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Research Update:

Polish Insurance Group PZU Core Subsidiaries Ratings Affirmed At 'A' After Insurance Criteria Change; Outlook Stable

Primary Credit Analyst:

Johannes Bender, Frankfurt (49) 69-33-999-196; johannes.bender@standardandpoors.com

Secondary Contacts:

Anvar Gabidullin, CFA, London (44) 20-7176-7047; anvar.gabidullin@standardandpoors.com

David Laxton, London (44) 20-7176-7079; david.laxton@standardandpoors.com

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Overview

- Following a review of Poland-based composite insurance group PZU under our revised insurance criteria, we are affirming our 'A' ratings on the company's core subsidiaries.
- The ratings reflect our view of the group's strong business risk profile and very strong financial risk profile, although somewhat constrained by the group's large exposure to domestic sovereign debt.
- The stable outlook reflects our view that the group will sustain its very strong, market-leading competitive position in Poland, which should enable it to achieve our base-case earnings assumption and maintain very strong capital and earnings.

Rating Action

On July 12, 2013, Standard & Poor's Ratings Services affirmed its 'A' insurer financial strength and counterparty credit ratings on the core operating subsidiaries of Poland-based composite insurance group PZU--property/casualty (P/C) insurer Powszechny Zaklad Ubezpieczen S.A. and life insurer Powszechny Zaklad Ubezpieczen na Zycie S.A. The outlook is stable.

Rationale

The ratings reflect our view of the group's strong business risk profile, supported by its very strong competitive position in Poland, and its very strong financial risk profile, built on its very strong capital and earnings. We combine these factors to derive an anchor of 'a' or 'a+' for PZU. We use the lower anchor of 'a' for PZU to reflect the group's large exposure to domestic sovereign debt. Although PZU has started to reduce its exposure to Polish government securities (about 70% of total investments in 2012), we expect it to remain material in 2013-2015, reflecting a lack of Polish zloty-denominated investment opportunities. We align the stand-alone credit profile (SACP) for PZU with the anchor, as we consider that potential modifying factors are neutral for the ratings. The ratings on PZU are at the same level as the group's SACP as there is no uplift for potential extraordinary government support.

We regard PZU as a government-related entity (GRE) because, among other reasons, the Ministry of the 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. However, this assessment provides no rating uplift owing to our current 'a' SACP on PZU and the 'A' local currency sovereign credit rating.

PZU is predominantly active in the Polish P/C (54% of gross premiums in 2012) and life sectors (46%), and has relatively small operations in Lithuania and Ukraine (both less than 1%). At the end of 2012, PZU also started operations in Latvia and Estonia by opening branches there. As a result, we believe PZU faces moderate industry and country risk, mainly based on our view of moderate country risk in Poland. Our assessment of industry risk in Poland reflects our neutral view of barriers to entry and product risk for the Polish P/C and life market, our positive view of profitability in the Polish life market, and our neutral view of profitability in the Polish P/C market. We do not expect to change our overall industry and country risk assessment in 2013-2015 in view of PZU's large domestic exposure and our belief that PZU might find it difficult in the current environment to achieve its goal of diversifying geographically via acquisitions in Central and Eastern Europe (CEE), owing to a lack of meaningful opportunities.

We consider that PZU has a very strong competitive position, reflecting its significant market-leading position in the Polish insurance market, unrivaled distribution capabilities, a well-diversified business mix, and strong brand recognition among the Polish population. Moreover, we believe PZU is well placed to continue to transform its very strong competitive position into an operating performance that is above peers in the Polish insurance market. Under our base-case scenario, we anticipate that PZU will maintain its market-leading position in Poland and that gross premiums written (GPW) on a group basis could grow by about 2%-4% annually through 2013-2015.

We assess PZU's capital and earnings as very strong, with capital adequacy exceeding our 'AAA' benchmark in 2012, according to our capital model. However, we expect the group's potential international expansion and high dividend payouts to weaken capital adequacy. Nevertheless, we expect capital adequacy to continue to exceed our expectations in 2013-2015, at least at the 'AA' level. Under our base-case scenario, we anticipate a net income of about Polish zloty (PLN) 2.5 billion, a combined (loss and expense) ratio of about 93%-96%, and a return on equity of about 18%-20%.

In our view, PZU's risk position reflects intermediate risks, based on a conservative investment strategy and reinsurance cover against the group's natural catastrophe exposure in Poland. About 74% of its investments comprise fixed income securities (including loans). The average rating of the bond portfolio is 'A' due to the large exposure to Polish government securities. We expect PZU to continue to reduce its exposure to Polish government securities, although it could remain material in 2013-2015 due to regulatory requirements to invest in Polish zloty-denominated assets.

PZU has strong financial flexibility, in our view, thanks to the limited capital it needs to fund its business growth, the group's earnings generation capacity, proven access to the capital markets, and a virtually debt-free balance sheet.

PZU's enterprise risk management (ERM) and management and governance practices are neutral factors for the rating. Our assessment of ERM as adequate reflects our neutral assessment of its risk management culture and risk controls for its main risks. In our view, the group's strategic risk management has improved to a more holistic view of its risk profile. These developments are very recent, however, and we believe the group still needs to demonstrate a longer track record in these areas. The importance of ERM to the rating is low, reflecting PZU's very strong capital and earnings and its geographic focus on Poland.

PZU's management and governance is satisfactory, in our view. This reflects the group's clear strategic planning, strong track record of executing its strategy, particularly since the existing management team was put in place in 2007, and conservative financial management, including strong balance sheet management and a track record of strong earnings.

We regard PZU's liquidity as exceptional, owing to the strength of available liquidity sources, mainly premium income, and its liquid asset portfolio.

Outlook

The stable outlook reflects our view that the group will sustain its very strong, market-leading competitive position in Poland, which should enable it to achieve our base-case earnings assumption and maintain very strong capital and earnings.

A negative rating action on the ratings on Poland would likely trigger similar rating actions on PZU due to its large exposure to domestic sovereign debt and its geographic business focus on Poland.

We could raise the ratings on PZU if:

- We raised the ratings on Poland, and
- It maintained very strong capital and earnings and continued to deliver earnings outperformance through leveraging its very strong competitive position in Poland.

Rating Score Snapshot

Financial Strength Rating A/Stable

Anchor a

Business Risk Profile	Strong
IICRA	Moderate Risk
Competitive Position	Very Strong
Financial Risk Profile	Very Strong
Capital & Earnings	Very Strong
Risk Position	Intermediate Risk
Financial Flexibility	Strong
Modifiers	0
ERM and Management	0
Enterprise Risk Management	Adequate
Management & Governance	Satisfactory
Holistic Analysis	0
Liquidity	Exceptional
Support	0
Group Support	0
Government Support	0

IICRA—Insurance Industry And Country Risk Assessment.

Related Criteria And Research

Related criteria

- Insurers: Rating Methodology, May 7, 2013
- Group Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Related research

- List Of Issuers With Ratings Under Criteria Observation Due To S&P's New Insurers Rating Methodology, May 7, 2013
- Standard & Poor's Assigns Insurance Industry And Country Risk Assessments, May 7, 2013

Ratings List

Ratings Affirmed

Powszechny Zaklad Ubezpieczen S.A.

Powszechny Zakład Ubezpieczeń na Życie S.A.
Counterparty Credit Rating
Local Currency A/Stable/--
Financial Strength Rating
Local Currency A/Stable/--

Additional Contact:

Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com

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