STANDARD & POOR'S

INSURANCE CREDIT REPORT

Powszechny Zaklad Ubezpieczen S. A.

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RATING A-/Negative/— (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.

RELATED RATINGS

Powszechny Zaklad Ubezpieczen na Zycie S.A.

Financial Strength Rating
Local currency A-/Negative/—

HOLDING COMPANY

None

GROUP MEMBERS

None

DOMICILE

Poland

LICENSED

None

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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;
- Uncertainty surrounding the future direction of the company, and the impact of the new CEO on the group and senior management team; and
- The risk of political intervention into company operations at any time.

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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 uncertainty surrounding the future direction of PZU, the impact of the new CEO on the group and senior management team, and the risk of political intervention into the operations of PZU at any time particularly whilst group's future ownership remains unresolved.

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.

Outlook

The uncertainty about the direction of PZU in the future, and the effect of the new CEO and senior management team supports the negative outlook. Even if the new management remains fully committed to the reforms initiated by PZU at the end of the past year, and confirms their intention to maintain the unchanged strategic direction, the risk of political intervention into PZU's operations at any time remains. The consequences of which may be disruptive and unpredictable.

If these concerns are alleviated, the outlook will be revised to stable subject to meeting Standard & Poor's Ratings Services additional expectations:

- PZU is expected to continue to demonstrate a 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.

The ratings could be lowered if the investment strategy, capital management, or dividend policy change, and if the continuation of the modernization and restructuring project initiated in 2004 by the former CEO is halted.

Corporate Profile: The Leading Universal Polish Insurer

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 48,9% and 39,8%, respectively. The group is also No. 3 in pensions and No. 14 in mutual funds, with market shares of 13.7% and 1,4%, respectively. The group had total assets of Polish zloty (PLZ) 43 billion ($13.6 billion) and gross premium income of PLZ13.7 billion at year-end 2005. 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 June, 2006, PZU's shareholders were the Polish state treasury (55.1%), Eureko B.V. (Eureko; core operating entities are rated A+/Positive/—) (32,1%), and other (12,8%).

Competitive Position: Unrivaled Market Leader In Poland

Table 1

PZU/Business Statistics

	—Year ended Dec. 31—				
(Mil. PLZ)	**2005**	**2004**	**2003**	**2002**	**2001**
Consolidated					
Total assets under management	40,816	36,802	32,869	27,663	22,974
Nonlinked (%)	95.6	96.5	95.8	95.6	95.3
Linked (%)	4.4	3.5	4.2	4.4	4.7
Annual change (%)	10.9	12.0	18.8	20.4	20.7
Non-life					
Gross premiums written	7,652	7,483	7,219	7,392	7,520
Net premiums written	7,252	6,945	6,687	6,889	6,268
Annual change (%)	4.4	3.9	(2.9)	9.9	0.0
Life					
Gross premiums written	6,096	5,480	5,127	4,898	4,711
Premiums, consideration, and deposit revenue increase (%)	11.2	6.9	4.7	4.0	0.0
Change in long term business provision (%)	6.9	14.3	5.9	19.3	17.6
Change in linked reserves (%)	37.0	-7.23	14.4	13.6	46.0
Reinsurance utilization ratio (%)	3.0	4.2	4.4	4.1	10.2

PLZ—Polish zloty.

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 with cross-sell potential.

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 can bring a higher level of operational efficiency and customer service, thereby cementing PZU's position in the market. During 2003-2005, PZU made meaningful acquisitions in the Lithuanian and Ukrainian insurance markets. The Ukrainian market where PZU is in seventh place in non-life and tenth place in life, in particular, offers excellent potential for profitable growth (in 2005, the non-life market grew by 138.2% and life by 185.6%). In Lithuania, the non-life market grew by 10.8% and in life by 23.1%. PZU holds a strong position in Lithuania, with a 14.5% share of the market in non-life, and 2.7% in life. However, in Standard & Poor's view, tangible benefits from this diversification can 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 48.9% of the non-life market, 39.8% of the life market, and 44.4% of the overall insurance market in 2005. PZU's nearest competitors had 11.5% of the non-life market (Towarzystwo Ubezpieczen i Reasekuracji WARTA S.A. {Warta; BBBpi}) and 12.4% of the life market (Commercial Union). This dominance may marginally reduce, but is viewed as sustainable in the medium term as the group can 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 has been initiated by in 2004.

Non-life

The strongest component of PZU's competitive position is PZU S.A.'s undisputable leading position in the Polish non-life market (48.9% of PZU's gross premiums written), where it has a relatively diversified portfolio (TPML 37.0%, other motor damage 34.9%, property 17.0%, accident and health 9.2%, and other 1.9%). 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 4.8 percentage points lower (on average) than the market average of 93.6% over the past two years, and is sustainable. PZU S.A. is expected to reduce its concentration on motor business in the long term 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 69.4% market share. PZU Zycie's position in individual business is weak, with only an 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, 77% immediately recognized the group and 91% recognized it with some prompting.The second best recognized brand in Poland is Warta, although this has a lower level of recognition, 31% and 63%, respectively (source: Pentor, 2005).

Unrivaled distribution capabilities

PZU's distribution network is unrivaled in size and reaches every corner of Poland, with more than 800 sales points and 12,438 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), Powszechna Kasa Oszczednosci Bank Polski (S.A.) (BBBpi), Deutsche Bank PBC S.A (not rated), and Bank Ochrony Srodowiska S.A. (not rated), and hold about 20% share of the bankassurance market (PZU Group's estimation).

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: Uncertain Future Direction Of PZU

The uncertainty surrounding the future direction of PZU, and the impact of the new CEO on the group and senior management team are negative contributors to the ratings. Even if the new management remains fully committed to the reforms initiated by PZU at the end of the past year, and confirms their intention to maintain the strategic direction as unchanged, its ability to implement this restructuring is unproven. Historically, 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 history appears to have just repeated itself once again. In addition, PZU has no role in the resolution of its ownership issue, disputed by Eureko. Therefore, management will continue to operate or merely acting as a 'care-taker management' under the continuous pressure of uncertainty, unaware of the impact that ownership resolution may have on the group's strategic direction, capitalization, financial flexibility, and on the senior management team. Previous management made strong progress in implementing its modernization and restructuring plans in 2004 and 2005 within PZU, and had very convincing plans and the ability to turn PZU into an even more profitable vehicle, with possible leading positions well beyond Poland. The progress achieved will allow PZU to sustain its positions in Poland in the medium term, but if continuous restructuring is halted now, the lost opportunities may limit PZU's competitive advantages in the future. Furthermore, the ratings are based on the assumption that capitalization will be maintained at a strong level, but risk remains that extraordinary dividends may have to be paid before the IPO/transfer of ownership. Being left with reduced 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 five 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.

Any resolution of PZU's ownership that ensures no further political interference in PZU is likely to be positive for the ratings on PZU.

Strategy

PZU's five-year business and financial objectives to support the strategy have been developed by the previous management, continuality of which is uncertain. The highlights are to:

- Grow premium income at 75% of market growth.
- Keep the combined ratio less than 92%.
- Grow embedded value by a discount rate plus one percentage point.
- Generate ROE of more than 20%.
- Expand market share to 15% in the second pillar pension market measured by net asset value.
- Generate 8% of the group's premium income on foreign markets.
- Cut the cost ratio: Life from 10% to 6%, non-life from 15% to 10%.
- Remain the top insurer in Central and Eastern Europe.
- Automate and centralize back-office processes, and
- cut claims handling duration by one-half.

Standard & Poor's regarded this strategy, supported by strong and clear implementation plans as appropriate for PZU, but challenging. Past management's track record and ability to deliver on the targets was plausible. The accomplishments during 2005 were noteworthy, particularly in IT modernization, improvements in sales/distribution network, claims handling, asset management integration, and the centralization of the real-estate management.

Operating Performance: Very Strong Performance Helped By A Strong Investment Income

Table 2

PZU/Operating Statistics

	—Year ended Dec. 31—				
(Mil. PLZ)	**2005**	**2004**	**2003**	**2002**	**2001**
Reported EBITDA	3,996	2,605	2,048	1,843	1,523
Reported EBITDA excluding nonrecurring items	3,996	2,605	2,048	1,843	1,523
EBITDA excluding realized and unrealized gains	2,811	1,530	1,022	-192	310
ROE—reported equity (%)	33.4	28.3	27.1	30.4	38.8
Consolidated					
EBITDA (excluding nonrecurring)/ total capitalization (%)	39.2	31.5	31.2	38.4	45.3
Gross expense ratio (%)	23.0	22.8	22.8	21.7	20.9
Administrative expense ratio (%)	14.4	14.5	13.1	13.6	12.8
Acquisition expense ratio (%)	8.8	8.8	10.1	8.4	8.3
Non-life					
ROR (%)	11.3	6.9	4.3	3.8	1.9
Net expense ratio (%)	30.3	29.7	27.9	25.3	23.7
Net combined ratio (%)	89.8	93.9	96.6	96.9	98.8
Life					
Post-tax return on technical reserves (bps)	729	415	249	300	349
Direct yield on invested assets (%)	6.0	5.4	5.6	3.4	5.9
Five-year capital gains/total invested assets (%)	1.1	1.1	0.0	0.0	0.0

Table 2

PZU/Operating Statistics (cont.'d)					
	—Year ended Dec. 31—				
(Mil. PLZ)	2005	2004	2003	2002	2001

PLZ—Polish zloty. Bps—basis points.

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 and strong investment income. 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 (55%) to net income in 2005, although its contributions are diminishing (64% in 2004). Going forward, operating performance can further improve if operational modernization continues, which will further reduce PZU's cost base and fine-tune underwriting resulting in a lower combined ratio.

With regard to PZU's non-life business, the group was projected to invest PLZ1.1 billion in restructuring under the old management, which expected to 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% (86.8% in 2005 due to a lower loss ratio) and average ROE of 27.7% (33.4% in 2005). PZU's projected investment in life business was about PLZ475 million, which expected to 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 15.8% in 2005 (18.1% in 2004).

Prospective

In Standard & Poor's view PZU's very strong performance is sustainable in the medium term with a net combined ratio less than 93% (based on the past three-year average), ROE in excess of 25%, and a return on embedded value in excess of 7% over the cycle.

Investments: Weak Diversity Due To Exclusive Exposure To Poland

Table 3

PZU/Investments					
	—Year ended Dec. 31—				
(Mil. PLZ)	2005	2004	2003	2002	2001
Life assets/total assets (%)	58.0	59.0	60.3	63.2	64.2
Realized gains/(losses)	474	483	655	506	2
Unrealized gains/(losses)	711	592	372	1,528	1,210
Direct yield on invested assets (%)	6.0	5.4	5.6	3.4	5.9
Total Investment return (including unrealized and realized) (%)	9.2	8.6	9.2	11.9	11.9
Investment in affiliates (%)	0.8	0.6	0.7	0.7	0.8
Loans to affiliates (%)	0.0	0.0	0.0	0.0	0.1
Bonds and other fixed interest securities (%)	78.5	80.6	78.6	89.5	87.9
Mortgages (%)	0.0	0.0	0.0	0.0	0.2
Equities and other variable interest securities (%)	10.0	10.0	7.7	5.0	6.2
Property (%)	2.9	3.1	3.7	1.0	1.4
Cash and bank deposits (%)	3.0	2.5	9.2	3.8	3.3
Loans and private placements (%)	4.9	3.1	0.0	0.0	0.0
Total nonlinked investments (%)	95.6	96.5	95.8	95.6	95.3
Assets held to cover linked liabilities (%)	4.4	3.5	4.2	4.4	4.7

Table 3

PZU/Investments (cont.'d)

	—Year ended Dec. 31—				
(Mil. PLZ)	**2005**	**2004**	**2003**	**2002**	**2001**
Liquid asset/nonlife technical reserves (%)	565.3	512.3	498.4	488.9	458.0
Cash in/out (%)	140.4	135.8	132.2	128.7	134.3
Debtor days less creditor days	17.9	16.4	17.9	19.3	24.9
Operating cash flow ratio (old basis) (%)	142.0	138.6	139.1	147.6	152.7

PLZ—Polish zloty.

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. Falling interest rates, the overheated stock market, and the asset liability matching gap prompted PZU to take efforts to diversify its asset portfolio into alternative assets (hedge funds, private equity, and real estate). The performance on the alternative asset market is uncertain, but the investment in alternative assets is capped at PLZ 500 million, which is a mere 4.5% of shareholders equity (excluding equalization reserve).

Credit risk

Credit risk is low, as about 70% of total investments are held in Polish government local currency debt issues (rated 'A-').

Market risk

Market risk is high. Of invested assets, 8.1% are in listed equities and 11.5% are in unlisted shares representing about 77% of shareholders' equity (excluding equalization reserve). Unlisted shares consistent essentially of PZU group companies.

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 23% of these liabilities.

Liquidity: Consistently Strong Cash In/Out Trend

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 (PLZ3,215 million versus PLZ6,827 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: Capital Is Ample, If Kept In The Group

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, 2005 (capital adequacy ratio more than 200%). The model also incorporates a charge for a full retention of a one-in 250 years event. 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 2005. 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 70% 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 90% 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 PLZ1,000 million, which, in combination with the catastrophe reserves, provides cover in excess of the probable maximum loss of PLZ860-920 million (one-in-250-year event).

Financial Flexibility: No Need For Capital In The Medium Term

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.