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PZU Group

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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

Strengths:

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

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

Weaknesses:

- Concentration of investments in Polish government securities.
- Modernization program that will continue to require intense management attention in the short to medium term.

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, strong operating performance, and strong capitalization, in Standard & Poor's Ratings Services' view. The ratings are constrained, however, by concentration of investments in Polish government securities and the need for management's full attention to successfully perform the group's ongoing modernization program.

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 moreover believe that PZU has successfully transferred its strong competitive position into a strong operating performance, consistently above the market average. This is reflected in a five-year average return on equity (ROE) of about 22% in 2010, a five-year combined ratio of about 93% and a return on European Embedded Value (EEV) of 10% in 2010.

PZU's capitalization is strong, in our view, reflecting extremely strong capital adequacy. We anticipate that capital adequacy will remain at least very strong, even against a publicly announced dividend policy revision that outlines future net profit payout ratios of 50%-100% and potential acquisitions. Further supporting factors are strong capital quality, adequate reserving, and a conservative reinsurance program.

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

We believe that some aspects of PZU's modernization program will continue to be challenging. In our view, the program will require management's full attention in the short to medium term, owing to the need for a significant cultural change within the organization. However, we believe that the current management is well placed to continue implementing these initiatives, which are paramount to PZU's maintaining its competitive position.

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 any 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 strong operating performance through the cycle. We expect PZU to report ROE in excess of 15% and net income of more than Polish zloty (PLN) 2 billion (about €485 million) in 2011 and 2012. The net combined (loss and expense) ratio, in the absence of large natural catastrophes, will likely be at least 98% in 2011, and we predict further improvements in 2012. We anticipate that life operating performance will continue to contribute significantly to PZU's earnings, with a return on EEV of 7%-10% and a new business margin based on annual premium equivalent (APE) of at least 10% in 2011 and 2012. We believe that PZU will maintain strong capitalization, with capital adequacy in the 'AA' range and a strong quality of capital.

A negative rating action on the local currency ratings on Poland could trigger similar rating actions on PZU.

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 reflecting PZU's substantial 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 market shares of 34.2% and 29.6%, respectively in 2010. The group is also No. 3 in pensions, with a market share of 14.7% in 2010. PZU's assets totaled PLN50.5 billion and its gross premiums income PLN14.5 billion at year-end 2010.

PZU's main shareholder is Poland's Ministry of Treasury, which has a share of 35.2%. Although the Ministry of Finance has gradually reduced its shareholdings in PZU, we believe it will remain the main shareholder and maintain a controlling stake.

PZU was floated on the Warsaw Stock Exchange on May 12, 2010. In November 2009, PZU paid an extraordinary dividend of PLN12.75 billion as part of an agreement between the Ministry of Treasury and Eureko B.V. (core operating entities rated A+/Stable/--) to resolve a 10-year dispute and to agree on a medium-term divestment of Eureko's PZU shares. In November 2010, Eureko disposed about 12.9% of PZU's shares and no longer holds a meaningful stake in PZU.

Government Support And GRE Methodology Impact

The 'A' rating on PZU reflects our assessment of the group's SACP. We consider PZU to be 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 large controlling shareholding of 35.2% 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 do not benefit from any uplift because our assessment of PZU's SACP is in line with the local currency rating on Poland.

Competitive Position: Unrivaled Market Leader In Poland

Table 1

PZU Group--Competitive Position*					
	--Year-ended Dec. 31--				
(Mil. PLN)	**2010**	**2009**	**2008**	**2007**	**2006**
Total invested assets	46,923	49,792	55,890	50,245	46,968
Total revenue	16,448	17,441	17,156	17,291	17,291
Gross premiums written	14,544	14,363	14,563	15,462	15,454
Annual change in gross premium written (%)	1.3	(1.4)	(5.8)	0.1	12.4
Property/casualty gross premiums written	8,032	8,022	8,433	8,196	7,864
Property/casualty: Annual change in gross premiums written (%)	0.1	(4.9)	2.9	4.2	2.8
Life gross premiums written	6,513	6,341	6,130	7,266	7,590
Life: Annual change in gross premiums written (%)	2.7	3.4	(15.6)	(4.3)	24.5

*Consolidated. 2006-2007 under Polish accounting standards. 2008-2010 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. The company's competitive position also stems from a very strong brand recognition, unrivaled distribution capabilities, and cross-selling potential.

The competitive advantages of operating in Poland result in some geographic concentration, but PZU continues to develop 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.

Significant position in the Polish insurance market

PZU maintains a significant position in Poland, with large market shares in 2010 in non-life (34.2%), life (29.6%), and pension (14.7%) businesses. PZU is 3x-4x larger than its closest competitors in non-life and life insurance, which, in our view, further underpins its strong market dominance. Considerable competition from new market entrants over recent years, however, has led to ongoing losses in market share. We also believe PZU has accepted market share losses to maintain profitability that is consistently better than that of the market average.

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, which makes up 55% of the group's gross premiums written (GPW) for 2010. PZU S.A.'s primary insurance portfolio comprises third-party motor liability (TPML; 33.2% of 2010 non-life GPW), other motor damage (28.8%), property (20.8%), accident and health (6.3%), and other (10.9%). There is some concentration in motor, but we believe the company has sustainable and significant scale and cost advantages, compared with peers, as a result of its agency distribution network. We believe that PZU S.A. can maintain its market dominance in non-life and can participate in rate increases that are anticipated particularly for the Polish motor market in 2011, following an intense price war over recent years.

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 and defendable presence in the highly profitable group business, which we believe is a key competitive advantage. PZU Zycie also started writing health insurance policies in 2002, with good growth rates so far, albeit on a relatively small scale. We believe that PZU Zycie could establish a good position in health insurance in Poland if the market were more liberalized and private insurers were 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 compared with that of competitors. 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 compared with peers', with more than 700 local branches and more than 12,000 agents. The agency network is a key factor supporting PZU's stronger position in smaller cities and rural areas than in the large cities. PZU also has a strong presence in large cities, where it also experiences the most competition. Bancassurance distribution has gained importance in the Polish life insurance market, and PZU continues to actively market its products through a number of banks.

Prospective

We believe PZU can maintain its strong competitive position in the Polish insurance market in life and non-life and will be able to transfer this into a strong operating performance. In our view, the Polish insurance market, and life insurance in particular, 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 secure its market leadership and dominance. We also expect its market share in life and non-life to decrease, owing to PZU's underwriting discipline and the continuously intense competition in the Polish insurance market.

Management And Corporate Strategy: Capable Management, But Ongoing Modernization Strategy Will Require Management Attention

Following many significant changes in management, PZU's current management team was put in place since December 2007 and since then has demonstrated consistency and execution capabilities, in our view. PZU has a clearly defined strategy: It is focused on being a leading financial institution in Central and Eastern Europe (CEE) by expanding in Poland, and by entering CEE markets that offer significant growth opportunities. We also believe that corporate governance after PZU's successful initial public offering (IPO) in 2010 has further improved.

However, we believe the implementation of some aspects of PZU's large and ongoing modernization program will continue to be challenging. In our view, it will require management's full capacity in the short to medium term, owing to the need for a significant cultural change within the organization.

Operational management

We believe that PZU's operational management is sound and that its management team is capable of implementing the group's modernization program, as demonstrated so far by the successful reduction of administration costs by 8% in 2010. Moreover, 2,300 full-time employees were laid off by year-end 2010 in line with the goal to reduce headcount by about 4,000 by 2012. Operational management, in our view, will further benefit from PZU's enlarged group board of management. We believe this will also create a more holistic management approach because all of the group's lines of business are now represented on the board.

Financial and risk management

PZU's financial risk tolerance is relatively low, in our view, compared with its risk-bearing capacity. We consider its financial management to be conservative. PZU focuses on enhancing ROE and fosters growth only if bottom-line results are not negatively affected. Moreover, with regard to its risk appetite, PZU remains committed to maintaining a solvency ratio of 250% and capital adequacy, based on Standard & Poor's capital model, in line with the 'AA' range.

Accounting

PZU's annual report and financial statements for 2010-2008 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 EEV principles. The accounting policies have not raised any rating concerns.

Enterprise Risk Management: Moderately Important For The Ratings, Given PZU's Strong Capitalization And Focus On Poland

We regard PZU's enterprise risk management (ERM) as adequate, reflected in adequate risk management culture and adequate controls for its main risks: Insurance, market/asset-liability management (ALM), and credit and operational risk. PZU remains exposed to natural catastrophes in Poland, such as floods, and remains concentrated on Polish sovereign debt. We, however, do not expect PZU to experience losses outside the normal ranges from traditional risk areas. ERM is of moderate importance for the ratings, given our view of PZU's currently strong capitalization and its geographical focus on Poland.

Risk-management culture, in our view, is adequate. In 2010, PZU made steps to further develop its risk-management culture and implemented an independent risk department and a chief risk officer function in order to build up a more holistic, rather than a silo-based, risk-management system. These measures also respond to the EU's proposed Solvency II requirements.

We regard the individual risk controls for underwriting, reserving, catastrophes, reinsurance, market/ALM, and credit risks as consistently adequate. PZU uses modeling extensively within the individual risk-management areas.

The group's strategic risk management, in our view, is partly constrained because the movement toward a more holistic management of the group's risk profile is only recent. We believe, however, that these measures could lead to improvements in strategic risk management over time.

Operating Performance: Consistently Strong

Table 2

PZU Group--Operating Statistics*

	--Year-ended Dec. 31--				
(Mil. PLN)	**2010**	**2009**	**2008**	**2007**	**2006**
EBIT	3,088	4,602	2,931	4,477	4,627
Return on equity (%)	20.3	24.0	12.6	23.9	30.7
Return on revenue (%)	13.1	20.0	27.4	23.4	20.1
Life return on revenue (%)	31.7	39.8	30.9	35.9	32.7
Property/casualty return on revenue (%)	32.3	28.0	32.3	15.6	19.1
Property/casualty net loss ratio (%)	73.9	69.3	63.2	60.3	55.7
Property/casualty total net expense ratio (%)	30.6	29.7	28.1	28.3	27.7
Property/casualty net combined ratio (%)	104.5	99.0	91.3	88.6	83.4

*Consolidated. 2006-2007 under Polish accounting standards. 2008-2010 under International Financial Reporting Standards. PLN--Polish zloty.

PZU's operating performance is 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 channeled into a very strong five-year average ROE of about 22% in 2010 and net income of consistently more than PLN2 billion over the past five years. PZU's strong operating performance is also supported by lower distribution costs than peers' and strong investment results in a comparably favorable interest rate environment in Poland; the 10-year government bond yield was about 6% after the second quarter of 2011. PZU's net investment yield, including all capital gains, was also sound at 5.75% in 2010.

Life business remains the primary contributor to operating profit, at 83.6% in 2010, benefiting from high profit margins, mainly in group life, which we believe will continue to generate strong and sustainable profits. The return on EEV in 2010 of 10.3% further supports this. The new business margin of 14.3%, based on annual premium equivalent, appears relatively smaller, but is affected by Bancassurance deposit products that generate high volumes but relatively lower profitability. When taking this into account, we believe that the new business margin will remain strong.

We believe that PZU's non-life performance in 2010 created some volatility to a number of extraordinary items. Natural catastrophes, including a large number of snow and flood claims, affected underwriting performance with a net effect of PLN369 million or 4.8 percentage points in the combined ratio. Moreover, ongoing price competition, mainly in motor, has further affected the underlying performance. As a consequence, the combined ratio increased to 104.5% in 2010 from 99% in 2009. Quarterly results in 2011 have nevertheless indicate an upward trend in non-life earnings, due to a much more favorable claims environment and increasing premium rates, particularly in motor. Corporate motor business in 2010 remained unprofitable but improved in the first half of 2011; and PZU aims to break even in the corporate motor business by 2012. We believe that this target is challenging but achievable, given PZU's market dominance, and will depend on PZU adhering to underwriting discipline.

Prospective

We believe that PZU can continue to transform its market dominance into a strong operating performance. We also expect PZU to benefit from its modernization initiatives, in particular those related to rationalization of PZU's cost base. We expect PZU to report ROE in excess of 15% and a net income of more than PLN2 billion in 2011 and 2012. The net combined (loss and expense) ratio in the absence of large natural catastrophes should be at least 98% in 2011, and we forecast further improvements in 2012. We believe that life operating performance will continue to contribute significantly to PZU's earnings, with a return on EEV of 7%-10% and a new business margin based on an annual premium equivalent of at least 10% in 2011 and 2012.

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

Table 3

PZU Group--Investment Statistics*

	--Year-ended Dec. 31--				
(%)	**2010**	**2009**	**2008**	**2007**	**2006**
Net investment yield	3.8	4.4	4.6	4.7	5.2
Net investment yield including realized capital gains/(losses)	4.4	5.1	3.4	6.1	6.5
Net investment yield including all capital gains/(losses)	5.8	6.5	1.0	5.7	7.9
Portfolio composition					
Cash and cash equivalents	7.1	9.4	15.0	4.1	3.9
Bonds	75.0	77.9	75.6	81.2	73.8
Common stock	12.2	9.6	6.5	7.9	9.5
Real estate	2.7	2.4	2.1	2.4	2.5
Mortgages	3.0	0.7	0.9	4.0	9.8
Investments in affiliates	0.0	0.0	0.0	0.4	0.4
Other investments	0.0	0.0	0.0	0.1	0.1
Total portfolio composition	100.0	100.0	100.0	100.0	100.0

*Consolidated. 2006-2007 under Polish accounting standards. 2008-2010 under International Financial Reporting Standards. PLN--Polish zloty.

We consider PZU's investment portfolio to be strong, although regulations limit the amount of overseas investments not denominated in Polish zloty, restricting the diversity of investments, which we view as a ratings constraint. 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 79% of PZU's total investments are government and supranational bonds, of which in turn about 98% are in Polish government local currency debt issues rated 'A' or 'A-'.

Market risk
We view market risk as manageable. PZU is exposed to interest rate increases and changes in equity market values. Under a stress scenario, a 100 basis-points increase would be a loss of PLN831 million and a 10% decrease of equity market values would be a loss of PLN233 million based on EEV sensitivities. This, in our view, indicates a relatively low market-risk exposure, in view of PZU's strong capitalization and strong operating performance capabilities.

Asset-liability management
Assets backing non-life liabilities appear to be fairly closely matched. However, significant reinvestment risk exists for life liabilities with maturities of more than 10 years because of a greater exposure to mismatching risk.

Liquidity: Consistently Strong Cash Inflows And Outflows

We regard PZU's liquidity as strong. Our liquidity stress test incorporates an assumption of a flood similar to that of 1997 and 2010, the biggest floods in Poland over the past 50 years. We estimate that under this scenario, PZU's potential liabilities would be fully matched by short-term assets and available for sale treasury bonds (PLN4,727 million versus PLN8,198 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 extremely strong capital adequacy. We anticipate that capital adequacy should remain at least very strong, even against a publicly announced dividend policy revision in that outlines prospective net profit payout ratios of 50%-100% and potential acquisitions. Further supporting factors are strong capital quality, adequate reserving, and a conservative reinsurance program.

Capital adequacy
PZU's risk-based capital adequacy was extremely strong as of Dec. 31, 2010. Capital adequacy also incorporates a charge for a net aggregate one-in-250-year non-life catastrophe event. The group's capital strength stems 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, although PZU announced its plans to increase its dividend policy with payout ratios of 50%-100% of net income annually. Quality of capital was strong and unchanged at year-end 2010: Shareholder equity represented about 63% 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.

Reinsurance

PZU's reinsurance program remains stable, with relatively low reinsurance utilization standing at 2.5% for non-life and 1.4% for the overall business at year-end 2010. However, we believe PZU's reinsurance program provides suitable cover.

The panel of reinsurers is highly rated, and more than 97% of ceded reinsurance premiums 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)	**2010**	**2009**	**2008**	**2007**	**2006**
Economic capital available	12,691	11,182	19,983	16,743	13,229
Total assets	50,534	53,176	59,359	52,654	49,445
Reinsurance utilization (%)	1.4	1.1	0.9	1.2	1.1

*Consolidated. 2006-2007 under Polish accounting standards. 2008-2010 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, strong underlying earnings, a virtually debt-free balance sheet, and sufficient reinsurance capacity.

Moreover, we believe PZU's 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

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 09, 2010
- Group Methodology, April 22, 2009
- Interactive Ratings Methodology, April 22, 2009

Ratings Detail (As Of September 8, 2011)*	
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/--

Ratings Detail (As Of September 8, 2011)***(cont.)**	
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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