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PZU Group

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Table Of Contents

Table Of Contents (cont.)

PZU Group

Please note that the ratings covered by this full analysis apply only to core entities of the group, which are listed below. These ratings do not apply to any noncore or nonrated entities of the group. Ratings assigned to noncore entities of the group are published individually.

Major Rating Factors

Operating Companies Covered By This Report
Financial Strength Rating
Local Currency
A/Stable/--

Strengths:

- Strong competitive position.
- Very strong operating performance.
- Strong capitalization.

Weaknesses:

- Execution risk associated with the group's modernization strategy.
- Concentration of investments in Polish government securities.

Rationale

The ratings on Polish non-life insurer Powszechny Zaklad Ubezpieczen S.A. (PZU S.A.) and Polish 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, very strong operating performance, and strong capitalization, in Standard & Poor's Ratings Services' view. The ratings are constrained, however, by execution risk associated with the group's modernization strategy and concentration of investments in Polish government securities.

PZU has a strong competitive position, owing to its significant position in the Polish insurance market, unrivaled distribution capabilities, and high brand recognition among the Polish population. We consider PZU's operating performance to be very strong, primarily because of the group's strong competitive position in life and non-life business, which translated into a five-year average return on equity of more than 25% in 2009. The strength of PZU's operating performance is also supported by lower distribution costs than those of domestic peers.

PZU's capitalization is strong, in our view, reflecting extremely strong capital adequacy, even after an extraordinary dividend of Polish zloty (PLN) 12.75 billion (about $4.42 billion) in 2009. We anticipate that capital adequacy should remain at least very strong. Further supporting factors are strong capital quality, adequate reserving, and a conservative reinsurance program.

Execution risk relating to PZU's modernization strategy is a relative rating weakness. We believe that implementation of some aspects of the modernization program will be challenging and require management's full capacity in the medium term, owing to the need for a significant cultural change within the organization. However, we believe the current management is well placed to implement these initiatives, which are paramount to PZU maintaining its competitive position in the medium term.

Further rating constraints are that PZU invests predominantly in Polish government securities, and regulation limits the amount of overseas investment. Consequently, we believe that PZU's ability to invest in assets of appropriate duration for its life insurance liabilities and to diversify its investment portfolio is restricted.

The ratings on PZU are based on our assessment of the group's stand-alone credit profile (SACP). However, we also regard PZU as a government-related entity (GRE) because the Ministry of Treasury of the Republic of Poland (foreign currency A-/Stable/A-2; local currency A/Stable/A-1) is its main shareholder. In our opinion, there is a "moderately high" likelihood that the government of Poland would provide timely and sufficient extraordinary support to PZU in the event of financial distress. This assessment is based on our view of PZU's "important" role for and "strong" link with the Polish government. Nevertheless, the ratings on PZU do not benefit from an uplift because of its GRE status, according to our GRE methodology.

Outlook

The stable outlook reflects our expectation that PZU will maintain its strong competitive position and generate a very strong operating performance through the cycle. We expect PZU to report a return on equity in excess of 15% and net income of more than PLN2 billion in 2010 and 2011. The net combined (loss and expense) ratio is likely to be at least 98% in 2010, and we expect further improvements in 2011 in the absence of large natural catastrophes. We expect PZU to maintain strong capitalization and strong quality of capital.

A negative rating action on the local currency ratings on Poland could trigger similar rating actions on PZU. Downward pressure on the ratings could also arise if PZU is unable to successfully implement the modernization strategy or underperforms relative to its targets.

We see limited upside rating potential in the short term, in line with our view of PZU's business and financial profile as stable and because of PZU's significant investments in Polish government securities.

Corporate Profile: The Leading Universal Insurer In Poland

PZU is Poland's largest insurance group and leads the non-life and life insurance markets with shares of 37% and 32.8%, respectively. The group is also No. 3 in pensions with a market share of 14.8%. PZU's assets totaled PLN53.2 billion and its gross premiums income PLN14.4 billion at year-end 2009.

As of May 13, 2010, PZU's shareholders were Poland's Ministry of Treasury (45.19%), Dutch-based Eureko B.V. (core operating entities rated A+/Negative/--; 12.99%), and free float and other (41.81%). In November 2009, PZU paid an extraordinary dividend of PLN12.75 billion as part of an agreement between the Ministry of Treasury and Eureko to resolve a 10-year dispute and to agree on a medium-term divestment of Eureko's PZU shares.

PZU was floated on the Warsaw Stock Exchange on May 12, 2010. New shareholders now represent about 30% of the company's share capital.

Government Support And GRE Methodology Impact

The 'A' rating on PZU reflects our assessment of the group's SACP. We consider PZU a GRE. In accordance with our criteria for GREs, our view of a "moderately high" likelihood of extraordinary support for PZU in the event of financial distress is based on our assessment of PZU's:

- "Important" role for the government, owing to PZU's dominant position as Poland's largest insurance company and its strong market penetration in non-urban regions; and
- "Strong" link with the government, owing to the state's majority shareholding of 45.2% in PZU and PZU's investments in government securities, which makes it the largest single investor in Polish sovereign debt.

Although we consider PZU a GRE, the ratings on PZU do not benefit from an uplift because our assessment of PZU's SACP is level with the local currency rating on Poland. Moreover, we believe that Poland will likely continue to divest part of its shareholding in PZU, in line with its strategy to raise funds from the privatization of state assets. The government sold a 10% stake in May 2010, reducing its shareholding to 45.2%.

Competitive Position: Unrivaled Market Leader In Poland

Table 1

PZU Group/Competitive Position*

	--Year-ended Dec. 31--				
(Mil. PLN)	**2009**	**2008**	**2007**	**2006**	**2005**
Total invested assets	49,792	55,890	50,245	46,968	40,816
Total revenue	17,441	17,156	17,291	17,291	15,577
Gross premiums written	14,363	14,563	15,462	15,454	13,748
Annual change in gross premium written (%)	(1.4)	(5.8)	0.1	12.4	6.1
Property/casualty gross premiums written	8,022	8,433	8,196	7,864	7,652
Property/casualty: Annual change in gross premiums written (%)	(4.9)	2.9	4.2	2.8	2.3
Life gross premiums written	6,341	6,130	7,266	7,590	6,096
Life: Annual change in gross premiums written (%)	3.4	(15.6)	(4.3)	24.5	11.2

*Consolidated. 2005-2007 under Polish accounting standards. 2008-2009 under International Financial Reporting Standards. PLN--Polish zloty.

PZU's strong competitive position stems from the group's significant foothold in the Polish insurance market, both in the non-life and life business segments, complemented by pension and asset-management activities; as well as from very strong brand recognition, unrivaled distribution capabilities, and cross-selling potential.

The competitive advantages of operating in Poland also bring some geographic concentration, but PZU is also developing a presence in Ukraine and Lithuania. In 2002-2005, PZU made meaningful acquisitions in the Lithuanian and Ukrainian insurance markets. Nevertheless, we believe tangible diversification benefits from these operations can only materialize in the medium to long term.

Modest industry risk

We consider industry risk in Poland to be modest, largely as a result of EU membership, which has brought reform to Poland's legal and regulatory landscape. Insurance regulation in Poland is now largely aligned with that in Europe. There are no significant barriers to entry in Poland, and many Western European insurers active in Central Europe are established in Poland.

Significant position in the Polish insurance market

PZU maintains a significant position in Poland with large market shares in 2009 in non-life (37%), life (32.8%), and pension (14.8%) business. PZU is 3x-4x larger than its closest competitors in non-life and life insurance, which in our view further underpins PZU's strong market dominance. Considerable competition from new market entrants in recent years, however, has led to a loss of market share.

Non-life

The strongest component of the group's competitive position is PZU S.A.'s undisputed leadership in the Polish non-life insurance market (56% of the group's gross premiums written). PZU S.A.'s primary insurance portfolio comprises third-party motor liability (TPML; 33.7% of 2009 non-life gross premiums written), other motor damage (28.4%), property (20.6%), accident and health (11.3%), and other (6%). There is some concentration in motor, but the company has sustainable and significant scale and cost advantages, compared with peers, as a result of its agency distribution network. We believe PZU S.A. can defend its market dominance in non-life and expect the company to gradually reduce its concentration in motor business in the medium term.

Life

The second pillar of PZU's competitive strength is PZU Zycie's significant position in the Polish life insurance market. PZU Zycie maintains a relatively stronger position in group life, than in individual-life business. Like the non-life entity, PZU Zycie enjoys sustainable cost advantages over its peers, due to its distribution network and well-known brand. We believe PZU Zycie will find it challenging to significantly increase its share of individual-life insurance business, but we expect it to maintain its strong presence in group business. PZU Zycie also started writing health insurance policies in 2001, with good growth rates so far, albeit on a relatively small level. Health gross premiums written totaled PLN41 million in 2009. We believe PZU Zycie to be well placed to establish a good position in health insurance in Poland if the market is more liberalized and private insurers are allowed to manage public health funds.

Very strong brand recognition

We believe PZU's brand recognition as a financial institution in Poland is extremely strong at 89% compared with that of the closest competitors that maintain a brand awareness of 55% or lower, based on data we received from PZU. We believe PZU's very strong brand recognition will remain a competitive advantage over the next few years.

Unrivaled distribution capabilities

PZU has the largest and most extensive distribution network in Poland, with more than 700 local branches and more than 12,000 agents. The agency network is a key support to PZU's stronger position in the smaller cities and rural areas than in the large cities. PZU also has a strong presence in the large cities, but it is here that the group experiences the most competition. Of the non-life portfolio, 58% of business is sold by agents, 28% by permanent employees, 13% by brokers, and 1% directly by PZU. Permanent employees sell about 46% of the life products, banks 49%, and agents 5%. Bancassurance distribution in 2008 and 2007 has gained importance in the Polish life insurance market and PZU is already actively marketing its products through a number of banks. Growth in life insurance stemmed mainly from single-premium tax-advanced bank deposits with relatively lower margins. This business, however, showed volume declines in 2009 and so far in 2010, but this should not weigh materially on PZU's profitability, in our view.

Prospective

PZU's non-life and life units will, in our view, remain a key driver of the group's competitive position, revenue generation, and earnings. In our view, the Polish insurance market--and life insurance in particular, typical of developing markets--continues to have substantial growth potential because the overall demand for insurance is increasing and the private property and health insurance sectors are underdeveloped. PZU is, in our view, well positioned to participate in this growth, and we believe it will continue to defend its market leadership and dominance. However, we expect PZU's market shares in non-life and life to decrease moderately this year, owing to its desire to maintain underwriting discipline and more intense competition in the Polish insurance market.

Management And Corporate Strategy: A Capable Management Team, But We See Execution Risks Associated With The Modernization Strategy

PZU's management has changed considerably over the past few years. As we understand, this is at the instigation of the main shareholder, the Polish government, resulting from changes in government. The current management team, in place since December 2007, has a clearly defined strategy and is focused on becoming a major financial institution in Central and Eastern Europe (CEE) by expanding in Poland and entering CEE markets that offer significant opportunities for growth. Cost control is another key strategic focus. Management aims to use more advanced technology to better exploit the combined scale of PZU's businesses in Poland and distribution and operational opportunities.

We believe PZU's management team is capable of implementing the new strategy, rationalizing PZU's cost base, and achieving cultural change within the organization to reposition the group for the evolving insurance landscape in Poland and CEE. However, we also believe that the modernization strategy poses execution risk and will continue to require management's full attention. This is especially because PZU is a major employer in Poland and management intends to lay off 4,000 full-time employees by 2012.

The long-running ownership dispute between shareholders Eureko and the Polish Ministry of Treasury ended in a settlement and divestment agreement concluded on Oct. 1, 2009. During the IPO process in May 2010, Eureko disposed of a substantial portion of its PZU shares. We believe that the settlement of the dispute and the successful IPO support PZU's modernization strategy and could improve corporate governance.

Operational management

Management of PZU is currently decentralized. The life and non-life businesses report to the group on risk management and financial reporting, but operating and product strategies are based on conditions within individual product lines. In line with its modernization strategy, PZU is likely to further rationalize its organizational structure to support management's focus on harnessing and extracting value from existing operations.

Financial and risk management

PZU's financial risk tolerance is low, in our view. We consider financial management conservative. It focuses on maximizing the internal rate of return on new business and managing the in-force business to improve the return on capital employed. PZU also minimizes risk by adopting what we regard as a relatively cautious investment strategy. It maintains capital at a very strong level relative to risk.

Accounting

PZU's annual report and financial statements for 2009 and 2008 were prepared in accordance with International Financial Reporting Standards, while those for previous years were according to Polish generally accepted accounting principles. We have analyzed PZU life's operating performance using unaudited supplementary embedded-value information, based on European Embedded Value principles. The accounting policies have not raise any rating concerns.

Enterprise Risk Management: Of Moderate Importance For The Ratings, Given Our View Of PZU's Strong Capitalization

We regard PZU's enterprise risk management (ERM) as adequate, reflected in adequate risk controls for its main risks: market, asset-liability management (ALM), and insurance risks. We do not expect PZU to experience losses outside the normal ranges from traditional risk areas. PZU has operational risk-management functions. The risk-management process is classical and not yet part of a holistic system. PZU is mainly exposed to risks associated with its corporate governance structure; credit risk because PZU's entire investment portfolio is exposed to the Polish economy, 78% of which is to Polish government securities; reinvestment risk associated with life insurance liabilities with durations in excess of 10 years; and flood catastrophes.

ERM is of low to moderate importance for the ratings, given our view of PZU's currently strong capitalization.

PZU has an adequate risk-management culture, in our view. The group has initiated activities to reinforce risk management by implementing a new system that complies with the EU's proposed Solvency II requirements.

We regard the individual risk controls for underwriting, reserving, catastrophes, reinsurance, ALM, and credit risks as consistently adequate. PZU uses modeling extensively within the individual risk-management areas, with some interactions, but a holistic system is not yet in place.

Operating Performance: Very Strong, Thanks Partly To Strong Investment Income

Table 2

PZU Group/Operating Statistics*

	--Year-ended Dec. 31--				
(Mil. PLN)	**2009**	**2008**	**2007**	**2006**	**2005**
EBIT	4,602	2,931	4,477	4,627	3,994
Return on equity (%)	24.0	12.6	23.9	30.7	33.4
Return on revenue (%)	20.0	27.4	23.4	20.1	18.0
Life return on revenue (%)	39.8	30.9	35.9	32.7	19.4
Property/casualty return on revenue (%)	28.0	32.3	15.6	19.1	18.2
Property/casualty net loss ratio (%)	69.3	63.2	60.3	55.7	59.5
Property/casualty total net expense ratio (%)	29.7	28.1	28.3	27.7	25.7
Property/casualty net combined ratio (%)	99.0	91.3	88.6	83.4	85.2

*Consolidated. 2005-2007 under Polish accounting standards. 2008-2009 under International Financial Reporting Standards. PLN--Polish zloty.

PZU's operating performance is very strong, in our view, primarily because of its strong competitive position in life and non-life business, in an expanding market, and strong investment income. This has channeled into a very strong five-year average return on equity exceeding 25% in 2009 and net income of consistently more than PLN2 billion over the past five years. Life business was the primary contributor (71.3%) to operating profit in 2009, benefiting from high profit margins, mainly in group life. PZU's strong operating performance is also supported by lower distribution costs than peers' and strong investment results in a still comparably favorable interest rate environment in Poland; the 10-year government bond yield was close to 6% after first-quarter 2010. We expect PZU's operating performance to improve on the back of the modernization initiatives, in particular, those relating to the rationalization of PZU's cost base.

In 2009, sizable flood-damage claims, higher claims from corporate business, and increasing competition, mainly in motor, depressed PZU's non-life profitability. The combined ratio therefore increased to 99% in 2009 from 91% the year before. Corporate motor business was again unprofitable in 2009, and PZU is targeting to break even in that line of business by 2012. We believe this target to be challenging, but achievable, given PZU's market dominance and if PZU adheres to underwriting discipline.

Prospective

We believe PZU can continue to transform its market dominance into a very strong operating performance, reflected in a return on equity in excess of 15% and net income of more than PLN2 billion in 2010 and 2011, based on continually sound investment income in Poland's comparably high-interest-rate environment. We expect the net combined ratio in 2010 to be less than 98%, despite large winter claims and floods in May 2010. For 2011, in the absence of larger natural catastrophes, we believe the combined ratio could improve further.

Investments: Lack Of Diversity, Due To Exclusive Exposure To Poland

Table 3

PZU Group/Investment Statistics*

	--Year-ended Dec. 31--				
(%)	**2009**	**2008**	**2007**	**2006**	**2005**
Net investment yield	4.4	4.6	4.7	5.2	6.0
Net investment yield including realized capital gains/(losses)	5.1	3.4	6.1	6.5	7.3
Net investment yield including all capital gains/(losses)	6.5	1.0	5.7	7.9	9.2
Portfolio composition					
Cash and cash equivalents	9.4	15.0	4.1	3.9	3.0
Bonds	77.9	75.6	81.2	73.8	78.5
Common stock	9.6	6.5	7.9	9.5	10.0
Real estate	2.4	2.1	2.4	2.5	2.9
Mortgages	0.7	0.9	4.0	9.8	5.0
Investments in affiliates	0.0	0.0	0.4	0.4	0.8
Other investments	0.0	0.0	0.1	0.1	0.0
Total portfolio composition	100.0	100.0	100.0	100.0	100.0

*Consolidated. 2005-2007 under Polish accounting standards. 2008-2009 under International Financial Reporting Standards.

We consider PZU's investment portfolio strong, although regulation limits the amount of overseas investment, which restricts the diversity of investments. The lack of suitably long-dated investments precludes accurate ALM for the life insurance business. PZU is the largest individual investor in Polish treasury securities, which may limit its ability to maintain stable investment returns in government bond markets in extreme situations.

Credit risk

Credit risk is low, in our view. About 78% of PZU's investments are in Polish government local currency debt issues rated 'A' or 'A-'.

Market risk

Equities represent about 10% of PZU's invested assets. Concentration risk within the equity portfolio is high because almost all of PZU's equity investments (excluding those in group companies) are in Polish companies, 42% of which are in the banking sector.

Asset-liability management

Assets backing non-life liabilities appear to be fairly closely matched. However, significant reinvestment risk exists for life liabilities with maturities in excess of 10 years because of the greater exposure to mismatching risk. Suitable assets currently match only about 30% of these liabilities.

Liquidity: Consistently Strong Cash Inflows And Outflows

We regard PZU's liquidity as strong. Our liquidity stress test incorporated an assumption of a flood similar to that of 1997, the biggest flood in Poland in the past 50 years. We estimate that under this scenario PZU's potential liabilities would be fully matched by short-term deposits with credit institutions and cash (PLN3,642 million versus PLN4,402 million). PZU does not maintain bank lines or a commercial paper program. We see PZU's need to use such facilities as minimal because the group has, in our view, sufficient internal liquidity and good reinsurance cover to mitigate the potential losses from catastrophes.

Capitalization: Strong, Supported By Extremely Strong Capital Adequacy

PZU's capitalization is strong, in our view, reflecting an extremely strong level of capital adequacy. We anticipate that PZU will maintain at least very strong capital adequacy, adequate reserving, and a conservative reinsurance program.

Capital adequacy

PZU's risk-based capital adequacy was extremely strong as of Dec. 31, 2009, although PZU paid an extraordinary dividend of PLN12.75 million in 2009. Capital adequacy also incorporates a charge for a net aggregate one-in-250-year non-life catastrophe event. The group's capital strength emanates from both the non-life and life operations. We anticipate that capital adequacy will be at least very strong over the next 12-18 months. Overall capital quality decreased after the dividend payment in 2009, but remains strong, in our view: Shareholder equity represented about 64% of total adjusted capital.

Reserves

We regard PZU's reserves as adequate. PZU uses independent consulting actuaries to review the reserve adequacy of its non-life business. Tillinghast-Towers Perrin has assessed PZU S.A.'s reserves as sufficient and its approach to reserving as conservative.

Reinsurance

PZU's reinsurance program provides suitable levels of coverage, in our view. The panel of reinsurers is highly rated, and more than 95% of the reinsurance receivables are rated 'A' or higher. The group continues to benefit from unlimited protection on TPML. The upper limit on PZU's catastrophe excess-of-loss program for 2010 is PLN1.2 billion, which provides cover for the probable maximum loss resulting from a one-in-250-year event.

Financial Flexibility: No Need For Additional Capital In The Medium Term

Table 4

PZU Group/Financial Statistics*

	--Year-ended Dec. 31--				
(Mil. PLN)	**2009**	**2008**	**2007**	**2006**	**2005**
Economic capital available	11,182	19,983	16,743	13,229	10,800
Total adjusted capital	10,719	19,551	16,731	13,210	10,798
Total assets	53,176	59,359	52,654	49,445	43,042
Reinsurance utilization (%)	1.1	0.9	1.2	1.1	3.0

*Consolidated. 2005-2007 under Polish accounting standards. 2008-2009 under International Financial Reporting Standards. PLN--Polish zloty.

PZU's strong financial flexibility, in our view, derives from its minimal requirements for additional external funding, limited capital needs to fund business growth, very strong underlying earnings, a virtually debt-free balance sheet, and sufficient reinsurance capacity.

Moreover, we believe that the divestment agreement between Eureko and the Polish Ministry of Treasury, coupled with the successful IPO in March 2010, has improved PZU's financial flexibility. We believe the listing on the Polish stock exchange and the resulting broader shareholder base have increased investors' attention on PZU. Should the group wish to enter the Polish debt market, we believe any issue is likely to be oversubscribed in a market where little quality corporate debt exists.

Related Criteria And Research

- Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
- Group Methodology, April 22, 2009
- Interactive Ratings Methodology, April 22, 2009

Ratings Detail (As Of September 16, 2010)*	
Operating Companies Covered By This Report	
Powszechny Zaklad Ubezpieczen S.A.	
Financial Strength Rating	
Local Currency	A/Stable/--
Counterparty Credit Rating	
Local Currency	A/Stable/--
Powszechny Zaklad Ubezpieczen na Zycie S.A.	
Financial Strength Rating	
Local Currency	A/Stable/--
Issuer Credit Rating	
Local Currency	A/Stable/--
Domicile	Poland

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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