STANDARD & POOR'S

INSURANCE CREDIT REPORT

PZU

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RATING A- (STRONG)

An insurer rated 'A' has strong financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

HOLDING COMPANY

None

GROUP MEMBERS

None

DOMICILE

Poland

LICENSED

Poland

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Rating description

STRONG

Rating explanation

An insurer rated 'A' has strong financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

RatingsDirect Publication Date

July 21, 2005

Major Rating Factors

Strengths:
- Strong competitive position; and
- Very strong operating performance.

Weaknesses:
- Limited ability to invest in assets of stronger credit quality or appropriate duration; and
- Concerns regarding the impact of ownership resolution on PZU's strategic development.

Rationale

The ratings on non-life insurer Powszechny Zaklad Ubezpieczen S.A. (PZU S.A.) and life insurer Powszechny Zaklad Ubezpieczen na Zycie S.A. (PZU Zycie) reflect the companies' status as core entities of Poland-based composite insurance group PZU. The ratings are supported by the group's strong competitive position and very strong operating performance. The ratings are constrained, however, by PZU's limited ability to invest in assets of stronger credit quality or appropriate duration. The ratings also factor in concerns regarding the impact that the resolution of PZU's future ownership may have on the group's senior management team and strategic direction.

PZU has a strong competitive position, driven by its significant position in the Polish insurance market, unrivaled distribution capabilities, and high recognition among the Polish population. However, the group is to some extent exposed to the fortunes of the Polish economy.

PZU's operating performance is very strong, driven primarily by its strong competitive position both in life and non-life business in a growing insurance market. The strength of PZU's operating performance is also supported by a low cost base compared with peers'.

Regulations limit the amount of overseas investment, thereby restricting the diversity of PZU's portfolio. Lack of availability of suitably long-dated investments precludes accurate asset-liability management.

The ratings are currently also constrained by uncertainty about how the resolution of the group's future ownership may affect the stability of the senior management team (in terms of retention of the current CEO) and the group's strategic direction (with regard to the continuation of strategy).

Outlook

Once the credit quality of the investment portfolio improves and uncertainties regarding the impact of ownership resolution on the group, which are currently reflected in the ratings, are resolved, the ratings may be raised, subject to meeting Standard & Poor's Ratings Services following expectations:
- PZU is expected to maintain a stable management team and retain the current CEO;
- PZU is expected to continue management's commitment to the modernization and restructuring projects initiated in 2004;
- PZU is expected to continue to demonstrate very strong operating performance through the cycle, with an average net combined ratio of 95% and ROE well in excess of 15%; and
- PZU is expected to maintain strong capitalization, with capital adequacy within the 'AA' range (according to Standard & Poor's risk-based capital model), strong quality of capital, sufficient reinsurance protection, and adequate reserving.

Revision of the outlook to positive would be an indication that the group is close to successfully resolving all of the above issues.

Table 1

PZU/Selected Statistics

	—Year ended Dec. 31—				
(Mil. PLZ)	**2004**	**2003**	**2002**	**2001**	**2000**
Total net premiums written	12,417.30	11,806.50	11,781.20	10,979.30	10,108.30
Total revenue*	15,558.80	14,703.10	14,386.60	13,473.00	11,807.10
Non-life (%)	44.60	46.60	45.10	46.00	43.80
Life (%)	46.20	43.70	46.00	45.40	48.10
Other (%)	9.20	9.70	8.80	8.60	8.10
Core operating result	2,529.00	1,925.70	1,882.50	1,624.00	1,629.80
Non-life (%)	24.90	15.80	17.80	17.60	23.20
Life (%)	33.00	24.10	26.50	29.80	31.50
Other (%)	42.10	60.20	55.70	52.60	45.30
Net income (before bonus allocation)	2,164.20	1,371.10	1,293.60	1,115.40	879.3
Net income	2,160.90	1,368.30	1,290.60	1,112.10	879.3
Total assets	38,428.80	34,368.20	30,369.30	25,677.30	20,826.30
Total equity	8,799.90	6,881.70	5,377.80	3,950.10	2,487.90

*Based on allocated investment income. PLZ—Polish zloty.

Corporate Profile

PZU is Poland's largest insurance group, and is the leader in both non-life and life business, with shares of the Polish market of 50.2% and 43%.0, respectively. The group is also No. 3 in pensions and No. 14 in mutual funds, with market shares of 16.2% and 1.1%, respectively. The group had total assets of Polish zloty (PLZ) 38.4 billion ($11.34 billion) and gross premium income of PLZ13.0 billion at year-end 2004. PZU is by far the largest insurance group from the recent EU accession countries, accounting for approximately 19% of those countries' total gross premiums written in 2003. At Jan. 31, 2005, PZU's shareholders were the Polish state treasury (55.1%), Eureko B.V. (Eureko; core operating entities are rated A+/Stable/—) (30.9%), institutional shareholders (5.8%), and individual shareholders (8.2%).

Competitive Position

Table 2

PZU/Business Statistics

	—Year ended Dec. 31—				
(Mil. PLZ)	**2004**	**2003**	**2002**	**2001**	**2000**
Consolidated					
Total gross premiums written	12,962.70	12,346.50	12,289.60	12,230.80	11,535.60
Annual change (%)	5.00	0.50	0.50	6.00	N.A.
Total net premiums written	12,417.30	11,806.50	11,781.20	10,979.30	10,108.30
Annual change (%)	5.20	0.20	7.30	8.60	N.A.
Total assets under management	36,808.80	32,873.50	27,667.50	22,978.00	19,040.90
Nonlinked (%)	96.50	95.80	95.60	95.30	96.10
Linked (%)	3.50	4.20	4.40	4.70	3.90
Non-life					
Gross premiums written	7,482.60	7,219.10	7,391.60	7,519.50	7,136.00
Annual change (%)	3.70	(2.30)	(1.70)	5.40	N.A.
Net premiums written	6,945.10	6,686.90	6,888.80	6,268.40	5,708.70
Annual change (%)	3.90	(2.90)	9.90	9.80	N.A.
Life					
Gross premiums written	5,480.00	5,127.40	4,898.00	4,711.30	4,399.60
Annual change (%)	6.90	4.70	4.00	7.10	N.A.

PLZ—Polish zloty. N.A.—Not available.

PZU's strong competitive position is driven by the group's:

- Significant position in the Polish insurance market both in non-life and life business lines, complemented by pension and asset management activities;
- Very strong brand recognition; and
- Unrivaled distribution capabilities.

PZU's competitive advantages are limited, however, by weak geographical diversity, although this is improving.

PZU has recently made good progress in sharpening its competitive edge by modernizing its distribution network and introducing a new, transparent organizational structure. In Standard & Poor's view, this will bring a higher level of operational efficiency and customer service, thereby cementing PZU's position in the market. During 2003-2004, PZU made meaningful acquisitions in the Lithuanian and Ukrainian insurance markets. The Ukrainian market, in particular, offers excellent potential for profitable growth after the introduction of compulsory third-party motor liability (TPML) cover in 2004, which is one of PZU's core competencies. However, in Standard & Poor's view, tangible benefits from this diversification will only materialize in the medium to long term. PZU is expected to further improve its competitive position in life business, but its competitive position is otherwise expected to remain relatively stable, in line with the growth and development of the Polish market.

Industry risk

Industry risk in Poland is regarded as modest, largely as a result of the EU accession process, which brought reform to the Polish regulatory and legal environment. Insurance regulation is now largely aligned with that in Europe, and solvency regulations are to be further strengthened in 2006. There are no significant barriers to entry in Poland, and the Western European insurers active in the accession countries are established in Poland.

Significant position in the Polish insurance market

Despite considerable competition from new entrants, PZU maintains a significant position in Poland, with 50.2% of the non-life market, 43.0% of the life market, and 46.9% of the overall insurance market in 2004. PZU's nearest competitors had 11.8% of the non-life market (Towarzystwo Ubezpieczen i Reasekuracji WARTA S.A. {Warta; BBBpi}) and 13.8% of the life market (Commercial Union). This dominance may marginally reduce, but is viewed as sustainable in the medium term as the group is expected to effectively build upon its already very strong distribution network and low cost base (compared with peers') by means of its restructuring and modernization process, which is already in progress.

Non-life

The strongest component of PZU's competitive position is PZU S.A.'s undisputable leading position in the Polish non-life market (58% of PZU's gross premiums written), where it has a relatively diversified portfolio (TPML 37.1%, other motor damage 35.9, property 12.9%, other 14.1%). There is some concentration in motor, but the company has a sustainable significant cost advantage over its peers thanks to its agency distribution network. This distribution cost advantage enabled PZU S.A. to achieve a combined ratio 18.5 percentage points lower (on average) than the market average of 112.2% over the past two years, and is sustainable. PZU S.A. is expected to reduce its concentration on motor business by growing its personal property and commercial lines business.

Life

The second-strongest element of PZU's competitive position is PZU Zycie's significant position in the Polish life insurance market—in group business in particular—with a 78.2% market share. PZU Zycie's position in individual business is weak, with only a 8.9% share of the market. Similar to non-life, PZU Zycie enjoys sustainable cost advantages over its peers due to its distribution network and very well known brand. PZU Zycie will be challenged to significantly improve its market ranking for individual life, while it is expected to maintain its strong presence in group business. PZU Zycie has also recently established a cooperation agreement with one of Poland's largest providers of private healthcare, which should help the group establish a good position in this market, which is in its infancy in Poland, due to the lack of suitable private healthcare facilities.

Very strong brand recognition

PZU's brand recognition as one of the most well-known institutions in Poland is extremely strong. Of the selected population sample, 83% immediately recognized the group and 95% recognized it with some prompting. The second best recognized brand in Poland is Warta, although this has a far lower level of recognition (source: Pentor, September 2004).

Unrivaled distribution capabilities

PZU's distribution network is unrivaled in size and reaches every corner of Poland, with more than 800 branches and 10,000 agents. It is this network that perpetuates PZU's strong position in the smaller cities and rural areas, which is even stronger than its position in the large cities. PZU is also strong in the large cities, but it is here that the group experiences the stiffest competition. Of the total non-life portfolio, 39% of business is sold by agents, 32% by permanent employees, 14% by brokers/intermediaries, and 13% by multi-tie agents. More than 70% of TPML business is sold through the branch network, with 35% automatically renewed by post. The total lapse ratio on the portfolio is 2%. Although bancassurance remains in the early stages of its development in Poland, PZU is already actively marketing its products (mainly life) through Bank Millennium Capital Group (BBpi) and Powszechna Kasa Oszczednosci Bank Polski (S.A.) (BBBpi).

Prospective

PZU's non-life and life units will remain a key driver of the group's competitive position, revenue generation, and earnings. The Polish insurance market—and life insurance in particular, typical of emerging markets—has substantial growth potential as the overall demand for insurance is increasing and private property insurance and health insurance are underdeveloped. PZU is well positioned to participate in this growth.

Management And Corporate Strategy

PZU's management and strategy are very strong, positive contributors to the ratings, but the current ownership structure and uncertainty surrounding its future negatively affects or limits management's actions and the timely implementation of set objectives. Consequently, these components have a marginally negative impact on the ratings. Management made strong progress in implementing its modernization and restructuring plans in 2004 within PZU S.A., and has very convincing plans and the ability to turn PZU into an even more profitable vehicle, with possible leading positions well beyond Poland. The major challenge it is facing is from PZU Zycie, which historically operated independently of the group and retains a separate supervisory board. Nevertheless, current management has made progress in integrating these operations.

PZU has no role in the resolution of its ownership issue. Therefore, management is operating under the continuous pressure of uncertainty, unaware of the impact that ownership resolution may have on the group's strategic direction, capitalization, and financial flexibility, as well as on the senior management team. Based on historical experience, changes in government have often led to changes in PZU's CEO, translating into a lack of continuity with what has been started by previous CEOs. The current CEO is the longest-serving CEO in the past 12-15 years. The new government elections are scheduled for September 2005 and Standard & Poor's will closely monitor the impact of these on PZU. In Standard & Poor's view, the strategic direction of the group is currently very clear. The ratings are based on the assumption that capitalization will be maintained at a strong level, although there remains some risk that extraordinary dividends may have to be paid before the IPO. Being left with minimal capital adequacy would hinder PZU's strong potential for growth and development outside Poland. Further delay in the IPO, which has been postponed since 2001, would continue to slow down progress in the group's restructuring, modernization, and development, and would be viewed negatively by Standard & Poor's.

Publicity surrounding the ownership dispute between Eureko and the Polish state treasury has been intense over the past four years. Outwardly, these ownership uncertainties have not affected PZU directly, as the group's core competitive position and underlying financial indicators show strong improvement compared with previous years. PZU has successfully maintained its strategic cooperation with Eureko, which is viewed as positive.

The outcome of the arbitration proceedings, which were expected at the end of 2004 before the process was stopped, is open to speculation. Any resolution that ensures no further political interference in PZU is likely to be positive for the ratings on PZU.

Strategy

PZU's strategy centers on the following three objectives:

- To increase revenue in existing and new business;
- To cut costs in claims management and through operational excellence and synergies (modernization and restructuring process); and
- To increase transparency and business continuation through effective corporate governance.

Standard & Poor's regards this strategy as appropriate for PZU, but challenging to implement as there have been too many uncertainties over the past five to six years, which have caused priorities to change and distracted management's focus.

Operating Performance

Table 3

PZU/Operating Statistics

	—Year ended Dec. 31—				
(Mil. PLZ)	**2004**	**2003**	**2002**	**2001**	**2000**
Consolidated					
Total revenue*	15,558.80	14,703.10	14,386.60	13,473.00	11,807.10
Core operating profit	2,529.00	1,925.70	1,882.50	1,624.00	1,629.80
Realized gains/core operating profit (%)	21.10	34.00	26.90	0.10	12.60
Net income	2,160.90	1,368.30	1,290.60	1,112.10	879.3
Post-tax ROE (%)	27.60	22.30	27.70	34.50	N.A.
Total profitability ratio (%)	34.20	30.60	39.50	47.30	N.A.
Total gross expense ratio (%)	22.40	22.00	22.30	21.00	18.50
Administrative expense ratio (%)	12.50	12.50	12.60	12.20	13.30
Acquisition expense ratio (%)	10.10	9.70	9.10	8.60	4.20
Nontechnical expenses/total revenue (%)	1.40	2.20	1.80	3.00	4.80

Table 3

PZU/Operating Statistics (cont.'d)

	—Year ended Dec. 31—				
(Mil. PLZ)	**2004**	**2003**	**2002**	**2001**	**2000**
Nontechnical expenses/total assets (bps)	56.6	94.6	87.2	160	274.3
Non-life					
Non-life revenue*	6,933.70	6,851.80	6,495.30	6,198.50	N.A.
Non-life operating result*	629.3	303.9	334.7	285.3	N.A.
ROR* (%)	9.10	4.40	5.20	4.60	N.A.
Gross loss ratio (%)	59.80	67.50	71.80	75.60	73.60
Gross expense ratio (%)	27.60	26.10	25.60	23.00	18.80
Gross combined ratio (%)	87.90	93.60	96.10	98.20	93.70
Reinsurance result	(415.7)	(350.1)	(39.9)	(19.3)	(47.6)
Growth in expenses (%)	9.60	5.20	18.60	47.80	N.A.
Net loss ratio (%)	64.20	71.40	71.50	75.10	73.80
Administrative expense ratio (%)	17.10	16.00	15.50	15.10	14.50
Acquisition expense ratio (%)	11.30	10.90	9.30	7.90	2.50
Net expense ratio (%)	28.40	26.90	24.80	23.00	17.10
Net combined ratio (%)	93.10	98.30	96.20	98.10	92.70
Operating ratio* (%)	90.70	95.40	94.80	95.30	N.A.
Life					
Life revenue	7,193.10	6,423.10	6,619.70	6,111.30	5,676.00
Growth in net life technical reserves (%)	12.60	7.00	17.90	21.30	N.A.
Life surplus available for distribution	838.1	466	502.5	488	514
Policyholders' bonus/surplus (%)	0.40	0.60	0.60	0.70	N.A.
Smoothed pretax ROA (before bonus allocation)	484.7	280.5	347.5	413.4	N.A.
Post-tax ROA (after bonus allocation) (bps)	482.8	278.8	345.4	410.6	N.A.
Unsmoothed pretax ROA (before bonus allocation)	484.7	280.5	347.5	413.4	N.A.
Growth in expenses (%)	0.40	(2.10)	0.70	7.10	N.A.
Administrative expense ratio (%)	6.60	7.90	8.60	8.20	11.60
Acquisition expense ratio (%)	8.60	8.30	8.70	9.60	6.20
Total gross expenses/gross premiums written (%)	15.20	16.20	17.30	17.80	17.80
Total net life expenses/total life assets (bps)	480.5	498.3	584.8	711.2	1,351.20
Maintenance expenses/gross premiums written (%)	6.50	7.90	8.60	8.20	11.60
Investments					
Life assets/total assets (%)	47.50	47.50	55.70	46.70	55.70
Net investment income	1,792.10	1,624.10	830.6	1,184.20	537
Realized gains/(losses)	532.7	654.7	506.4	2.3	205.9
Unrealized gains/(losses)	622.3	371.6	1,528.30	1,210.20	(18.8)
Direct yield on invested assets (%)	5.40	5.60	3.40	5.90	N.A.
Yield (incl. realized) (%)	6.90	7.90	5.50	5.90	N.A.
Total return (incl. unrealized and realized) (%)	8.80	9.20	11.90	11.90	N.A.

*Based on allocated investment income. PLZ—Polish zloty. Bps—Basis points. N.A.—Not available.

PZU's operating performance is very strong, driven primarily by its strong competitive position in both life and non-life in a growing insurance market. The strength of PZU's operating performance is also supported by a low cost base compared with that of its peers. Non-life business was a primary contributor (65%) to net income in 2004, and is expected to remain as such in the medium term. Going forward, operating performance is expected to further improve as a result of operational modernization further reducing PZU's cost base and fine-tuning underwriting resulting in a lower loss ratio.

With regard to PZU's non-life business, the group is projected to invest PLZ1.1 billion in restructuring, which will bring cost savings of PLZ350 million per year (on average), translating into an excellent average combined ratio over the next five years (covering the current cycle) of 90.5% (91.0% in 2004) and average ROE of 27.7% (29.5% in 2004). PZU's projected investment in life business is about PLZ475 million, which will bring cost savings to about PLZ100 million-

PLZ115 million per year. This should result in a reduction in the cost ratio (costs/gross premiums written) to 12.1% in 2009, from 16.9% in 2004.

Prospective

In Standard & Poor's view, this level of performance is sustainable, and PZU is therefore expected to continue to deliver very strong results, with a net combined ratio of 90.5% (based on company projections), ROE in excess of 25%, and a return on embedded value in excess of 7% over the cycle.

Investments

PZU's investment portfolio is regarded as good. Regulations limit the amount of overseas investment, thereby restricting diversity. The lack of availability of suitably long-dated investments precludes accurate asset-liability management.

Credit risk

Credit risk is low, as about 62% of total investments are held in Polish government local currency debt issues (rated 'A-').

Market risk

Market risk is medium. Of invested assets, 10% are in listed equities, representing about 40% of adjusted shareholders' funds. PZU has some exposure to nonlisted equity participations, for which the information available is limited.

Asset-liability management

Although in general assets and liabilities appear to be fairly closely matched, reinvestment risk exists for liabilities with maturities in excess of 10 years at PZU Zycie, where the situation is more exposed to risk. Suitable assets match about 3% of these liabilities.

Liquidity

Liquidity is regarded as strong. The stress test liquidity scenario was estimated by actuaries using the 1997 Polish flood—the biggest flood in Poland in the past 50 years—and fully matched by short-term assets and T-bonds available for sale (PLZ2,867 million versus PLZ2,891 million). PZU does not maintain bank lines or a CP program. The need to use such facilities is minimal, however, as the group has sufficient internal liquidity and good reinsurance cover for catastrophic loss.

Capitalization

Capitalization is strong, reflecting a very strong level of capital adequacy, strong quality of capital, adequate reserving, and a conservative reinsurance program.

Capital adequacy

According to Standard & Poor's risk-based capital model, PZU had a very strong capital adequacy ratio at Dec. 31, 2004. The group's capital strength comes from the non-life operations, which, on a stand-alone unconsolidated basis, had exceptionally strong capital adequacy at year-end 2004. PZU Zycie's capital adequacy is good and consistent with its status as a core operating entity under Standard & Poor's group methodology. Overall quality of capital is good.

Polish government debt represents more than 60% of group-invested assets. There is, therefore, some sensitivity in capital requirements for investment risk relating to any adverse change in the ratings on these instruments.

Reserves

Reserve adequacy at PZU is satisfactory. PZU uses independent consultant actuaries to verify reserve adequacy on non-life operations. Tillinghast-Towers Perrin has recognized PZU S.A.'s reserves as sufficient and has underlined PZU's conservative approach toward reserving policy.

Reinsurance

PZU's reinsurance program provides suitable levels of coverage, with a panel of highly rated reinsurers (more than 80% of reinsurance receivables are rated 'A' and higher). The group continues to benefit from unlimited protection on TPML. Upper protection on the catastrophe excess-of-loss program is PLZ700 million, which, in combination with the catastrophe reserves, provides cover in excess of the probable maximum loss of PLZ740 million (one-in-150-year event).

Financial Flexibility

Table 4

PZU/Financial Statistics

	—Year ended Dec. 31—				
(Mil. PLZ)	**2004**	**2003**	**2002**	**2001**	**2000**
Consolidated					
Total assets	38,428.80	34,368.20	30,369.30	25,677.30	20,826.30
Change in total assets (%)	11.80	13.20	18.30	23.30	N.A.
Total adjusted equity	8,799.90	6,881.70	5,377.80	3,950.10	2,487.90
Change in adjusted equity (%)	27.90	28.00	36.10	58.80	N.A.
Total capital	8,799.90	6,881.70	5,377.80	3,950.10	2,497.70
Group solvency measure (x)	4.6	3.8	3	2.5	1.8
Reinsurance exposure ratio (%)	14.30	22.20	31.90	42.30	61.30
Investment leverage (incl. policyholder capital) (%)	55.30	55.60	32.90	46.60	152.90
Liquid assets/technical reserves (%)	132.40	128.50	119.90	115.20	107.40
Non-life					
Reinsurance utilization ratio (%)	7.20	7.40	6.80	16.60	20.00
Technical reserves/net premiums written (%)	136.40	136.40	119.40	114.40	109.80
Loss reserves/net premiums written (%)	85.30	85.40	75.90	74.40	64.90
Net technical reserves/gross technical reserves (%)	84.70	82.40	77.80	74.00	74.40
Net claims reserves/net claims incurred (%)	136.20	120.20	114.00	102.90	97.00
Net claims paid/net claims incurred (%)	95.60	84.90	84.90	78.10	80.90

PLZ—Polish zloty. N.A.—Not available.

PZU's adequate financial flexibility is driven by:

- Minimal requirements for additional external funding, with sufficient capitalization to meet expected growth;
- A debt-free balance sheet; and
- Sufficient reinsurance capacity.

Nevertheless, if a need for capital arises, the availability of funding from existing shareholders is likely to be low, and this is a limiting rating factor. Should the group wish to enter the debt market, any issue is likely to be heavily oversubscribed in a market where little quality corporate debt exists, although this has not been tested. The possibility of an IPO is likely to further enhance PZU's financial flexibility, but Standard & Poor's considers this possibility to be still remote at present, and has not factored this into its assessment of PZU's financial flexibility.

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