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Insurance

Insurance
Peru
Full Rating Report

Pacifico Peruano-Suiza Compañia de Seguros y Reaseguros

Ratings

Security Class	Current Rating
Local Currency	
Insurer Financial Strength	BBB–
Sovereign Risk	
Foreign Long-Term IDR	BBB–
Local Long-Term IDR	BBB

Rating Outlook

Sovereign Local Long-Term IDR	Positive
Insurer Financial Strength	Stable

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Related Research

Applicable Criteria
- *Insurance Rating Methodology, Dec. 29, 2009*

Other Research
- *Latin America Insurance Review & Outlook 2010: Good Growth Prospects but Challenges Ahead, May, 18 2010*

Rating Rationale

- Pacifico Peruano-Suiza Compañia de Seguros y Reaseguros' (PPS) ratings reflect its adequate retention levels, solid market share, franchise in Peru, and association with the largest and most dominant financial conglomerate in the country. Despite its recent improvement, PPS' combined ratio, overall profitability, and leverage metrics will require a period of consolidation and a more stable trend over time before those gains can be considered as part of a sustainable trend in the long term.
- After two years of poor earnings (2007 and 2008) undermined by a significant increase in its claim ratio and a sharp deterioration of its combined ratio, PPS has managed to revert its results and post adequate profitability in 2009. These results were based on a dramatic improvement of PPS' combined ratio (98% in 2009 vs. 126% in 2007), an increase in the profits of its subsidiaries (the largest life insurance company in the country and a health care administrator), and the reversion of some conservative investment provisions made during 2008. Positive growth prospects in the Peruvian insurance market and the overhauled underwriting policies of the company suggest that these results should hold or improve during the year. Despite the former, high market rivalry and the need to consolidate the restructuring process will require a conservative business plan in order to sustain these results. Lower operating costs are still the key to preserving PPS' improved combined ratio.
- Lower dividends, a capital injection of around USD18 million, and improved profitability allowed the company to end the deterioration of its liabilities-to-equity ratio (1.4x in 2009 vs. 2.2x in 2008). Nevertheless, the burden of PPS' investments in subsidiaries still undermines the quality and flexibility of its capital base given that the capital invested on these subsidiaries must follow the local regulatory guidelines imposed by its regulators. These investments represented 42% of total equity and were 50% of net income during 2009.

Key Rating Drivers

- The Rating Outlook is Stable. PPS' ratings should benefit from the stability of its profitability ratios and the preservation of its current capital levels.

Profile

PPS' shareholder structure is composed of Credicorp S.A. (75%), a local financial conglomerate that owns, among other investments, the largest commercial bank in Peru, Banco de Crédito del Peru (BCP). Another 20% is controlled by ALICO, which is now a subsidiary of Met Life. The remaining 4% of PPS' shares are held by approximately 190 minority shareholders. The current shareholder structure could be affected by the recent acquisition announcement of ALICO by MetLife, although it is too early to judge the final outcome of this financial transaction. PPS is the second largest insurance company in a very concentrated market. On a consolidated basis, the company managed 28% of total collected premiums as of December 2009.

- The second largest insurance company (consolidated basis) in Peru and a member of the largest financial conglomerate.
- Several changes in its business plan and underwriting policies have occurred since 2005.
- Possible changes in its shareholder structure should not affect the performance and financial strength of the company.

Profile

PPS is the result of a 1992 merger involving El Pacifico Compañia de Seguros y Reaseguros (founded in 1943) and Peruano Suiza Compañía de Seguros y Reaseguros (founded in 1948). After some changes in regulation and the spinoff of its life business in 1997, PPS provided diversified insurance protection in nonlife branches, while the life business was provided by one of its subsidiaries, El Pacifico Vida Compañía de Seguros y Reaseguros (Pacifico Vida, 61.99% owned by PPS and the remainder is owned by ALICO). At year-end 2009, Pacifico Vida registered gross earned premiums of about USD190 million and equity of USD118 million, making it the largest life insurance company in the country.

The company has also operated a health services company since 1999. As such, El Pacifico S.A. Entidad Prestadora de Salud (Pacifico EPS, 99.9% owned by PPS) offers health protection services and complementary workers' compensation protection. At year-end 2009, Pacifico EPS managed premium income of about USD125 million. Also, the company owns a health care company. PPS provides financial information on a consolidated basis, and it presents its investments using the equity participation accounting rule according to local guidelines. Given the shareholder structure and nature of the life and health business, our financial review is mostly driven by the unconsolidated results of the company, while consolidated figures are considered secondary information.

At year-end 2009, total consolidated earned premium (including the property and casualty [P&C], life, and health businesses) reached approximately USD609 million with a total consolidated equity of USD186 million, making PPS the second largest insurance group in Peru with a 20% market share in terms of earned premium.

PPS' shareholder structure is composed of Credicorp S.A. (75%), a local financial conglomerate that owns the largest commercial bank in Peru, Banco de Crédito del Peru (BCP). Another 20% is controlled by ALICO (shares that were formerly in the hands of American Underwriters Overseas [AIUO], a subsidiary of American International until 2009). The remaining 4% of PPS' shares are held by approximately 190 minority shareholders. PPS and Pacifico Vida have enjoyed a very close collaboration with AIG in terms of underwriting skills, business development initiatives, and the overall management of the company. This relationship is still maintained with ALICO, although it is too early to judge whether or not the current shareholder structure will prevail in the future or what Met Life's approach in regards to its minority position in the company will be. What can be said, however, is that PPS and Pacifico Vida have a sufficient amount of commercial and technical skills to continue managing the business in a conservative and appropriate way, despite the possibility of not having an international partner. It is also worth mentioning that given the minority position of ALICO and the relatively small importance of the company in regards to the global operation of ALICO, PPS's rating is considered a stand-alone rating (see "Fitch's Approach to Rating Insurance Groups," published March 24, 2010 at www.fitchratings.com).

Strategy

PPS and its subsidiaries have been one of the market leaders in their respective market segments for a number of years due to the strength of its franchise and the dominant position of Credicorp, its largest shareholder and the largest financial conglomerate in the country.

Since 2005 PPS started a comprehensive revamp of its business model and underwriting policies and pursued an aggressive commercial approach in order to expand its market share, increase its profitability, and take advantage of the economic expansion in Peru.

The expansion of massive branches, such as auto and health, and the intention to lower the concentration of the insured portfolio were the cornerstone of the plan, while the introduction of more up-to-date risk control techniques was also included. The plan not only demanded significant investments in IT, branding, and control tools, but also demanded a massive change in the workforce in all business and control areas.

As any restructuring process, especially in a highly competitive market, some of the initial changes resulted in a deterioration of the underwriting results, while an earthquake that affected an area outside of the capital city in 2007 and the international financial crisis of 2008–2009 undermined the impact of growing claims and high overheads even further. With such negative results, the company has engaged new, aggressive control measures since mid-2008 in order to revert the negative results observed in most of its business lines (auto, third-party liability, and also in the traditional fire line). Improved underwriting, an in depth revision of its reinsurance programs and claims control measures, and the creation of some impairment reserves in regards to a portfolio whose value was affected by the international financial crises were completed. Temporary interruption of cash dividends, a fresh capital infusion, and some organizational changes happened during 2008 and 2009.

During the first quarter of 2010, PPS' restructuring plan was delivering good results, including improved profitability, controlled market share, and a more conservative investment portfolio. The bright prospects of the Peruvian economy in 2010 bode well in propelling the company's business plan, which calls for further diversification of its insured portfolio and a possible expansion of its market share. Prudent pricing among market participants will be required to sustain the improved results of the company, as is the case with the other players in the market.

At year-end 2009, PPS managed approximately 28% of the total insurance market in Peru (approximately 28% of the nonlife market), making it the second largest insurance company in the country. If life and EPS business are included, Pacifico manages around 28% of the consolidated insurance market. It is worth noting that the Peruvian market is heavily concentrated, given that the largest player manages more than 35% of the market (including all business segments); and, in aggregate, the five largest players manage almost 80% of total collected premiums, which results in major rivalries between players. At year-end 2009, PPS operated through a nationwide network of branches and commercial offices, and 80% of its sales came from brokers and agents and 20% from direct sales and nontraditional channels.

Market Trends

- A highly concentrated but competitive insurance market.
- Good growth prospects for the economy and the sector.
- Fierce competition will prevail in the short and medium term.

After a period of sustained deterioration in its technical results (2004–2008) due to fierce price competition, the Peruvian insurance market (life and P&C combined) is finally on its way to posting improved results in the short and medium term. The most concentrated insurance market in the region, where the three largest insurance companies manage more than 70% of total collected premiums, has been characterized by high rivalry levels despite the sustained growth provided by vigorous economic activity and the expansion of the insured universe in the country (12.4% average premium growth during the 2004–2009 period). During the 2004–2008 period, competition was highly driven by price reductions, while the trend in the average cost of claims (and its frequency) has deteriorated in part due to less than proportional growth in the providers of goods and services to the insurance market and the outdated transportation grid in the country. The occurrence of some high value claims in 2007 and 2008 also resulted in a deterioration of the claims ratio. As such, the net loss ratio increased to a peak of 81% in 2007 (from 68% in 2003), while net operating costs were still sizable at around 40%. With that in mind, the Peruvian insurance market has posted combined ratios well above 100% from 2004 to 2008 (126% average) due to a more cautious approach in terms of pricing since late 2008, advances in terms of claims cost control, and slight, but limited advances in operating costs, resulting in the first combined ratio below 110% in 2009. This trend may continue in 2010 thanks to price discipline, the overall expected growth of the economy, and the benefits of better underwriting and claims control techniques.

Similar to most of the countries in the region, asset quality was slightly affected by the international financial crisis due to the conservative investment policies followed by the market, the controls over investments abroad contemplated by the regulator, the sizable participation of Peruvian government debt, and, to a lesser extent, investments in the shallow local capital market. Accordingly, financial income improved in 2009.

Similar to the Chilean insurance market and, to a lesser extent the Brazilian market, the significant and growing share of life insurance — annuities related to the private pension fund scheme as the largest driver of such growth — results in a steady increase in the liabilities-to equity-ratio (average of 4.5x during the 2005–2009 period) but is still well below to the levels seen in Chile where this industry is more mature. Despite the former, a relatively conservative dividend payout ratio has helped mitigate that trend, a policy that may be expected in the short and medium term given the optimistic growth prospects of the sector for 2010 and 2011. Recent regulatory changes in regards to earlier pension possibilities for employees with certain characteristics will at least result in a temporary expansion of the life insurance market in the country. (See the "Latin American Insurance Review & Outlook 2010: Good Growth Prospects with Challenges Ahead," published on May 18, 2010 at www.fitchratings.com.)

Financial Performance

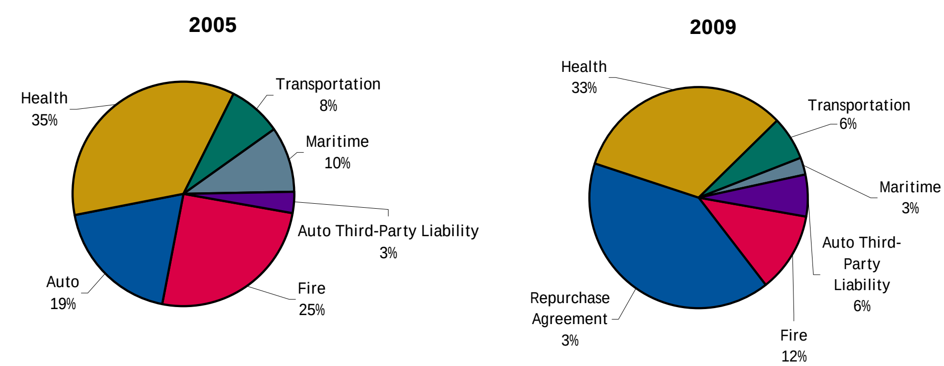
Underwriting and Business Lines

PPS directly controls the nonlife insurance and health business of the group, while its subsidiaries manage the life and health business. After the restructuring process mentioned earlier, the company has clearly outlined its business units and created some centralized units responsible for managing claims and other common departments. Underwriting techniques have been through an ongoing, evolving process during the last five years. For a number of years PPS has tried to incorporate international best practices (acknowledging some information limitations often seen in developing markets) and learn the intrinsic characteristics of the Peruvian insurance market. This process may take several years to consolidate. Price wars in several business lines (auto and to a lesser extent fire) were also addressed by PPS and many players in the market, being that PPS has shifted its marketing efforts towards the introduction of value-added products to its clientele, specifically focusing on the quality of the service. Also, a thorough review of the largest insured risks has been completed in order to keep an adequate control of such exposures in line with PPS risk appetite.

The company has made vast efforts to curb the average cost of claims in an environment where costs are not only affected by the inflation trends of car repairs and medical costs, but also higher claims frequency. The increase in claim frequency is explained not only by an outdated transit infrastructure, but also by deteriorating personal security conditions. By the same token, PPS has completed several reviews of its health business, trying to identify problems in its pricing and overhaul its cost control policies. Most of the aforementioned changes have been in place for a year or more, resulting in a significant improvement of the claim ratio and overall profitability. The challenge going forward will be to preserve these advances and resume the expansion growth of the company without compromising its technical result.

Despite this fact, the company enjoys a leading position in several markets such as mining, energy, and transportation. The auto and health branches are now the largest contributors to PPS' business base. As is the case with many companies in the region, the link with its related bank (BCP) is still not exploited intensively because there is significant room for the expansion of PPS' business using BCP as a commercialization channel.

Retained Premium Breakdown



Source: PPS and normative data.

As shown in the chart above, the changes in the business model have resulted in a significant change in the premium breakdown of the company. Massive business lines such as auto and third-party liability for auto and health now account for 65% of total retained premiums, while the total contribution was less than 50% of total premiums in 2005. This trend is not only explained by the significant expansion of the number of insured vehicles (and higher prices since 2008), but also by changes in the risk appetite for larger risks in fire and technical lines. Changes in the retention and underwriting policies for large risks have resulted in a significant depuration of the insured portfolio, a trend that may continue (but more moderate) in the short term after the proper renewal process is completed. It is also worth mentioning that the company maintains a conservative retention policy for large risks, resulting in a less than proportional participation of such business lines in terms of retained premiums. This trend is similar to PPS' competitors and to what is seen throughout Latin America.

- Claims ratio responds positively to the overhaul of the underwriting process.
- The expansions of massive branches in a market with fierce competition require lots of price discipline.
- Operating costs are the next big challenge to enhance the combined ratio.

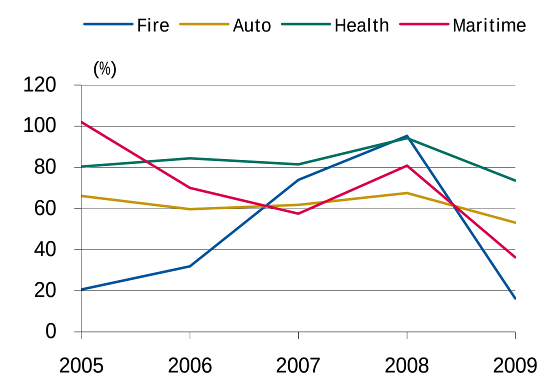
Given the high level of dollarization in the Peruvian economy, most of the business subscribed by PPS is denominated in U.S. dollars because the behavior of the foreign exchange market could affect its premium income due to sudden changes in the exchange rate, while local inflation is not always parallel to the changes of the exchange rate. Given this fact, the company has managed to motivate the migration of some U.S. dollar-denominated policies into local currency, mostly in those branches where local inflation is key for the cost of the claim.

Operating Performance

Propelled by strong economic activity and the revamped commercial plan of the company, PPS's premium growth has sustained well over the last five years as a result of higher average prices in some of the massive branches and in spite of the portfolio clean up. As such, net earned premium grew 14% on average (15% in 2009 and 23% in 2008) over the last five years, while slightly higher retention levels due to the increase of the participation of retail or massive lines indicated a less vigorous growth in terms of gross premium. Growth prospects in the Peruvian insurance market are promising, while the change in regards to price wars has helped to expand the business in a healthy way. Massive branches will still be the largest source of growth even though significant investment projects will also require adequate insurance coverage. However, given the scope of such projects, retention levels (and hence its effect on retained premium) will be just a fraction of the actual size of the business.

From 2003 to 2008, net claims have ramped up for PPS, pressured not only by the larger participation of massive lines (usually with higher claims ratios compared to traditional life), but also by the occurrence of several sizable claims (some of them partially retained but still sizable) and the overall increase in the average cost of claims in the country. Reinstallation costs derived from some of the sizable claims that affected reinsurance programs also were recorded. As such, the company's net claims ratio peaked at 81% in 2008 from a baseline level of around 60% in 2002–2005. The significant changes in the underwriting criteria, claims cost control, and reinsurance programs allowed the company to post an improved net claim ratio of 52%, although this ratio benefits from some claim reserve reversions (around 5% of net claims) that were conservatively made in the past. The preservation of the improved underwriting techniques and claim control policies bode well for the net claim ratio outlook of the company, although some time should elapse before a new baseline claim ratio is achieved.

PPS: Net Claims Ratio



Source: PPS and normative data.

The implementation of a new business plan, the restructuring of internal processes, and the revamp of the commercial image of PPS have been costly, while the significant turnover in personnel — in order to provide the company with human capital capable to deal with the new approach of the company — has also resulted in significant nonrecurrent charges related to the layoff of personnel and the training of the new breed of employees. Given the long span where those expenses were recorded, it is not easy to isolate this burden, but according to management, the vast majority of such expenses are already paid, and operating cost increases will be more in line with the growth of the business in the short and medium term. It is worth mentioning that despite the incursion into retail or massive distribution channels acquisition costs have remained fairly stable in line with relative terms (11% to 12% of earned premiums). Administrative costs were still well beyond local inflation and the growth of the overall business (37% growth in 2009) resulted in further deterioration of the net cost ratio (net costs to retained premium) to almost 40%, which is below the 46% average for 2002–2007 but well above international best practices. A more moderate growth in operating costs is key to sustaining an adequate combined ratio, especially when the current claim ratio could be below the medium-term average of a company highly focused on massive lines.

As previously mentioned, the pressure from the high claims and cost resulted in a very weak combined ratio for PPS over the last five years, in some instances worse than the market average. Since 2002, PPS' combined ratio was above 100% (2002–2008 average of 112%, peaking at 126% in 2007) because the plunge in its claim ratio during 2009 (especially during the second half) resulted in a 98% combined ratio for the company. Given the volatile trend of the ratio in recent years and the presumption that current low claim levels may not be sustainable over time, the enhancement of the operative costs burden is key to posting combined ratios below 100% in the short and medium term.

Financial income has also been volatile since 2004. Such volatility is explained by nonrecurring gains recorded due the sale of a portion of the securities portfolio under a plan to rebalance the portfolio of the company and not due to losses in its investment portfolio. It is also worth mentioning that the income provided by PPS' subsidiaries has been increasing as a share of its overall financial income due to lower participation of extraordinary trading gains and the overall improvement in the results of these companies. As such, the income received from PPS' participation in Pacifico Vida and Pacifico EPS represented a high 56% of total financial income in 2009 (43% in 2008). This trend in the profits of PPS' subsidiaries seems to be sustainable over time given the solid results of its life insurance company and the improved (but still yet to be consolidated) results from Pacifico EPS. Both companies are a part of the overall franchise of the group.

PPS' operating ratio improved to 67% in 2009 from an average of 82% in the 2004–2008 period. At year-end 2009, PPS reverted its net loss from the previous year and posted its second highest net income in the last eight years (PEN109 million). The company's return on average assets (ROAA) of 8.5%, which is more than adequate compared to regional best practices, has yet to be tested in the medium term due to the challenges concerning the sustainability of its claim ratio. Effective tax rate of PPS (and the majority of the Peruvian insurance market) is relatively low for international standards given several tax exemptions contemplated by the Peruvian tax law and mostly related to the income resulting from the investment portfolio. Recent changes in Peru's tax regime will not affect this trend in a significant way but will result in an additional burden in regards to investment income.

Reserves and Other Liabilities

- Good reserving policies.
- Moderate reserve premium coverage.
- No meaningful financial debt.

Under Peruvian insurance law there are five different types of reserves: claims (including incurred but not reported [IBNR]), unearned premium, mathematical for life insurance and annuities, complementary workers' compensation, catastrophic risk, reserves for disability and survivor obligations, and, in the case of EPS companies, one additional reserve related to IBNR claims and unearned payments from affiliates. These reserves must be created following a diverse array of formulas mandated by the regulator. Nevertheless, much of the calculus is related to past claim experiences (rolling average) of each company and does not necessarily follow actuarial calculus such as international trends and suggesting a possible underestimation of reserves, which many of the players and the regulators are aware of. It is worth mentioning that, excluding the workers' compensation scheme, the vast majority of the insured portfolios are short term.

PPS has developed different tools to enhance the reserve creation process — trying to adapt it to the actual needs of its portfolio, but always in compliance with local regulations — while in many cases the companies engage in a more conservative reserve methodology compared to local regulations (using international accounting practices and ad hoc internal estimates). The reserve methodologies are developed and monitored by an actuary with significant international experience and also by the internal auditors of Credicorp. Given that PPS has consolidated its operation into Credicorp and the latter is listed on the NYSE, the company must present its financials and follow the accounting rules of those used by international players. Given the sustained increase in the average cost of claims, the company has recently moved to a more in depth claim reserving process. As such, the claims of most of the massive business lines are reserved considered average claim cost (adjusted by the type of the claim) and in the case of large claims, the company is assuming a worst case scenario approach. As previously mentioned, this conservatism has resulted in an improved claim reserves development since 2009 (see Operating Performance).

As of December 2009, PPS' total reserves slightly decreased to PEN446 million, mainly due to the significant reversion of claim reserves associated with paid claims, being that unearned premium reserves remained fairly stable. Unearned premium reserves (mostly through health, auto, and fire branches) represent the largest individual reserve, with a participation of 54%, consistent with the larger participation of such branches in total retained premium. Also, claims reserves (including IBNR) represented 39% of the total, while the remaining is related to catastrophic reserves. The company shows moderate levels of reserve coverage for a nonlife insurer (73% of retained premium at year-end 2009) because the overall trend of this ratio has been somewhat volatile (but on average remained above 70% in the last five years).

Technical reserves continued to be the largest component of PPS' liabilities (59% at year-end 2009), while accounts payable to reinsurers represented 17% and financial debt of about 5% of total liabilities. The remainder is explained by some accounts payable (including taxes) and some deferred earnings. The aforementioned financial debt is completely explained by a medium-term lease contracted with BCP related to the acquisition of the company's headquarters in 2006. Given the steady increase in retention levels and the phase-in of the nonproportional reinsurance program since 2003, PPS would need to keep its conservative policy toward reserves in order to preserve and enhance its financial profile going forward.

Investments and Liquidity

- Higher than proportional exposure to variable income securities.
- Virtually no exposure to critiqued assets.
- Investments in subsidiaries are almost one-third of the investment portfolio, but liquidity levels remain ample.

PPS' investment policies are considered conservative in terms of credit risk and asset and liabilities management, but still include a significant portion of variable income investments, which can be volatile. The company not only complies with local regulations in terms of its investment portfolio, but also applies more stringent policies in regards to the quality of the investment, limits per issuer and economic group and currency, and follows cautious asset and liability management. Also, the company follows an investment policy differentiated by portfolios associated to the local regulatory rules and its own equity position. The investment objectives in terms of profitability, maturity, and volatility are differentiated among portfolios because the one that represents reserves and the solvency margin is concentrated in short-term fixed income securities that match their reserves in terms of maturities and currency. In its equity position portfolio, the guidelines include the possibility to invest in variable income securities, while its duration tends to be higher on average.

Market risk is monitored by the middle office area of the investment department and the risk committee of the company (formed by three executive members, one representative of Credicorp and another from Pacifico Vida). The investment committee is in charge of the creation and monitoring of the investment policies. It is also worth mentioning that the company leverages the ample expertise of Credicorp and BCP in terms of risk control and treasury management.

Historically, PPS has tried to sustain low concentrations in its investment portfolio due to the fact that Peruvian government debt has represented a relatively small portion of total investments (less than 10% of liquid investments in the last five years), a trend that contrasts local and regional standards but is considered conservative given the relatively high volatility of these instruments in the past.

Following local guidelines (recently changed in 2009), the securities portfolio is registered through three different categories: trading (registered at market value through the income statement), available for sale (registered at market value through changes in equity), and held to maturity (at cost). At the end of December 2009, total liquid investments increased to PEN530 million, while investments in subsidiaries stood at PEN235 million. During 2009 and after the significant volatility in the international capital markets, the company decided to lower its above average exposure to short-term bank deposits and expand its share of mutual funds (mostly money market funds) in order to enhance the profitability of the portfolio without affecting the overall quality of the portfolio. In general, the company invests in securities issued abroad that are rated at least investment grade. In the case of fixed income securities investments in the local market, the company only invests in securities with national scale ratings of 'AA–' or above. At year-end 2009, only a minor portion of the foreign investment portfolio was represented by securities rated below the investment grade (1.2% of its equity), while the portion of securities with national scale ratings below 'AA–' was minimal.

The bulk of PPS' investment portfolio is registered as available for sale investments (80% of the total), while the rest is the equity position on its subsidiaries. Also, the breakdown of the gross portfolio (including cash and bank deposits) at year-end 2009 was as follows: private fixed income (34%), investment in subsidiaries (31%), variable income securities (17%), short-term bank deposits (5%), and Peru sovereign debt (4%). The rest is composed of a very small portion of mutual funds and warrants backed by Credicorp shares (used to hedge the stock option plan of its employees). PPS presents a moderate concentration of its investment portfolio in related parties (less than 15% excluding its participation on its subsidiaries Pacifico Vida and Pacifico EPS, but including deposits in BCP). Fixed asset investments (not included in the previous breakdown) represented 19% of PPS' equity as of Dec. 31, 2009. Parts of those assets are income generators in the form of leases (around 10% of total financial income).

For a couple of years PPS' liquidity ratios were under pressure as a result of higher leverage and negative technical results. In 2009, the reversion of those negative results and some changes in the profile of the investment portfolio allowed the company to slightly improve its liquidity ratios. At the end of 2009 the liquid-assets-to-total-reserves ratio reached 1.1x, while the ratio of liquid assets to total liabilities was 0.7x. The company does not account for loans in its assets, while fixed assets represent a moderate 8% of total assets (already mentioned) and premium receivables show moderate but decreasing rotation and low past-due levels. It is worth mentioning that Fitch's liquidity ratios don't include the flow of premium receivables, however, those account for the largest amount of cash provided to PPS' day-to-day operation.

Reinsurance

- Good quality and a well-diversified reinsurance pool.
- Conservative retention levels.
- Low reinsurance receivables.
- Ongoing fine tuning of its reinsurance department.

PPS's reinsurance program is composed of proportional and nonproportional coverages that not only provide the company with sufficient acceptance capacity, but also properly protect its results against unexpected deviations in claims and catastrophic (CAT) events through a pool of highly ranked reinsurance companies. It is worth mentioning that given the ample acceptance capacity of the company, the bulk of the insured risks are managed through automatic contracts, while around 10% of the insured risk must be directed through facultative contracts.

The bulk of the reinsurance program is ceded to at least investment grade companies in the international markets (with a significant use of international brokers) because the pool is properly diversified among international reinsurance companies. For the 2009–2010 reinsurance program, around 95% of the total cession was made to international reinsurance companies rated at least 'A' or above. The participants of the reinsurance program are Lloyd's Underwriters, New Hampshire Reinsurance Company, Munich Re, Zurich Re, Hannover Re, Swiss Re, W.R. Berkley Insurance, and BRIT Insurance Ltd., among others.

Retained risk is still small given that the maximum loss retention per event reaches less than 1.5% of PPS' equity, while the maximum loss retention per CAT is around 9% equity (above the international best practices). It is worth mentioning that despite the relatively low retention per event, the ample participation of the company in large size risks (especially in the mining and transport sectors) results in above-average exposure to frequency issues in those branches, which occurred in 2005–2008 when several large claims and its reinstallations costs resulted in a significant increase in its claims ratio.

An adequate control of such exposures and the control of the inherent operating risk of reinsurance contracts has been enough to sustain good recoveries from its protections in case of a catastrophe, and, in general, the level of reinsurance receivables has remained low during time (below 15% of PPS' equity in the each of the last five years). Total catastrophic exposure appears to be adequately covered at around 5.7%–6.9% of the largest CAT accumulation in the country (down from 6.9% in 2008). Also, the company manages a catastrophic reserve of around PEN29 million, which is an additional coverage to its retention.

Capital and Capital Adequacy

- Leverage ratios improving thanks to conservative earnings retention and a fresh capital infusion in late 2008.
- Relatively high concentration of investments in subsidiaries and fixed assets lower the shock absorption capacity of PPS' equity.

Thanks to a capital injection of around USD18 million made in late 2008 and lower cash dividends in 2009, PPS' leverage ratios have started to return to previous averages. At year-end 2009, the liabilities-to-equity ratio decreased to 1.35x (2.1x in 2008), while the total leverage ratio (total net premium plus liabilities to equity) reached almost 2.4x. It is also important to note that the leverage of the company is higher when consolidated figures are addressed. At year-end 2009 the liabilities-to-equity ratio stood at 5.4x, and the total leverage ratio was 7.6x. These ratios are in line with market trends and international best practices, considering the significant burden of Pacifico Vida's annuities business.

As is the case for local regulations in many other countries, Peru's capitalization requirements are monitored through the solvency margin methodology. Until now, this capitalization measure did not incorporate any charge for credit and operating risk (issues to be addressed in the future by the regulator. Despite the former, the local rule now adds another capital requirement (locally know as a guarantee fund — a fixed proportion of total collected premiums) that represents an additional 35% of the required equity demanded by the solvency margin rule on average. Companies must hold enough capital to cover both requirements because regulatory capital is only comprised of tier 1 capital and retained earnings are not considered part of this capital.

At year-end 2009 the company had an excess of 14% of the required equity. This margin looked relatively tight compared to other international capital measures such as the RBC in the U.S. and the Solvency I rule in Europe. Excluding the burden of the guarantee fund and incorporating retained earnings (after cash dividends but not adjusting for the investments in subsidiaries), the adjusted solvency margin excess should be more than 270%.

PPS' equity quality is hindered by its sizable equity participation in subsidiaries (42% of total equity at year-end 2009 considering unconsolidated figures). The expected improvement in the stability of the profitability of the company and a conservative cash dividend policy will provide PPS with enough equity base to keep expanding its business in a market with positive growth prospects.

Prospects

PPS plans to expand its market share by increasing its target clientele and through more cross selling of its current insured portfolio. This goal seems appropriate in a market with good growth prospects, but it will require prudent underwriting due to strong rivalries and the limited average income of the population. Increased use of the network provided by BCP and other massive channels is key to offering low-priced products to the population, while a conservative equity base is required in order to expand the current size of the business.

Financial Summary — El Pacifico Peruano Suiza Compañía de Seguros y Reaseguros (Not Consolidated)

(Millions of Nuevos Soles, Years Ended Dec. 31)

	2009	2008	2007	2006	2005
Balance Sheets					
Liquid Assets	530	503	380	500	381
Deposits with Banks	35	105	50	162	105
Securities Portfolio	495	397	329	338	276
Private Sector	258	258	204	237	172
Government	34	38	37	23	15
Variable Income	133	94	81	66	90
Other	72	22	16	21	13
Reserves	(2)	(15)	(9)	(9)	(14)
Other	0	0	0	0	0
Loans	0	0	0	0	0
Premiums Receivable (Net)	310	299	225	176	173
Current	348	347	255	203	201
Past Due (> 30 days)	28	17	11	5	3
Reserves	(66)	(65)	(41)	(32)	(31)
Reinsurance Receivables	49	58	27	9	16
Fixed Assets	104	106	109	110	104
Investments in Subsidiaries and Affiliates	235	192	194	169	157
Other Assets	92	93	63	64	53
Total Assets	**1,320**	**1,250**	**998**	**1,028**	**884**
Claims Reserves	174	225	163	114	83
Claims	168	206	145	99	71
Incurred but not Reported	6	18	18	15	12
Technical Reserves	272	272	218	189	202
Mathematicals	0	0	0	0	0
Unearned Premiums	243	239	195	157	168
Other	29	34	23	32	34
Bank Debt	38	49	45	41	31
Reinsurance Payable	125	159	100	75	124
Accounts Payable	72	74	59	58	38
Other Liabilities	77	82	36	42	15
Total Liabilities	**758**	**861**	**621**	**520**	**494**
Minority Interest	**0**	**0**	**0**	**0**	**0**
Paid in Capital	314	303	271	254	254
Reserves	102	99	89	85	81
Unrealized Gains (Losses)	49	0	0	0	0
Retained Earnings	96	(13)	17	170	55
Total Equity	**561**	**389**	**377**	**508**	**390**
Year-End Exchange Rate (Nuevos Soles/USD)	2.89	3.14	3.00	3.27	3.30

Source: PPS audited financial information.

Financial Summary — El Pacifico Peruano Suiza Compañía de Seguros y Reaseguros (Not Consolidated)

(Millions of Nuevos Soles, Years Ended Dec. 31)

	2009	2008	2007	2006	2005
Income Statement					
Gross Written Premium and Affiliates Contribution	900	871	754	587	570
Earned Premium and Affiliates Contribution	878	835	705	586	555
Ceded Premium	264	301	270	186	197
Net Written Premium and Affiliates Contributions	614	534	435	400	358
Gross Paid Claims	487	629	600	301	276
Claims Recovered from Reinsurance	155	184	269	52	49
Claims Recoveries	13	13	8	0	0
Net Claims Reserves	(2)	0	0	0	4
Retained Claims	316	431	323	249	230
Acquisition Costs	100	100	87	75	61
Operating Expenses	144	105	121	115	99
Net Operating and Acquisition Costs	244	205	209	190	160
Other Operating Income (Expenses) Net	(39)	(20)	(14)	(7)	(1)
Operating Result	**15**	**(123)**	**(111)**	**(47)**	**(33)**
Financial Income	104	64	79	61	53
Financial Expenses	3	3	7	3	1
Other Income (Expenses) Net	11	27	58	143	18
Extraordinary Items	0	0	0	0	0
Income from Subsidiaries and Affiliates	0	0	0	0	0
Profits before Taxes	**127**	**(35)**	**18**	**155**	**38**
Taxes	18	(16)	1	2	(1)
Participation of Minority Shareholders	0	0	0	0	0
Net Income	**109**	**(19)**	**17**	**153**	**39**
Financial Ratios (%)					
Performance					
Market Share (% Total Earned Premium)	20.6	20.3	20.5	18. 6	20.8
Retention Ratio	69.9	64.0	61.7	68.2	64.5
Gross Loss Ratio	55.2	75.3	85.2	51.3	50.3
Net Loss Ratio	51.5	80.8	74.4	62.3	64.3
Acquisition Costs/Earned Premium	11.4	12.0	12.4	12.9	11.0
Operating Expenses/Earned Premium	16.4	12.6	17.2	19.5	17.8
Net Operating and Acquisition Costs/Net Earned Premium	39.8	38.5	48.0	47.5	44.6
Operating Result/Earned Premium	1.7	(14.7)	(15.8)	(7.9)	(5.9)
Combined Ratio	97.6	123.0	125.6	111.7	109.1
Operating Ratio	66.7	99.1	89.4	57.5	89.0
Net Financial Income/Earned Premium	12.8	10.5	18.4	34.4	12.7
ROAA	8.5	(1.7)	1.7	16.0	4.7
ROAE	23.0	(4.9)	4.4	34.1	9.7
Solvency and Leverage					
Liabilities/Equity (x)	1.40	2.20	1.70	1.00	1.30
Reserves/Liabilities (x)	0.60	0.60	0.60	0.60	0.60
Financial Debt/Liabilities (%)	5.04	5.71	7.20	7.92	6.30
Reserves/Net Earned Premium (%)	72.70	93.06	87.61	75.87	79.76
Net Earned Premium/Equity (Times)	1.09	1.37	1.15	0.79	0.92
Regulatory Capital Superativ (%)	N.A.	5.33	21.03	25.15	28.91
Total Leverage/Equity	2.44	3.58	2.80	1.81	2.18
Equity/Assets (%)	42.53	31.14	37.72	49.45	44.13
Investments and Liquidity					
Liquid Assets/Reserves (x)	1.19	1.01	1.00	1.65	1.34
Liquid Assets/(Reserves + Financial Debt) (x)	1.09	0.92	0.89	1.45	1.20
Liquid Assets/Liabilities (x)	0.70	0.58	0.61	0.96	0.77
Fixed Assets/Total Assets (%)	7.88	8.47	10.95	10.74	11.72
Accounts Receivables Rotation (Days)	127.1	128.9	114.9	108.2	112.4

N.A. – Not available.
Source: PPS audited information.