Profits and fair profits

PZU's Cocktail of Results

Risk management within PZU

The net premiums earned have fallen from 3.614 billion in the 1st quarter of 2009 to 3.445 billion in the 1st quarter of 2010 – a drop of 4.7 percent. Income based on fees and commissions has also been subject to a reduction from 79.9 million down to 62.6 million – a drop of 21.6 percent.
On the other hand Net insurance claims incurred have risen from 1.693 billion in the 1st quarter of 2009 to 2.459 billion in the 1st quarter of 2010 – **an increase of 45 percent!** Such a big rise in compensation payments is concerning as it gives rise to reasonable doubts regarding PZU's risk management.

An insurance company should be as little susceptible as possible to the rise in payments in relation to the premiums and fees cashed. The nature of an insurance business is the skilful spreading of risk, where high individual payouts (e.g. for an explosion of a boiler in a power station) or events resulting in launching a large number of compensation payments (natural disasters) should be reinsured. Predictability is of primary significance in this line of business and constitutes value to the shareholders. The insurer exchanges unpredictable events on the clients' side to predictable compensation costs on the basis of their policies.
Reducing the part of reinsurance is a false saving, which can be clearly seen during natural disasters. Above all, reinsurance means giving up part of one's own risk and accepting shares in the risk of other insurance companies. Active and passive reinsurance are to guarantee the predictability of the insurer's results, is that also the case with PZU?

It is worth posing a question here about the activity of the insurance authority, has the Polish Financial Supervision Authority instigated proceedings in relation to the high increase of compensation in the PZU group and has it analysed the actuarial accounts and reinsurance levels? A significant matter indeed, for both the whole insurance sector and the safety of its clients.
No regional natural disaster or adverse weather conditions should affect the insurer's results in a significant way, and the rise of burden of claims should be compensated by disproportional reinsurance contracts. PZU's results in the 1st quarter give rise to significant doubts regarding the procedures used by the insurer.

It should be stressed – that in this line of business the predictability of results has a huge significance and affects the insurer's valuation. Insurance companies do not have to have "additional" equity above that which is required to cover the solvency margin in order to be safe. It isn't one's high equity, which decides whether the insurer is safe, but good insurance practice. Otherwise, with these criteria in mind, the insurer's equity should be valued by applying a discount to the industry's mean figures.

Profits and fair profits

Social justice is something other than justice; similarly, fair profits differ from profits. Looking at PZU's report for the 1st quarter of 2010, it is of particular interest how the company board has presented their profits in terms of quantity and type.

The results have been shown as overall results as well as divided into segments. Unfortunately, the profits from the equity capital were subordinated into segments, where each segment contained an insurance activity result (including the result from investing funds from technical reserves), as well as

the board-created result based on its equity. Hence it is not possible to state which results originate from insurance activity and which from operations based on PZU's equity.
The investments each insurance company makes from the technical reserves capital (premiums) is subject to strict precautionary measures and they are generally safe deposits. However, the result which the company board displays in relation to its equity is a different story altogether.

The insurance company board does not have much room to manouver in order to retouch its insurance activity results, including the result from investing technical reserves – which has its main source in the type of financial instruments used, primarily treasury securities and bank deposits. It's a different picture altogether where the company invests its own resources – the possibility of creating a result increases dramatically.

If PZU were to present the results from insurance activity and the result from operations on its own in-house funds separately, then the company would be much more transparent. Many investors would assess the core business and add equity (or part thereof) to the valuation. The result which the company board presents on the investments of equity fund would be of no significance to them – after all they are investing in an insurance business and not in the ability of the management to manage the investment fund. In this situation the profit from investing equity capital, which is much higher than the market rate (risk-free) may be assessed in very critical terms.

How was PZU result made for the 1st Quarter of 2010?

The above reservations indicating the need to present the result split into the core business and investment of equity capital start to become significant when we take a closer look at the way PZU's has presented its activity in the report for the 1st quarter of 2010. The result from investments has compensated for technical losses.

In thousands of zloty (PLN)	**1 January – 31 March 2010**	**1 January – 31 March 2009**
Net income from investments	442 309	678 427
Net result of the implementation and impairment loss of investments	135 274	(108 614)
Net change in fair value of and liabilities at fair value	333 831	(153 094)

Combined results generated from technical reserves and from PZU's equity capital - (unfortunately these are combined results as mentioned above)

Only the first item does not cause reservation – the reduction in income is replicated in the reduction in PZU's equity capital, which results from a huge dividend payment. The next two items, however, are surprising as the result of the 1st Qtr of 2010, as opposed to the 1st Qtr of 2009, PZU explains as caused, *"mainly by the increase in value of capital instruments in 1st Qtr 2010, compared to decrease its value in the 1st Qtr of 2009"*.
One needs to note, that debt securities are also included in either of both items and these components also recorded an outstanding increase in value.

Most significant from the point of the composition of the results is a comparison of the results on capital instruments included in both items

In thousands of zloty (PLN)	**1 January – 31 March 2010**	**1 January – 31 March 2009**
Capital Instruments included in the item: Net result of the implementation and impairment loss of investments	102 845	(69 868)
Capital Instruments included in the item: Net change in fair value of assets and liabilities at fair value	185 762	(161 877)
Total:	**288 607**	**(231 745)**

Whilst, when excluding items which "are valued at the fair value by the financial result – qualified for this category at first recognition", we get:

In thousands of zloty (PLN)	**1 January – 31 March 2010**	**1 January – 31 March 2009**
All capital instruments excluding items valuated at fair value by the financial result – qualified for this category at first recognition	**268 025**	**(211 827)**

Compared to the fall of the WIG20 index during the 1st Qtr of 2009 by 15.5%, the decrease of the above capital instruments amounts to 211.8 million zloty, whereas against the rise of WIG20 in the 1st Qtr 2010 by only 4.5% the same item indicates an increase of 268 million (should the most basic analogy of percentage changes be applied then it would increase in the 1st Qtr of 2010 by a mere 60 million).
It turns out, therefore, that in the 1st Qtr of 2010, the PZU Board can pride themselves on the extraordinary good results generated on capital instruments, however, most of it was derived from… revaluating it to the fair value.

At the same time an essential impact on the 1st Qtr of 2010 result had the change in "financial assets and financial instruments valuated at fair value by the financial result – qualified for this category at first recognition".

In thousands of zloty (PLN)	**1 January – 31 March 2010**	**1 January – 31 March 2009**
Financial assets valuated at fair value by the financial result – qualified to this category at first recognition, including **capital instruments and debt securities**	20 657	1 362
Financial instruments valuated at fair value by the financial result – qualified to this category at first recognition, incl. **capital instruments and debt securities**	112 852	(21 333)
Total:	**133 509**	**(19 971)**

The items mentioned above are subsequent ones whose value depends on valuation by fair value. Intangible assests are another specific item in the PZU report, it turns out that this item increased from 62,462 thousand at the end of the 1st Qtr of 2009 to 92,154 thousand at the end of 1st Qtr of 2010, which is 45% per annum.

Fund managers in PZU

PZU results for the first quarter were saved by the extraordinarily good results **on** the investment activity. It may well be that PZU's management is wasting its talents and would have much higher achievements as part of running investment funds?

In order to be able to answer with more certainty the question relating to the qualifications of PZU board, the company should open up its black portfolio and show what the investment portfolio is made of and how the fair value valuation was carried out.

The strictly operational activity of the PZU group does not look so good anymore, the summing up criterion is, in this instance, cash flow. In the 1st quarter of 2009 the cash flow from operational activity was –623 million, **whilst in the 1st quarter of 2010 the negative value of cash flow from operational activity had already reached –1,254 million**. Both values (including 2009) and tendency are of great concern.

The skills of the PZU's board to generate profit on investment activity are therefore all the more significant. Let us hope that PZU will let us take a peek at the secret and will reveal the magical curtain, so that investors may admiringly gaze at the operations carried out.

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