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Ratings

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Research Update:

Poland-Based PZU Group Outlook Revised To Stable From Positive On Weaker Business Conditions; Affirmed At 'A-'

April 6, 2020

Overview

- The COVID-19 pandemic has led to volatility in Poland's financial markets, including a material bank equity values, and current environment could constrain growth of PZU Group's earnings from its investments in Polish banks.
- In the uncertain operating environment, we anticipate somewhat lower profits for PZU than in 2018 and 2019, which could hamper the group's achievement of its current strategic performance targets for 2020.
- We are therefore revising our outlook on PZU Group to stable from positive and affirming our 'A-' ratings.
- The outlook is stable because of the group's very robust capital position and strong and stable insurance operations in Poland, which position it well to withstand the economic implications of the pandemic.

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Rating Action

On April 06, 2020, S&P Global Ratings revised its outlook on Poland-based insurer Powszechny Zaklad Ubezpieczen S.A. and its core operating subsidiaries Powszechny Zaklad Ubezpieczen na Zycie S.A. and Towarzystwo Ubezpieczen Wzajemnych Polski Zaklad Ubezpieczen Wzajemnych (together, PZU Group) to stable from positive. We affirmed our 'A-' issuer credit and financial strength ratings on all three entities.

Rationale

Our ratings reflect PZU Group's status as the largest financial conglomerate in Poland with a leading position in life and non-life insurance, sizable asset management operations, and banking operations in the expanding Polish market. We consider that the group's market standing in

Poland, capitalization, and performance in 2019 remained very robust. The group's net income of around Polish zloty (PLN) 3.3 billion (about €780 million) in 2019 was its highest over the past 10 years, resulting from solid insurance results that were materially better than its strategic targets. As such, the insurance operations were able to offset a slight decrease in the banking segment's contributions to PLN515 million from PLN654 million in 2018. The company's insurance premiums continued to improve last year, leveraging on a more diversified portfolio of risks, although competition in motor lines increased slightly.

As in the rest of the Europe, financial and business conditions in Poland deteriorated rapidly toward the end of the first quarter of 2020, due to outbreak of the new coronavirus. This put a strain on external demand in Poland's key export destinations and depressed domestic demand. We consider that uncertainty regarding the future operating environment in Poland has led to volatility of equity values in the banking sector, which declined by around 50% in the first quarter of this year. Given that PZU Group is the single largest investor in Bank Pekao (20%) and Alior (32%), large fluctuations in equity prices of bank stocks could lead to an increase in capital volatility at PZU Group.

Poland's financial sector regulator (KNF) issued recommendation on March 26, that all insurance and bank entities suspend dividends payments in 2020 from 2019 profits. We consider that this recommendation reduce the effect of equity value fluctuations on PZU Group's capital base, while also reducing dividend income for the PZU Group. In our view, the suspension of dividend payments supports the group's capital strength and current creditworthiness. As a result, retained profits will further strengthen PZU Group's already comparably solid capital position, providing an additional capital cushion if needed. According to our risk-based capital model, PZU's capitalization at year-end 2019 remained above the 'AAA' confidence level, as underscored by a Solvency II ratio of 239% in third-quarter 2019. We also believe that KNF's recommendation to limit bank dividends makes Bank Pekao's capital position more resilient. In our view, increased provisioning in 2019 reduces the risk of Alior tapping into its risk transfer facility with PZU.

That said, in our base-case scenario, we consider that the weaker economic conditions will curb future volume and profitability growth at PZU's insurance and banking operations, in particular earnings contribution from the banking segment. We assume the bank earnings contribution is unlikely to increase further and therefore not reach the group's target in its strategic plan of at least PLN900 million for 2020. In addition, insurance business volumes and profitability may decline, in non-life as well as life. However, we project that PZU Group's insurance operations will remain resilient, although its performance will likely be lower than in 2018-2019, which were extraordinarily strong.

Overall, we now expect that PZU Group's performance in 2020 may not materially outperform that of domestic and international peers, which is why we revised our outlook to stable from positive. In our view, non-life business could face lower volumes in non-mandatory lines, higher competition in motor business, as well as an increase in claims on smaller lines like credit, and directors and officers' liability. As such, we now expect that non-life insurance results may converge toward the group's longer-term strategic target of a combined (loss and expense) ratio of around 92%. In life business, the impact may mainly come from lower volume induced by higher-than-usual lapse rates on profitable group life policies. Due to the COVID-19 pandemic, mortality could increase, but under our current base-case scenario, we estimate the profit impact as small. Consequently, we expect that life business will remain very profitable, with a margin of around 20%, and continuation of significant contributions to the group's profit.

We also note that the CEO of Powszechny Zaklad Ubezpieczen S.A. stepped down on March 12, and has already been replaced. This development does not raise immediate concerns regarding the governance or stability of the company. We have seen, in the past, instances of fast and unexpected changes of CEOs with a relatively limited overall impact on the company's operational stability; new CEOs have not radically changed the company's business strategy. As such, we do not think the recent change of CEO would have an immediate negative impact on the group's creditworthiness. Nonetheless, we will closely monitor any potential large strategic shift resulting from the CEO change.

Outlook

The stable outlook reflects our view that the group can sustain its leading business position in Poland, as well as the strength and stability of its capital position and insurance earnings, thereby enabling it to withstand potential further deterioration of the economic environment. In addition, we anticipate that PZU Group's banking and asset management businesses will continue to generate satisfactory earnings.

Upside scenario

In the next 12-24 months, we could consider a positive rating action if the group's:

- Capital adequacy remains consistently at, or above, the 'AA' benchmark while continuing to sustainably pass our hypothetical foreign currency sovereign stress test;
- Banking investments successfully adapt to the changed business cycle and lower interest rate environment to allow further material growth of profit contributions to PZU Group; and
- Insurance performance remains resilient, with the non-life combined ratio at around 92% and the life business margin at around 20%. This should translate into combined insurance and banking contributions that lead to reported net income after tax exceeding PLN2.6 billion.

Downside scenario

We consider a negative rating action remote in the next 12-24 months. However, we could take a negative rating action if, contrary to our current expectations, the group:

- Materially and consistently underperforms its domestic and international insurance peers;
- Substantially increased business or investment risk exposures, leading to higher capital requirements and materially increased risk of earnings volatility; or
- Experienced a material balance-sheet loss that reduces capital below our 'AA' benchmark and brings into question the effectiveness of PZU Group's risk management.

Ratings Score Snapshot

Business risk profile	Strong
IICRA	Moderately high risk
Competitive position	Very strong
Financial risk profile	Strong
Capital and earnings	Very strong
Risk exposure	Moderately high risk

Funding structure	Neutral
Anchor*	a-
Modifiers	0
Governance	Neutral
Liquidity	Exceptional
Comparable ratings analysis	0
Support	0
Group support	0
Government support	0
Financial strength rating	A-

*Although PZU's insurance operations remains very solid, its relatively recent banking investments have a comparably shorter history of stable and resilient group earnings contributions. IICRA--Insurance Industry And Country Risk Assessment.

Related Criteria

- Criteria | Insurance | General: Insurers Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria | Insurance | General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Global Credit Conditions: Triple Trouble: Virus, Oil, Volatility, April 1, 2020
- Credit Conditions Europe: Europe Goes Into Lockdown, April 1, 2020
- European Banks' First-Quarter Results: Many COVID-19 Questions, Few Conclusive Answers, April 1, 2020
- COVID-19: The Steepening Cost To The Eurozone And U.K. Economies, March 26, 2020
- COVID-19 Will Test Insurers’ Resilience, March 26, 2020
- Emerging Markets: Empty Streets And Rising Risks, March 26, 2020
- Bulletin: Polish Alior Bank's Increased Consumer Loan-Related Provisioning Does Not Materially Affect Our Capitalization Forecast, Nov. 8, 2019

- Research Update: Polish Insurer PZU's Core Entities Affirmed At 'A-'; Outlook Remains Positive, Oct. 11, 2019
- Bulletin: European Court of Justice's Ruling Adds Weight To The Polish Banking Sector's Negative Industry Risk Trend, Oct. 10, 2019
- Bank Polska Kasa Opieki S.A., Sept. 30, 2019
- PZU Group Outlook Revised To Positive On Advancing Strategy And Evolving Enterprise Risk Management; Affirmed At 'A-', June 14, 2019
- Alior Bank S.A., Aug. 14, 2019

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Powszechny Zaklad Ubezpieczen S.A.		
Powszechny Zaklad Ubezpieczen na Zycie S.A.		
Issuer Credit Rating	A-/Stable/--	A-/Positive/--
Powszechny Zaklad Ubezpieczen S.A.		
Towarzystwo Ubezpieczen Wzajemnych Polski Zaklad Ubezpieczen Wzajemnych		
Powszechny Zaklad Ubezpieczen na Zycie S.A.		
Financial Strength Rating	A-/Stable/--	A-/Positive/--