio for the year 2007 and 2008 were Rs.330.01 million and Rs.255.15 million respectively thus totaling gain of Rs.585.16 million. The major scrip involved in the said portfolio was JSCL. The provision of impairment provided in the value of investment in the year 2009 was Rs.554.93 million which is still less than the previous gains in this portfolio. This impairment in investment was a result of the crash of stock market in the year 2008, which was an unforeseen and beyond anyone's control event swamping the total economic activity of the country. However, in order to safeguard the interest of the company, the sponsor Directors decided to offload the entire scrip of JSCL on 22-06-2010 and purchased the same by themselves @ Rs.30.00 per share despite closing rate of Rs.13.05 per share on that day. Hence, the Directors have taken the burden of loss of Rs.35.20 million by themselves. Copies of the said transaction are enclosed for your kind perusal.

In the light of the above submissions/clarifications you would observe that the discrepancies mentioned in the show cause notice are neither material nor intentional and resulted mainly due to system errors and extra ordinary conditions of the stock market beyond our control. However, for adequate control measures as stated above, we are in process of implementation of effective system of control to avoid such unintentional future mistakes. After implementation of the above said manuals for standard operating procedures and modules for our systems we will be in a position to meet the requirement of section 11 and 12 relating to internal control system of the company. We



would also like to submit that keeping in view that the discrepancies mentioned are not knowingly/willful therefore, they do not attract penal action under section 156 of the ordinance. We request you to decide our matter on the basis of these written submission and we further request you to kindly take the lenient view of the above discrepancies and drop further proceedings if any, under the subject reply show cause notice."

7. The reply of the Company revealed that the Company is now in the process of drafting the manuals for various functional areas, which were previously with out any proper controls.

8. Additionally, the Company has admitted that the Company's reinsurance program has certain limitations with regards to the control over the processing of data due to the use of an obsolete system, which is built on FoxPro.

9. Furthermore, the software application that the Company was using to calculate the excisable premium upon feeding the premium register was erroneous, and accordingly, the payment of FED was made in accordance with that calculation. Therefore, the deficit of Rs.3.8 million was due to the system error, which was rectified later and full payment was made to the Government treasury.

10. Further, it can also be deduced that the Company's Director and its management carried out the huge amount of investment in Jahangir Siddiqui & Company Limited (JSCL), which is also an associated company, without due care, professional skills and proper portfolio management exercise.

11. Although, the Company had mentioned in their reply to the Show-Cause Notice that they would like the Commission to decide their case on the basis of their written submission, but in order give another opportunity to the Company to clarify their position, the Company was asked to appear for the hearing in the matter on December 28, 2010, which was propagated via Commission's letter dated December 10, 2010. However, the Company vide their letter of December 13, 2010 requested to reschedule the hearing after January 15, 2011.

12. Therefore, the hearing in the matter was rescheduled for January 17, 2011 at 11:00 a.m., which was communicated to the Company vide Commission's letter dated December 20, 2010

Proceedings of the Hearing

13. At the commencement of the hearing (which was held on January 17, 2011), the Company's representatives presented a "General Power of Attorney" duly authorizing Mr. Naved K. Yunus to be the true and lawful attorney of the Company in the name.



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

- a. The Company's representatives admitted that the software system was erroneous, which was not capable of generating appropriate indications of whether a particular policy has to be placed in facultative arrangement or not. This was also due to rounding off errors committed by this system, and this was reflected only in 5 percent of the cases.
- b. Regarding the investments in Jahangir Siddiqui & Company Limited (JSCL), the Company's representatives argued that the Company had never incurred losses on these investments, on an aggregate basis. Additionally, the impairment losses booked due to the crash of the stock market during the year 2008 were far lesser than the overall capital gains on these investments.
- c. The Directors bore losses to their account by purchasing the shares of JSCL at Rs.30 per share when the actual share price was standing at Rs.13 per share.
- d. Although the provisioning for Federal Excise Duty was made, the audit team of the Excise Department did not visit the Company, hence the amount could not be reconciled.
- e. Additionally, the Internal Audit Department of the Company had already pointed out that there was a shortfall in the payment of FED due to the system error, prior to the onsite inspection, and the payment was made subsequently.
- f. Finally, the Company's representatives indicated that the Underwriting manual and the manuals/procedures of other functional areas of the Company are now ready and the Company is now in the process of updating their software application.

Consideration of the Submission

15. 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 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, therefore, it could be legitimately inferred that the default was committed knowingly and willfully.

Conclusion

16. 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 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

17. In exercise of the power conferred on me under Section 156 of the Ordinance, instead of imposing the maximum penalty, I impose a nominal fine of Rs. 50,000/- (Rupees Fifty Thousand Only) due to the fact that:

- a. The investment losses were borne by the Directors to safeguard the interests of the stakeholders of the Company;
- b. The Company's management has taken a proactive approach to rectify the shortfall in the payment of Federal Excise Duty (FED); and
- c. The Company has assured that the rectification of the errors in the system is in the process.

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.

18. *M/s. East West Insurance Company Limited* are hereby directed to deposit the aforesaid fine of Rs. 50,000/- (Rupees Fifty Thousand Only) in the designated bank account maintained in the name of Securities and Exchange



the receipt of this Order and furnish receipted vouchers issued in the name of Commission for information and record.

Nasreen Rashid
Executive Director