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Research Update:

Polish Insurance Group PZU 'A' Ratings Affirmed On Criteria For Rating Above The Sovereign; Outlook Stable

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

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

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Overview

- Poland-based composite insurance group PZU passes our hypothetical foreign currency sovereign default stress test under our revised criteria for rating companies above the sovereign. This indicates that, in our view, PZU would not exhaust its regulatory solvency capital under the stress of a sovereign foreign currency default.
- We are therefore affirming the 'A' ratings on PZU and removing them from CreditWatch negative, where they were placed on Nov. 26, 2013.
- The stable outlook on PZU mirrors the outlook on Poland, reflecting that the ratings on PZU are constrained at the level of the long-term local currency rating on the sovereign.

Rating Action

On March 25, 2014, 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. At the same time, we removed the ratings from CreditWatch with negative implications, where they were placed on Nov. 26, 2013. The outlook is stable.

Rationale

The affirmation follows the implementation of our revised criteria on rating companies above the sovereign level (see "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013). Under the criteria, we assess the potential impact of a hypothetical Polish sovereign default on PZU's consolidated balance sheet, based on a stress scenario. Based on our assumptions underlying the foreign currency stress scenario, we believe that PZU would likely retain positive regulatory capital, owing to the execution of a credible risk-mitigation plan, and maintain a liquidity ratio in excess of 100%. According to our criteria, this indicates that the insurer is unlikely to default on its insurance liabilities under the scenario and passes the sovereign foreign currency stress test. Therefore, the ratings on PZU can be higher than the 'A-' long-term foreign currency rating on Poland.

The ratings on PZU are one notch higher than the long-term foreign currency rating on Poland. This reflects PZU's indicative group credit profile (GCP; our assessment before the impact of sovereign risk) of 'a', and our assessment that PZU passes the foreign currency sovereign stress test, factoring in that PZU will take timely actions to mitigate the effects of Poland experiencing a foreign currency default. We would currently not rate PZU more than one notch above the foreign currency rating on Poland owing to the group's substantial sovereign risk exposure and the 'A' local currency sovereign credit rating. PZU does not pass our local currency stress test owing to its material exposure to Poland-based assets.

We generally view country exposure as material when an entity has about 25% or more of its investments in a single country's assets (including sovereign bonds and other assets). In PZU's case, about 96% of its assets are invested in Poland. We have applied our hypothetical foreign currency sovereign default stress test to PZU's balance sheet, including haircuts on all Poland-based assets, such as sovereign bonds, local bank and corporate bonds, real estate, deposits, and equities. We then compared the amount of hypothetical losses with the regulatory solvency capital (capital stress), to which we added one year of pretax, post-haircut earnings. We also applied a liquidity stress under our criteria that used the asset haircuts above.

We estimate that the regulatory capital buffer in a sovereign foreign currency default scenario would remain positive, after taking into account a mitigation plan that we expect PZU will implement gradually in case of deteriorating sovereign credit conditions in Poland. This plan includes reallocating Poland-based assets into investments outside of the country if Poland's creditworthiness were to deteriorate. The risk-mitigation plan contemplates reducing the assets invested in Poland to 76% of investment assets of PZU S.A. and PZU na Zycie S.A. (excluding assets covering investment products and non-quoted own investments) if the Poland sovereign rating deteriorates materially.

The mitigation plan has been approved by PZU's management board, with the knowledge of the supervisory board. In this case, we consider this approval as consistent with our criteria (which refers to the approval of the issuer's board of directors), because of the executive powers of the management board under PZU's governance structure (which is required under Polish company law). Such powers include decisions to carry out changes to the investment strategy, such as the various steps included in the mitigation plan, with no explicit authority for the supervisory board to veto such changes. Under these assumptions, we consider that the plan is credible and bears limited execution risk.

In the sovereign foreign currency default scenario, we consider it likely that PZU would benefit from regulatory forbearance and consider that it would be allowed to operate even if it were not able to maintain solvency capital in excess of the regulatory minimum.

PZU is Poland's largest insurance group and leads the non-life and life insurance markets. The indicative GCP of 'a' reflects our view of the group's strong business risk profile, supported by its very strong competitive position in Poland. It has a regular premium life insurance market share of 43% and a non-life market share of 31% in 2013. The indicative GCP is also supported by PZU's very strong financial risk profile, built on its very strong capital and earnings. The group continues to outperform its peers in the domestic market.

We combine these factors to derive an anchor of 'a' or 'a+'. For PZU, we use the lower anchor of 'a' to reflect the group's large exposure to Polish government securities rated 'A'. These comprised about 60% of total investments in 2013 and we expect this proportion to remain material through 2016. Because we consider that management and governance and enterprise risk management are neutral rating factors, the indicative GCP for PZU is also 'a'.

We regard PZU as a government-related entity, chiefly because the Polish treasury is its main shareholder. We consider that 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 because we cap the ratings on PZU at the local currency rating on Poland.

Outlook

The stable outlook on PZU mirrors that on Poland, reflecting that the ratings on PZU are constrained at the level of the long-term local currency rating on the sovereign.

We would likely lower the rating on PZU if we lowered Poland's local currency sovereign rating or if management actions increased PZU's exposure to sovereign risk, causing it to fail the foreign currency stress test. We could also lower the ratings if we were to take a more negative view of the execution risk of the mitigation plan. This could result from a material weakening in capital, higher-than-expected exposure to Polish assets, or a failure to execute the plan in the event of deteriorating sovereign creditworthiness. Finally, we could lower the rating if we revised PZU's indicative GCP to below 'a', which could happen if its capital adequacy or competitive position were to weaken.

As long as PZU continues to pass the foreign currency stress test, we could raise the ratings if:
- We raised the local currency ratings on Poland, and
- We revised upward our assessment of PZU's indicative GCP to 'a+'. This could happen if PZU maintains at least very strong capital and earnings and continues to outperform peers in terms of profitability.

Ratings Score Snapshot

	To	From
Financial Strength Rating	A/Stable/--	A/Watch Neg/--
Anchor	a	a
Business Risk Profile	Strong	Strong
IICRA	Moderate risk	Moderate risk
Competitive Position	Very strong	Very strong
Financial Risk Profile	Very strong	Very strong
Capital and Earnings	Very strong	Very strong
Risk Position	Intermediate	Intermediate
Financial Flexibility	Strong	Strong
Modifiers	0	0
ERM and Management	0	0
Enterprise Risk Management	Adequate	Adequate
Management and Governance	Satisfactory	Satisfactory
Liquidity	Exceptional	Exceptional
Support	0	0
Group Support	0	0
Government Support	0	0

IICRA--Insurance Industry And Country Risk Assessment.

Related Criteria And Research

Related Criteria

- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Enterprise Risk Management, May 7, 2013
- Insurers: Rating Methodology, May 7, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related Research

- Polish Insurance Group PZU Ratings Remain On CreditWatch Negative, Feb. 21, 2014

- Credit FAQ: How Does Standard & Poor's Apply Its Ratings Above The Sovereign Criteria To Insurers?, Dec. 20, 2013
- Credit FAQ: Why Our Updated Criteria On Rating Above The Sovereign Led To CreditWatch Placements On Some EMEA Insurers, Dec. 3, 2013
- Rating Actions On Nine European And African Insurance Groups After Revision Of Criteria On Rating Above The Sovereign, Nov. 26, 2013

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Powszechny Zaklad Ubezpieczen na Zycie S.A.		
Powszechny Zaklad Ubezpieczen S.A.		
Counterparty Credit Rating	A/Stable/--	A/Watch Neg/--
Financial Strength Rating	A/Stable/--	A/Watch Neg/--

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com

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