STANDARD & POOR'S

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PZU

Primary Credit Analyst:
Charis Adu-Kwapong, London (44) 20-7176-7062; charis_adu-kwapong@standardandpoors.com

Secondary Credit Analyst:
David Laxton, London (44) 20-7176-7079; david_laxton@standardandpoors.com

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PZU

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 implementing the modernization strategy
- Concentration of investments in Polish government stocks limiting ability to invest in assets of appropriate duration for its life insurance liabilities

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. The ratings are constrained, however, by the execution risk associated with implementing the modernization strategy and the concentration of investments in Polish government securities limiting its ability to invest in assets of appropriate duration for its life insurance liabilities.

PZU has a strong competitive position, driven by its significant position in the Polish insurance market, unrivaled distribution capabilities, and high brand recognition amongst the Polish population. The group is exposed to the fortunes of the Polish economy, however.

PZU's operating performance is very strong, driven primarily by its strong competitive position both in life and non-life business in a growing insurance market. The strength of PZU's operating performance is also supported by its lower product distribution cost base relative to peers.

PZU's capitalization is strong, reflecting an extremely strong capital adequacy ratio according to Standard & Poor's Ratings Services' risk-based model, adequate reserving, and a conservative reinsurance program.

The ratings are currently constrained by execution risk relating to the implementation of the modernization program. Implementation of some aspects of the modernization program is made more challenging by PZU being a major employer in Poland. However, Standard & Poor's believes the current management is well placed to implement these initiatives, which is paramount to maintaining PZU's competitive position in the medium term.

PZU invests predominantly in Polish government securities and regulation limits the amount of overseas investment. Consequently, the ability to invest in assets of appropriate duration for its life insurance liabilities is rather limited and the diversity of PZU's investment portfolio is restricted.

Outlook

The stable outlook reflects Standard & Poor's view that the risk of major shareholder intervention in the running of PZU's operations has receded. The stable outlook also reflects Standard & Poor's expectation that PZU will maintain its strong competitive position and generate very strong operating performance through the cycle with an average net combined ratio not greater than 93% and ROE well in excess of 15%. Standard & Poor's expects PZU to maintain strong capitalization, with capital adequacy at least within the 'AA' (very strong) range according to Standard & Poor's risk-based capital model and strong quality of capital.

The ratings may be raised, subject to meeting Standard & Poor's expectations above as well as the following:

- PZU is expected to maintain a stable management team and retain the current CEO; and
- PZU demonstrates clear evidence of progress in implementing key aspects of the modernization and restructuring strategy, with execution supported by the major shareholder

A revision of the outlook to positive would be an indication that the group is close to successfully meeting the above expectations.

Conversely, the outlook may be revised to negative if there is an adverse change in capital management or dividend policy and if management is not allowed to implement key aspects of the modernization and restructuring strategy initiated in 2005. A negative rating action could also result if Standard & Poor's believes shareholder intervention is proving detrimental to the company's operations.

Corporate Profile: The Leading Universal Polish Insurer

PZU is Poland's largest insurance group, and is the leader in both non-life and life business, with shares of the Polish market of 44% and 29%, respectively. The group is also No. 3 in pensions and No. 14 in investment funds, with market shares of 14% and 2%, respectively. The group had total assets of Polish zloty (PLN) 52.7 billion ($21.5 billion) and gross premium income of PLN15.5 billion at year-end 2007. As at December 2007, PZU's shareholders were the State Treasury of the Republic of Poland (55.09%), Eureko B.V. (Eureko; core operating entities are rated A+/Stable/--; 32.12%), and other (12.79%).

Competitive Position: Unrivaled Market Leader In Poland

Table 1

PZU/Business Statistics (Consolidated)

	--Year-ended Dec. 31--				
(Mil. PLN)	**2007**	**2006**	**2005**	**2004**	**2003**
Total nonlinked investments	46,467	43,806	39,037	35,505	31,477
Total consolidated revenue	17,291	17,291	15,577	14,098	13,471
Total net written premiums	15,282	15,287	13,340	12,417	11,806
Annual change (%)	(0.0)	14.6	7.4	5.2	0.2
Reported EBITDA	4,393	4,639	3,996	2,605	2,048
ROE (reported equity) (%)	23.3	30.7	33.4	28.3	27.1

Table 1

PZU/Business Statistics (Consolidated)(cont.)					
Direct yield on invested assets (%)	4.7	5.2	6.0	5.4	5.6

PLN--Polish zloty.

PZU's strong competitive position is driven by the group's significant position in the Polish insurance market, both in non-life and life business segments of the insurance market, complemented by pension and asset management activities, as well as its very strong brand recognition and unrivaled distribution capabilities with cross-selling potential. PZU's competitive advantages are focused in the Republic of Poland, which brings some geographic concentration, but PZU is developing activities in Ukraine and Lithuania.

Over the period from 2002 to 2005, PZU made meaningful acquisitions in the Lithuanian and Ukrainian insurance markets. The Ukrainian market in particular, where PZU is No. 13 in non-life and No. 10 in life, offers excellent potential for profitable growth and diversification (in 2007, the non-life market grew by 28.7% and life by 73.9%). In Lithuania, the non-life market grew by 27.3% and the life market by 53.5% in 2007. PZU holds a strong position in Lithuania, with a 13.0% share of the market in non-life and 2% in life. Nevertheless, in Standard & Poor's view, tangible diversification benefits from these operations can only materialize in the medium to long term. PZU is expected to further improve its competitive position in life business, but its competitive position is otherwise expected to remain relatively stable, in line with the growth and development of the Polish market, which demonstrated dynamic growth of 16.6% in 2007 (non-life growth of 10.8%; life growth of 20.9%, primarily linked business).

Industry risk

Industry risk in Poland is regarded as modest, largely as a result of EU membership, which has brought reform to the Polish legal and regulatory landscape. Insurance regulation is now largely aligned with that in Europe. There are no significant barriers to entry in Poland, and the Western European insurers active in Central Europe are established in Poland.

Significant position in the Polish insurance market

Despite considerable competition from new entrants, PZU maintains a significant position in Poland, with 44% of the non-life market, 29% of the life market, and 35% of the overall insurance market in 2007. PZU's nearest competitors had 10% of the non-life market (Towarzystwo Ubezpieczen i Reasekuracji WARTA S.A. {Warta; unsolicited rating 'BBBpi'}) and 12% of the life market (Commercial Union). PZU's dominance has been gradually reducing over the past five years and may continue to reduce going forward. Standard & Poor's expects PZU to leverage its very strong distribution capabilities and brand to support its leading market position over the medium term.

Non-life

The strongest component of PZU's competitive position is PZU S.A.'s undisputed market leadership within the Polish non-life insurance market (52% of PZU's gross premiums written), with a portfolio comprising third-party motor liability {TPML} representing 34.2% of 2007 non-life gross written premiums (GWP), other motor damage 33.2%, property 18.5%, accident and health 6.4%, and other 7.8%. There is some concentration in motor, but the company has a sustainable and significant scale and cost advantages, compared with peers, as a result of its agency distribution network. PZU S.A. is expected to reduce its concentration in motor business in the medium term by growing its personal property and commercial lines business.

Life

The second pillar of strength for PZU's competitive position is PZU Zycie's significant position in the Polish life insurance market--albeit concentrated in the group life segment of the market--with a 52% market share. PZU Zycie's position in individual business is relatively weak, with only a 10% share of the market. Similar to non-life, PZU Zycie enjoys sustainable cost advantages over its peers due to its distribution network and very well known brand. PZU Zycie will be challenged to significantly improve its market ranking for individual life, while it is expected to maintain its strong presence in group business. PZU Zycie has also recently established a cooperation agreement with one of Poland's largest providers of private healthcare, which should help the group establish a good position in this market, which is in its infancy in Poland, due to the lack of suitable private healthcare facilities.

Very strong brand recognition

PZU's brand recognition as one of the most well known financial institutions in Poland is extremely strong. Of the selected population sample, 82% immediately recognized the group and 96% recognized it with some prompting. The second best recognized brand in Poland is Warta, although this has a lower level of recognition (36% and 81%, respectively) (source: PBS DGA, January 2008).

Unrivaled distribution capabilities

PZU's distribution network is unrivaled in size and reach within Poland, with in excess of 700 local branch units and more than 12,000 agents. The agency network acts as a key support to PZU's stronger position in the smaller cities and rural areas, compared with its position in the large cities. PZU is also strong in the large cities, but it is here that the group experiences the most competition. Of the total portfolio, 42% of business is sold by agents, 28% by permanent employees, 13% by brokers/intermediaries, and 14% by multi-tie agents. Although the development of the bancassurance channel remains at an elementary stage within the Polish insurance market, PZU is already actively marketing its products (mainly life) through Bank Millennium Capital Group (unsolicited rating 'BBBpi'), Powszechna Kasa Oszczednosci Bank Polski (S.A.) (unsolicited rating 'BBBpi'), Deutsche Bank PBC S.A., and Bank Ochrony Srodowiska S.A., Bank Gospodarki Zywnosciowej SA, Polbank EFG, and is targeting a 25% share of the bancassurance market in 2008. Harnessing of this distribution channel is pivotal in developing PZU's position within the individual life and savings segment of the Polish insurance market, a segment of the market Standard & Poor's expects to experience significant growth going forward. PZU's efforts in this area are showing early signs of success.

Prospective

PZU's non-life and life units will remain a key driver of the group's competitive position, revenue generation, and earnings. The Polish insurance market--and life insurance in particular, typical of emerging markets--has substantial growth potential as the overall demand for insurance is increasing and private property and health insurance sectors of the non-life market are underdeveloped. PZU is well positioned to participate in this growth. However, Standard & Poor's expects some moderate decline in PZU's non-life and life market shares over the rating horizon due to its desire to maintain underwriting discipline and the increased competitive landscape within the Polish insurance market. PZU's medium- to long-term competitive strength is reliant to a large extent on improving product and distribution diversity in the non-life portfolio and strengthening the individual life and savings propositions.

Management And Corporate Strategy: Capable Management Team, But Challenges Of Implementing Modernization Program Remain

PZU has endured considerable change in management over the past three to four years instigated by the majority shareholder, the Polish government, as a result of changes in government. Despite the changes, the new management team, which has been in place since December 2007, is fully committed to the modernization program embarked upon by its predecessors in 2005. Standard & Poor's views the current management team as possessing all the necessary attributes and qualities to implement the modernization strategy, rationalize its cost base, and drive cultural change within the organization to reposition the group for the changing insurance landscape in Poland. The results of some of the initiatives management regards as quick-wins are increasingly evident. However, management's ability to deliver on some aspects of the modernization program is made more challenging by PZU being a major employer in Poland.

Historically, there have been frequent changes in PZU's CEO, translating into a lack of continuity in key initiatives started by previous CEOs. Implementation of the modernization strategy is paramount to PZU maintaining its competitive position given the increasing number of players with ambitious growth aspirations within the Polish insurance market. Successful implementation of the modernization strategy will stabilize PZU's competitive position within the Polish insurance market in the medium term and safeguard it for the future. However, if management is not allowed to implement this strategy it is likely to lead to lost opportunities and may limit PZU's competitive advantage in the medium to long term.

Publicity surrounding the ownership dispute between Eureko and the Polish state treasury has been intense over the past five to six years. Outwardly, these ownership uncertainties have not affected PZU directly, as the group continues to post strong underlying financial performance. Nevertheless, this dispute limits PZU's growth potential and could inhibit momentum in terms of strategic direction. Standard & Poor's expects the resolution of the dispute to be positive for PZU.

Strategy

PZU's five-year business and financial objectives to support the strategy have been developed by previous management. The highlights are to:

- Grow premium income at 75% of market growth.
- Maintain the combined ratio at below 92%.
- Grow embedded value by the risk discount rate plus one percentage point.
- Generate ROE of more than 20%.
- Expand market share to 15% in the second-pillar pension market as measured by net asset value.
- Generate 8% of the group's premium income on foreign markets.
- Cut the administrative cost ratios: life to 6% from the current 9%; non-life to 10% from the current 13%.
- Remain the top insurer in Central and Eastern Europe.
- Automate and centralize back-office processes.
- Cut claims handling duration by 50%.

Standard & Poor's regards this strategy, which is supported by strong and clear implementation plans, as entirely appropriate although challenging for PZU, given its role as a major employer within the Polish economy.

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

We find that the enterprise risk management (ERM) of PZU is adequate with adequate risk controls for its main risks which are market, ALM, and insurance risks. We do not expect PZU to experience losses outside of normal ranges from traditional risk areas. PZU has operational risk management functions. The risk management process is classical and silo-based. PZU is mainly exposed to risks associated with its corporate governance structure, credit risk (PZU's investment portfolio is 100% exposed to the Polish economy, 83% of which is exclusively to Polish government securities), interest rate risk (mismatch on the life side with liabilities in excess of 10 years), and catastrophic flood.

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

PZU has an adequate risk management culture. The group has initiated activities to reinforce the systems supporting risk management by implementing a new system that complies with the new Solvency II directive requirements.

Silo-based risk controls for underwriting, reserving, catastrophe, reinsurance, asset-liability management, and credit risks are consistently adequate. Modeling is used extensively within the silos, with some interactions considered (but not yet holistically).

Operating Performance: Very Strong Performance Supported By Strong Investment Income

Table 2

PZU/Operating Statistics (Consolidated)

	--Year-ended Dec. 31--				
(Mil. PLN)	**2007**	**2006**	**2005**	**2004**	**2003**
Reported EBITDA	4,393	4,639	3,996	2,605	2,048
Reported EBITDA (excl. non recurring items)	4,393	4,639	3,996	2,605	2,048
EBITDA (excl. realized and unrealized gains)	3,964	3,493	2,811	1,530	1,022
ROE (adjusted equity) (%)	23.3	30.0	31.6	26.3	24.6
EBITDA (excl. nonrecurring items)/total capitalization (%)	29.1	37.4	39.2	31.5	31.2
Total gross expense ratio (%)	22.4	22.0	23.0	22.8	22.8
Total administrative expense ratio (%)	13.1	13.1	14.4	14.5	13.1
Total acquisition expense ratio (%)	9.7	8.8	8.8	8.8	10.1
Non-life ROR (%)	9.2	14.0	11.3	6.9	4.3
Non-life net expense ratio (%)	31.1	30.7	30.3	29.7	27.9
Non-life net combined ratio (%)	91.4	86.4	89.8	93.9	96.6
Life post-tax return on technical reserves (basis points)	904	928	729	415	249
Direct yield on invested assets (%)	4.7	5.2	6.0	5.4	5.6
Five-year capital gains/total invested assets (%)	1.2	1.3	1.1	1.1	0.0

PLN--Polish zloty.

PZU's operating performance is very strong, driven primarily by its strong competitive position in both life and non-life in a growing insurance market and strong investment income. Life business was the primary contributor (69%) to technical income in 2007. The strength of PZU's operating performance is also supported by its low distribution costs relative to peers. Going forward, operating performance is expected to benefit from some of the modernization initiatives, in particular those relating to the rationalization of PZU's cost base.

The group is projected to invest PLN730 million in restructuring its non-life business. Management is targeting run rate cost savings of PLN370 million, translating into a very strong average net combined ratio over the next five years (covering the current cycle) of 90.5% (91.4% in 2007) and an average ROE of 24% for the group (23.8% in 2007). PZU's projected investment in the life business is about PLN153 million, which is expected to generate run rate cost savings of about PLN37 million. This should result in a reduction in the cost ratio (costs/GPW) to 12.9% in 2009 (14.0% in 2007).

Prospective

In Standard & Poor's view, PZU's very strong performance is sustainable in the medium term, with a net combined ratio of less than 93% (based on the past three-year average of 88.9%), ROE in excess of 15%, and a return on embedded value in excess of 10% over the cycle.

Investments: Lack of Diversity Due To Exclusive Exposure To Poland

Table 3

PZU/Investment Statistics (Consolidated)

	--Year-ended Dec. 31--				
(Mil. PLN)	**2007**	**2006**	**2005**	**2004**	**2003**
Life assets/total assets (%)	50.8	57.5	58.0	59.0	60.3
Realised gains/(losses)	640	561	474	483	655
Unrealised gains/(losses)	(212)	585	711	592	372
Direct yield on invested assets (%)	4.7	5.2	6.0	5.4	5.6
Total investment return (incl. unrealized and realized) (%)	5.7	7.9	9.2	8.6	9.2
Investment in affiliates (%)	0.5	0.5	0.8	0.6	0.7
Bonds and other fixed-interest securities (%)	81.2	73.8	78.5	80.6	78.6
Equities and other variable-interest securities (%)	7.9	9.5	10.0	10.0	7.7
Property (%)	2.4	2.5	2.9	3.1	3.7
Cash and bank deposits (%)	4.1	3.9	3.0	2.5	9.2
Loans and private placements (%)	3.9	9.8	4.9	3.1	0.0
Total nonlinked investments (%)	92.5	93.3	95.6	96.5	95.8
Assets held to cover linked liabilities (%)	7.5	6.7	4.4	3.5	4.2
Liquid assets/non-life technical reserves (%)	434.7	410.7	565.3	512.3	498.4
Cash in/out (%)	133.2	144.0	140.4	135.8	132.2
Debtor days less creditor days	12.3	9.5	17.9	16.4	17.9
Operating cash flow ratio (%)	131.9	146.7	142.0	138.6	139.1

PLN--Polish zloty.

PZU's investment portfolio is regarded as strong, although regulation limits the amount of overseas investment, thereby restricting diversity of investments. The lack of availability of suitably long-dated investments precludes accurate asset-liability management for the life insurance business. PZU is the biggest individual investor in Polish treasury securities, which may limit the levers the group has at its disposal to maintain stability in government bond markets in extreme situations.

Credit risk

Credit risk is low with about 85% of total investments held in Polish government local currency debt issues (rated 'A' or 'A-').

Market risk

Concentration risk within the equity portfolio is high due to almost 100% of PZU's equity investment (excluding investments in group companies) being in Poland, 46% of which is in the Polish banking sector. Equities represent about 10% of invested assets, accounting for about 21% of shareholders' equity (including equalization reserves).

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, where there is greater exposure to mismatching risk. Suitable assets match only about 20% of these liabilities.

Liquidity: Consistently Strong Cash In/Out Trend

Liquidity is regarded as strong. The stress test liquidity scenario was estimated using the 1997 Polish flood--the biggest flood in Poland in the past 50 years--and fully matched by short-term assets and T-bonds available for sale (PLN3,587 million versus PLN4,566 million). PZU does not maintain bank lines or a CP program. The need to use such facilities is minimal, however, as the group has sufficient internal liquidity and good reinsurance cover to mitigate the potential losses emanating from catastrophic losses.

Capitalization: Strong Supported By Extremely Strong Capital Adequacy

Capitalization is strong, reflecting an extremely strong level of capital adequacy, adequate reserving, and a conservative reinsurance program.

Capital adequacy

PZU's risk-based capital adequacy is extremely strong capital adequacy as at Dec. 31, 2007. The 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 although the non-life operation demonstrates greater capital adequacy as at year-end 2007. Overall quality of capital is strong.

However, Polish government debt represents about 85% of group-invested assets and the risk associated with these investments adversely impacts Standard & Poor's view of capitalization.

Reserves

Reserve adequacy at PZU is satisfactory. PZU uses independent consulting actuaries for the review of reserve adequacy of its non-life business. Tillinghast-Towers Perrin has recognized PZU S.A.'s reserves as sufficient and highlighted PZU's conservative approach to reserving.

Reinsurance

PZU's reinsurance program provides suitable levels of coverage, with a panel of highly rated reinsurers (more than 95% of reinsurance receivables are rated 'A' or higher). The group continues to benefit from unlimited protection on TPML. Upper protection on the catastrophe excess-of-loss program is PLN1,000 million, which, in combination with the catastrophe reserves, provides cover in excess of the probable maximum loss of PLN850 million-PLN990 million (one-in-200-year event).

Financial Flexibility: No Need For Capital In The Medium Term

Table 4

PZU/Financial Statistics (Consolidated)

	--Year-ended Dec. 31--				
(Mil. PLN)	**2007**	**2006**	**2005**	**2004**	**2003**
Non-life annual change in net premiums written (%)	4.1	6.3	4.4	3.9	(2.9)
Non-life reinsurance utilization ratio (%)	2.1	2.0	5.2	7.2	7.4
Change in total assets (%)	6.5	14.9	10.5	11.5	12.8
Total adjusted equity	17,357	13,331	11,454	8,924	7,037
Annual change (%)	26.5	16.4	28.3	26.8	27.1
Total capital	16,865	13,351	11,454	8,924	7,592
New solvency measure	4.2	3.5	3.1	2.5	2.2
Reinsurance utilization ratio (%)	1.2	1.1	3.0	4.2	4.4
Net reserves/gross reserves (%)	97.22	96.66	95.61	95.1	93.7
Basic adjusted capital (%)	97.8	93.1	92.7	91.2	88.1
Revaluation reserves (%)	1.6	2.3	1.7	1.6	2.4
Other (%)	2.83	4.14	4.9	6.3	8.3
Non-life unearned premium reserves/net premiums earned (%)	26.0	24.7	25.8	27.1	26.1
Non-life net technical reserves/gross technical reserves (%)	63.6	62.0	68.9	70.7	68.5
Non-life loss reserves/net premiums written (%)	40.7	38.4	40.8	45.5	44.1
Life reinsurance utilization ratio (%)	0.1	0.1	0.1	0.1	0.2

PLN--Polish zloty.

PZU's adequate financial flexibility is driven by minimal requirements for additional external funding, limited capital needs to fund business growth, a debt-free balance sheet, and sufficient reinsurance capacity.

Nevertheless, if a need for capital arises, the availability of funding from existing shareholders is likely to be restricted, and this is a limiting rating factor. Should the group wish to enter the debt market, any issue is likely to be heavily oversubscribed in a market where little quality corporate debt exists, although this has not been tested. The possibility of an IPO is likely to further enhance PZU's financial flexibility, although Standard & Poor's considers this possibility to be still remote at present, and has not factored this into its assessment of PZU's financial flexibility.

Ratings Detail (As Of August 15, 2008)*

Operating Companies Covered By This Report

Ratings Detail (As Of August 15, 2008)*(cont.)	
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.

Additional Contact:
Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com

Additional Contact:
Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com