STANDARD & POOR'S — INSURANCE

Publication Date: 12-Aug-2004
Reprinted from Ratings Direct

Research

PZU

Analyst: Tatiana Grineva, London (44) 20-7176-7061; David Laxton, London (44) 20-7176-7079

RATING A- (STRONG)

An insurer rated 'A' has STRONG financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

RELATED RATINGS

Powszechny Zaklad Ubezpieczen na Zycie S.A.

Financial Strength Rating	
Local currency	A-

HOLDING COMPANY

None

GROUP MEMBERS

None

DOMICILE

Poland

LICENSED

Poland

Company Contact

PZU S.A.
24 Jana Pawla II Av.
00-133 Warsaw
Poland
Tel.: (48) 22-582-3016
Fax: (48) 22-582–2881
Head of Investor Relations: Michal Perlik

■ Major Rating Factors

Strengths:

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

Weaknesses:

- Concerns regarding investment diversity and asset-liability management;
- Relatively weak financial flexibility, constrained by ownership issue; and
- Short tenure of senior management team and uncertainty regarding the impact of impending

ownership changes.l

■ Rationale

The ratings on Powszechny Zaklad Ubezpieczen S.A. (PZU S.A.) and 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 capitalization, and strong operating performance. Offsetting factors are concerns regarding investment diversity and asset-liability management. In addition, financial flexibility (defined as the ability to source capital relative to capital requirements) is a relative weakness for the ratings, reflecting to some extent the ongoing uncertainty surrounding ownership.

PZU is Poland's largest insurance group, with its life and non-life insurance subsidiaries achieving market shares of 45.9% and 53.1%, respectively. The group had total assets of Polish zloty (PLZ) 35 billion ($9.3 billion) at year-end 2003.

PZU has a strong competitive position, based on its dominant position in the Polish insurance market with high recognition among the Polish population. However, the group is to some extent exposed to the fortunes of the Polish economy.

Capitalization is strong, reflecting a very high level of capital adequacy. Quality of capital is lower, however, due to a high proportion of "soft" capital items.

PZU's operating performance has historically been very strong, driven by its competitive position. Going forward, operating performance will temporarily decline as the group invests in operational modernization, but will remain strong in the longer term.

PZU's investment portfolio is regarded as good. Although the company has conservatively invested in Polish government bonds, the lack of availability of suitably long-dated investments precludes accurate asset-liability management. Regulations also limit the amount of overseas investment, thereby restricting diversity.

The PZU group demonstrates adequate financial flexibility. The group has substantial debt and reinsurance capacity, but the availability of funding from existing shareholders is likely to be low.

Standard & Poor's regards PZU's management and corporate strategy as challenged by a number of factors. These include the short track record of the current management, uncertainty regarding the impact of impending ownership changes, and the long-term impact of past management changes on the operational effectiveness of the group.

■ Outlook

The negative outlook on the core entities of the PZU group reflects the negative outlook on the Republic of Poland (foreign currency BBB+/Negative/A-2, local currency A-/Negative/A-2). Any lowering of the local currency rating on the sovereign would result in the immediate lowering of all the ratings on PZU's core subsidiaries.

PZU's competitive position will remain strong, despite a gradual decline in market share. Long-term competitive strength is most reliant on improving diversity in the non-life portfolio and strengthening the individual life segment.

The current uncertainty regarding the future ownership of PZU is not a major rating driver. Nevertheless, there are potential ownership scenarios that could have rating implications if they delay progress on delivery of key strategic initiatives.

Once the ownership issue is resolved, Standard & Poor's would expect any excess capital within the group to be released. Nevertheless, capital adequacy is expected to remain strong, with no deterioration in capital quality.

Table 1 PZU/Selected Statistics				
	--Year ended Dec. 31--			
(Mil. PLZ)	2003	2002	2001	2000
Total net premiums written	11,806.5	11,781.2	10,979.3	10,108.3
Total revenue*	14,721.0	14,386.1	13,473.0	11,807.1
Non-life (%)	46.5	45.1	46.0	43.8
Life (%)	44.3	46.0	45.4	48.1
Other (%)	9.1	8.8	8.6	8.1
Core operating result	2,176.2	1,882.5	1,624.0	1,629.8
Non-life (%)	13.4	17.8	17.6	23.2
Life (%)	37.4	26.5	29.8	31.5
Other (%)	49.2	55.7	52.6	45.3
Net income before bonus allocation	1,527.6	1,293.6	1,115.4	879.3
Net income	1,524.8	1,290.6	1,112.1	879.3
Total assets	34,304.7	30,369.3	25,677.3	20,826.3
Total equity	6,468.3	5,377.8	3,950.1	2,487.9
*Based on allocated investment income. PLZ--Polish zloty.				

■ Competitive Position

Table 2 PZU/Business Statistics				
	--Year ended Dec. 31--			
(Mil. PLZ)	2003	2002	2001	2000
Consolidated				
Total gross premiums written	12,346.5	12,289.6	12,230.8	11,535.6
Annual change (%)	0.5	0.5	6.0	0.0
Total net premiums written	11,806.5	11,781.2	10,979.3	10,108.3
Annual change (%)	0.2	7.3	8.6	0.0
Total assets under management	31,849.5	27,667.5	22,978.0	19,040.9
Nonlinked (%)	95.6	95.6	95.3	96.1
Linked (%)	4.4	4.4	4.7	3.9
Non-life				
Gross premiums written	7,219.1	7,391.6	7,519.5	7,136.0
Annual change (%)	(2.3)	(1.7)	5.4	0.0
Net premiums written	6,686.9	6,888.8	6,268.4	5,708.7
Annual change (%)	(2.9)	9.9	9.8	0.0
Life				
Gross premiums written	5,127.4	4,898.0	4,711.3	4,399.6
Annual change (%)	4.7	4.0	7.1	0.0
PLZ--Polish zloty.				

PZU has a strong competitive position, based on its dominant position in the Polish insurance market with high recognition among the Polish population. At Dec. 31, 2003, PZU had a market share of 50% of the total Polish insurance market. The maintenance of this position is supported by a substantial branch network, which brings unrivalled regional coverage. However, the group is to some extent exposed to the fortunes of the Polish economy.

Historical.

In July 1990, the Polish insurance market was freed from state control. Despite significant competition from new entrants, PZU maintains a dominant position in Poland with 53.1% of the non-life market and 45.9% of the life market in 2003. PZU's nearest competitors had 12.8% and 15.1% of the non-life and life markets, respectively.

The group is the third largest company in Poland in terms of sales, has assets of PLZ35 billion ($9.3 billion), and has been the most profitable company in Poland for the past two consecutive years. In March 2004, the shareholders were the Polish state treasury (55.1%), Eureko B.V. (Eureko; core operating entities rated A+/Negative/A-2) (20.9%), Bank Millennium Capital Group (Millennium; BBpi) (10%), institutional shareholders (5.8%), and individual shareholders (8.2%). Eureko has an effective 30.9% shareholding through Millennium.

PZU's brand recognition as one of the most well-known institutions in Poland is very strong. This recognition is not only based on PZU's pre-1990 duopoly position, but is maintained by PZU's substantial network, which reaches every corner of Poland with more than 800 branches and 10,000 agents.

PZU is by far the largest insurance group from the recent European accession countries, with approximately 25% of total gross premiums written. Although PZU is concentrated in the Polish market, it has already expanded into Lithuania, where it has quickly established a strong market position through acquisition, and is planning to expand into Ukraine.

Industry risk in Poland is regarded as modest, largely as a result of the European accession process, which brought reform to the Polish regulatory and legal environment in Poland. Insurance regulation is now largely aligned with that in Europe and solvency regulations are to be further strengthened in 2006. There are no significant barriers to entry in Poland and the western European insurers active in the accession countries are established in Poland.

The Polish insurance market has substantial growth potential in which PZU is well-positioned to participate. Insurance spend as a proportion of GDP is approximately 3.5%, well below the European average. Although third-party motor liability (TPML) has been established for many decades, private property insurance and health insurance are underdeveloped. Life insurance, typically of emerging markets, has the most substantial growth potential. Individual life insurance is still underdeveloped, with pension reform in its early stages. With a population of 39 million, Poland is the sixth largest country in the European Union and Standard & Poor's expects GDP growth to exceed 4% over the next three years, with economic growth having stalled in recent years.

Non-life.

PZU S.A. has a very strong competitive position in the Polish non-life insurance market as a result of its historic near-monopoly position in TPML prior to 1990 and its substantial distribution advantage. At Dec. 31, 2003, motor business represented 73.6% of the total non-life portfolio, reflecting both PZU's historic position and the current stage in the development cycle of the local insurance market. Perhaps surprisingly, given the group's market share in motor in excess of 60%, PZU has not demonstrated consistent price leadership in some segments, with strong competition from new entrants. Nevertheless, during the severest competition in the late 1990s which forced a number of competitors close to bankruptcy, PZU continued to be profitable as a result of its cost advantage.

PZU S.A.'s brand and sales network are its most significant assets to help maintain the group's competitive strength. The company has in excess of 7,000 agents spread throughout Poland, in addition to its substantial branch network. It is this network which perpetuates PZU's strong position in the smaller cities and rural areas, which is even stronger than its position in the large cities, and it is worth noting that PZU has in excess of 85% of the agricultural insurance market. PZU is also strong in the large cities, but it is here where the group experiences the stiffest competition.

Standard & Poor's expects PZU to reduce concentration on motor business by growing its personal property and commercial lines business. PZU is well positioned to capitalize on the expected growth in personal property insurance which will come with improved affluence. Greater penetration into the commercial lines arena will be more difficult to achieve due to the established position of Towarzystwo Ubezpieczen i Reasekuracji WARTA S.A. (WARTA; BBBpi), and to some extent TU Allianz Polska S.A. (BBpi). However, given that PZU is already established in servicing public institutions, the group can claim expertise in commercial lines, but will need to establish a greater presence with brokers who are becoming increasingly important in this sector.

Of the total non-life portfolio, 39% of business is sold by agents, 32% by permanent employees, 14% by brokers/intermediaries, and 13% by multiagents. More than 70% of TPML business is sold through the branch network, with 35% automatically renewed by post. The total lapse ratio on the portfolio is 2%.

Life.

PZU Zycie has a strong competitive position in the Polish life insurance market due to its entrenched position in workplace-based life product sales, where it has an 84% market share (although its position in individual life insurance is much weaker).

PZU Zycie's core business is so-called "group life", for which it has six million policyholders. This involves individual life products sold to groups of employees, usually at the same workplace. Importantly, they differ from the more commonly known definition of group life, as the life insurance contracts are with the individual employee and not with the employer. Therefore, employees can easily continue coverage on leaving their employer, an option with a very high take-up rate due to the attractiveness of the product features. PZU Zycie representatives agree a single scheme in the workplace, which includes some flexibility in coverage and is typically simple life cover for the employee and family members. PZU Zycie also has in excess of 95,000 "Zosias", employees within Polish companies who collaborate with PZU Zycie agents to extend the number of participants in existing group life schemes. Although this approach has been very successful to date, Standard & Poor's has some concerns regarding its long-term viability given the changing sales force compliance regulations in Europe.

PZU Zycie is entrenched among the major public and private institutions in group life sales, a standing in the market that is strengthened by the good relations the company established with the trade unions in the past, when PZU Zycie had a near-monopolistic position. Competitors are focused on providing narrower coverage at lower prices, but--as can be seen by the market share trends--inroads have been slight as PZU's share still exceeds 80%.

PZU Zycie had a 45.9% share of the Polish life insurance market in 2003, with the next nearest competitor, Commercial Union Polska, at 15%. New entrants have successfully entered the individual life market, in which PZU Zycie has only 10% of the market as the fourth-largest provider. Unsurprisingly, management is focused on improving this position. At present, individual life products are popular with the most affluent in Poland and PZU Zycie is creating a new dedicated sales force, working on its unit-linked product offerings to target this client base. Its major competitors can, however, draw on international experience and established local positions and PZU Zycie will therefore be challenged to substantially improve its market ranking for individual life.

Health products are in their infancy in Poland partly due to the lack of suitable private healthcare facilities. Nevertheless, PZU Zycie has established cooperation with one of Poland's largest providers of private healthcare, which should help the company establish a good position in this market.

Although bancassurance remains in the early stages of its development in Poland, a number of new cooperation agreements have been signed by the larger banks and insurers in the past two years. PZU is already actively marketing through Millennium and Powszechna Kasa Oszczednosci Bank Polski (S.A.) (PKOBP; BBpi/--/--). At present non-life insurance products are the largest sales area, but this will undoubtedly change and strategic links with PKOBP, the largest Polish savings bank, will be important.

Historically, the sales process at PZU Zycie has been entirely independent of the group's non-life operations. This must change if PZU is to leverage the diversity of composite status. Progress on this front has been minimal thus far.

Prospective.

PZU's competitive position will remain strong, despite a gradual decline in market share. The group's long-term competitive strength is most reliant on improving diversity in the non-life portfolio and strengthening the individual life segment. PZU will be able to maintain good growth as the overall demand for insurance in Poland increases.

■ Management and Corporate Strategy

Management has ambitious modernization and restructuring plans for the group.

Standard & Poor's regards PZU's management and corporate strategy as challenged by a number of factors. These include the short track record of the current management, uncertainty regarding the impact of impending ownership changes, and the long-term impact of past management changes on the operational effectiveness of the group.

Management will be stretched over the next few years with an intended internal rationalization, potential changes as a result of the resolution of the ownership issue, and a possible IPO.

Publicity surrounding the ownership dispute between Eureko and the Polish state treasury has been intense. Arbitration proceedings are, however, underway, which should resolve the situation in the medium term. The primary issue is a former agreement between Eureko and the state treasury for the acquisition of a majority shareholding--taking Eureko's share in PZU from 30%-51%--which was rejected by the incoming government. Standard & Poor's considers the most likely outcome of arbitration to be that Eureko remains the largest strategic investor, with the European Bank of Reconstruction and Development and/or the International Finance Corporation holding a minority interest to bring their share combined with that of Eureko to just above 50%. The government would then sell its remaining interest through an IPO. Some potential outcomes of the arbitration process could impact PZU's long-term financial strength. In particular, any option which delays the current operational restructuring or results in further substantive management changes would be viewed negatively.

Outwardly, these ownership uncertainties have not affected PZU directly as the group's core competitive position and underlying financial indicators remain the same as previous years. Although a number of projects, including partnership projects, with Eureko that Standard & Poor's would have regarded as critical for the long-term future of the company have not proceeded, a substantial operational restructuring is now underway which will make up for lost time.

Throughout these uncertainties, Eureko has sought to maintain strategic cooperation, and most importantly has retained all its board representations. PZU S.A. has five board members, with three state treasury representatives and two from Eureko, and the supervisory board comprises eight individuals equally allocated to the state treasury and Eureko. Although there is no chairman at present due to the death of the incumbent, the post is a joint Eureko/treasury nomination. PZU Zycie has three directors of the board, one of which represents Eureko.

There has been some discussion regarding strategic cross-shareholding or a merger with Poland's largest savings bank, PKOBP. In Standard & Poor's opinion, an outright merger would be undesirable as PZU's management must concentrate on the modernization of the company and a suitable bancassurance model can be built without such a merger.

Strategy.

PZU's major strategic initiatives center around three key areas. The most important, in Standard & Poor's opinion, is the centralization of operating functions and associated IT developments. Currently, policy and claims administration and underwriting is largely carried out within the group's extensive branch network, which potentially brings a number of problems including slow communication and inconsistent execution of key operational controls. Although this has not led to a level of cost inefficiency that could challenge profitability, in the longer term reliance on this labor-intensive structure is not desirable. Meanwhile, the cost of centralization, which is still in its early stages, will be substantial, but the group has the advantage of implementing the initiative from a position of strength. The effective delivery of this essential project will be crucial to Standard & Poor's ongoing assessment of management.

In terms of competitive position, PZU aims to defend existing positions while continuing to develop new capabilities. The implementation of this defensive strategy will prove increasingly difficult to achieve, as a number of competitors have repositioned themselves in recent years and flexibility in pricing will be temporarily reduced for non-life business.

Finally, PZU is targeting growth outside Poland, particularly in bordering countries where historic and cultural links exist. Again, a defensive strategy and, in the longer term, wholly appropriate to reduce concentration in what will be an increasingly competitive market. At present, current acquisition activity is minimal with the group's new operations having minimal impact on PZU's balance sheet, but Standard & Poor's is concerned that any sharp increase in this activity could result in the diversion of management time and capital support away from the centralization project.

Operational management.

PZU S.A. is the holding company and main operating company of the PZU group. It wholly owns PZU Zycie and the pension fund PTE PZU S.A. Significant operational change is underway as previously mentioned, which is necessary to improve operational effectiveness.

It is only relatively recently that the management of PZU Zycie has come under greater control at the PZU S.A. level. The previously devolved control of PZU Zycie led to corporate governance failures, which were widely reported. The boards of PZU Zycie and PZU S.A. now have a greater level of integration with more regular meetings, but at present functional crossover is low. Clearly, rationalization gains can be made as the companies have largely separate branch networks. Standard & Poor's would like to see greater operational integration in the short term with support demonstrated from all levels of management.

Financial management.

Centralized financial management is improving as greater managerial control is assumed by PZU S.A., the effective holding company. Once the ownership issue is resolved, a change in the organizational structure of the PZU group is likely with the creation of a dedicated holding company.

Financial strategy is driven in the short term by the centralization project, which will temporarily disrupt operating performance. Capital management is increasingly focused on risk-based measures and the dividend strategy of minimum 25% sees significant value retained within the group.

■ Operating Performance

Table 3 PZU/Operating Statistics				
	--Year ended Dec. 31--			
(Mil. PLZ)	2003	2002	2001	2000
Consolidated				
Total revenue*	14,721.0	14,386.1	13,473.0	11,807.1
Core operating profit	2,176.2	1,882.5	1,624.0	1,629.8
Realized gains/core operating profit (%)	33.7	26.9	0.1	12.6
Net income	1,524.8	1,290.6	1,112.1	879.3
Post-tax ROE (%)	25.7	27.7	34.5	0.0
Total profitability ratio (%)	35.1	39.5	47.3	0.0
Total gross expense ratio (%)	22.1	22.2	21.0	18.5
Administrative expense ratio (%)	12.6	12.5	12.2	13.3
Acquisition expense ratio (%)	9.8	9.1	8.6	4.2
Nontechnical expenses/total revenue (%)	2.5	1.8	3.0	4.8
Nontechnical expenses/total assets (bps)	108.5	87.2	160.0	274.3
Non-life				
Non-life revenue*	6,851.8	6,495.3	6,198.5	0.0
Non-life operating result*	292.6	334.7	285.3	0.0
ROR* (%)	4.3	5.2	4.6	0.0
Gross loss ratio (%)	67.6	71.8	75.6	73.6
Gross expense ratio (%)	26.3	25.6	23.0	18.8
Gross combined ratio (%)	93.8	96.1	98.2	93.7
*Based on allocated investment income. Bps--Basis points. PLZ--Polish zloty				

Table 3 PZU/Operating Statistics cont				
	--Year ended Dec. 31--			
(Mil. PLZ)	2003	2002	2001	2000
Non-life cont				
Reinsurance result	(344.1)	(39.9)	(19.3)	(47.6)
Growth in expenses (%)	6.0	18.6	47.8	0.0
Net loss ratio (%)	71.4	71.5	75.1	73.8
Administrative expense ratio (%)	16.1	15.5	15.1	14.5
Acquisition expense ratio (%)	11.0	9.3	7.9	2.5
Net expense ratio (%)	27.1	24.8	23.0	17.1
Net combined ratio (%)	98.5	96.2	98.1	92.7
Operating ratio* (%)	95.6	94.8	95.3	0.0
Life				
Life revenue	6,525.5	6,619.2	6,111.3	5,676.0
Growth in net life technical reserves (%)	11.4	17.9	21.3	0.0
Life surplus available for distribution	816.4	502.5	488.0	514.0
Policyholder bonus/surplus (%)	0.3	0.6	0.7	0.0
Smoothed pretax before bonus ROA	450.5	347.5	413.4	0.0
Post-tax return on life assets (after bonus allocation) (bps)	448.9	345.4	410.6	0.0
Unsmoothed pretax before bonus ROA	450.5	347.5	413.4	0.0
Growth in expenses (%)	(1.5)	0.2	7.1	0.0
Administrative expense ratio (%)	8.0	8.3	8.2	11.6
Acquisition expense ratio (%)	8.2	8.9	9.6	6.2
Total gross expenses/gross premiums written (%)	16.2	17.2	17.8	17.8
Total net life expenses/total life assets (bps)	457.2	581.9	711.2	1,351.2
Maintenance expenses/gross premiums (%)	8.0	8.3	8.2	11.6
Investments				
Life assets/total assets (%)	56.3	55.7	46.7	55.7
Net investment income	822.6	830.1	1,184.2	537.0
Realized gains/(losses)	732.3	506.4	2.3	205.9
Unrealized gains/(losses)	1,109.2	1,528.3	1,210.2	(18.8)
Direct yield on invested assets (%)	2.9	3.4	5.9	0.0
Yield (incl. realized) (%)	5.5	5.5	5.9	0.0
Total return (incl. unrealized and realized) (%)	9.4	11.8	11.9	0.0
*Based on allocated investment income. Bps--Basis points. PLZ--Polish zloty				

PZU's operating performance has historically been very strong, driven by its competitive position. Going forward, operating performance will temporarily decline as the group invests in operational modernization, but will remain strong in the longer term.

Historical.

Non-life.

PZU S.A.'s strong earnings performance has historically been driven by the group's dominance of the Polish motor market, supported by a low cost base compared with its competitors. A concentration in motor business is, however, of some concern, although this will decrease as PZU S.A. achieves greater portfolio diversity.

PZU S.A. has remained profitable in motor insurance while many competitors have generated substantial losses. The company has a particularly strong presence in the smaller cities and rural areas where motor loss ratios are lower than in the large cities. In addition, PZU S.A. has a substantial database of historical information and experience, which allows it to set adequate prices.

A low cost base has assisted PZU S.A.'s overall non-life performance. Although the expense ratio has risen gradually, mainly due to an increase in commissions, it remains comparatively low, averaging 22.0% over the past five years. Overall, the five-year combined ratio to 2003 was excellent at 97.1%.

In addition, the company has generated strong investment returns assisted by strong bond yields, with the total return averaging more than 10% over the past five years.

Life.

PZU Zycie's operating performance has been very strong historically, driven by low acquisition costs and lapse rates. The company's core group life product has particularly low distribution costs due to its unique servicing structure. The addition of a new employee to an existing scheme requires minimal effort, particularly as the leads are supplied by the Zosias. Furthermore, lapse rates on this product are approximately 1% as many employees continue the cover when changing employer, which also keeps cost down. Undoubtedly, this structure will change in the future as the expanding individual life segment involves higher servicing and acquisition costs.

Prospective.

Operating performance is expected to decline in the short term as the group focuses on operational restructuring. Nevertheless, as the fundamentals of PZU's business remain and will be strengthened, longer term operating performance is expected to remain strong. The group will continue to generate earnings sufficient to maintain capital strength while meeting dividend expectations.

■ Investment

PZU's investment portfolio is regarded as good. Although the company has conservatively invested in Polish government bonds, the lack of availability of suitably long-dated investments precludes accurate asset-liability management. Regulations also limit the amount of overseas investment, thereby restricting diversity.

Credit risk.

Approximately 80% of total investments are held in Polish government local currency debt issues. This apparent lack of diversity could be regarded as a weakness in the investment portfolio, but currency restrictions and low availability of good-quality Polish corporate debt restricts diversity in this asset class. There are no concentrations by entity/issuer in excess of 10% of total adjusted capital (TAC).

Market risk.

The Warsaw Stock Exchange is still relatively underdeveloped, which causes concern regarding the overall market risk. In 2003, the life company increased its equity weighting, but at 10% of total assets this remains low. Although PZU has some exposure to nonlisted equity participations, for which the information available is limited, an active reduction in these investments by management is noted.

Asset-liability management.

With a restricted pool of available investments, and with fixed-interest securities remaining largely short dated, PZU has some mismatch in the duration of assets and liabilities. Approximately 40% of PZU's non-life technical provisions have an expected duration in excess of five years, relating almost entirely to the TPML annuity reserves. With an average bond duration of about three years, the longer term liabilities are matched with other investments, including equities. Undoubtedly, this will expose the company to reinvestment risk as the fixed-income portfolio is refreshed over time to meet ongoing liabilities. This risk also occurs at PZU Zycie where the situation is more acute, with suitable assets matching about 3% of liabilities in excess of 10 years.

■ Liquidity

Liquidity is regarded as strong, with high asset liquidity, plentiful cash flow, and low exposure to short-term cash requirements from catastrophes.

Cash flows.

Underwriting cash flow is very strong, with the underwriting cash flow ratio averaging in excess of 125% over the past five years.

Balance sheet.

With a balance sheet rich in sovereign debt, equities, and cash, balance sheet liquidity is very strong. Liquid assets were some 125% of technical provisions in 2003.

Backup.

PZU S.A. does not maintain bank lines or a commercial paper program. The need to use such facilities is minimal, however, as the group has sufficient internal liquidity and good reinsurance cover for catastrophic loss.

■ Capitalization

Capitalization is strong, reflecting a very high level of capital adequacy. Quality of capital is lower, however, due to a high proportion of "soft" capital items.

Capital adequacy.

According to Standard & Poor's risk-based capital model, PZU had very strong capital adequacy at Dec. 31, 2003. The group's capital strength comes from the non-life operations, which--on a stand-alone unconsolidated basis--had exceptionally strong capital adequacy at year-end 2003. PZU Zycie's capital adequacy is good and consistent with its status as a core operating entity under Standard & Poor's group methodology. PZU's dividend payouts have been low and for the 2003 dividend the majority shareholder requested that management's dividend recommendation be lowered. Standard & Poor's expects some surplus capital to be paid out in the longer term.

Quality of capital.

Overall quality of capital is regarded as good. More than 55% of TAC is in core shareholder funds and the group also has substantial equalization and catastrophe reserves. TAC can be sensitive to changes in the treatment of embedded value on the life business. Embedded value represents 41% of PZU Zycie's TAC, but only 18% of group TAC.

Polish government debt represents more than 80% of group-invested assets. There is, therefore, some sensitivity in capital requirements for investment risk relating to any adverse change in the rating of these instruments.

Reserves.

Reserve adequacy at PZU S.A. is satisfactory. PZU uses independent consultant actuaries to verify reserve adequacy. PZU S.A. has a substantial database from which it can establish adequate pricing models and incurred-but-not-reported reserve levels.

PZU S.A. maintains a substantial annuity reserve for TPML bodily injury claimants, as Polish regulation does not allow lump-sum settlements. PZU S.A. will pay claimants sufficient sums to top up income to levels received before the accident. There are strict terms under which PZU provides payouts to policyholders, although any change in the litigation environment and a higher standard of living could increase policyholder expectations regarding appropriate income levels. The Polish legal system is not, however, governed by precedent and individual annuitants must seek court approval for any increase in annuity payments.

Reinsurance ceded.

PZU's reinsurance program appears appropriate, with suitable levels of coverage provided by a panel of rated reinsurers. At Dec. 31, 2003, approximately 90% of reinsurance debtors were with reinsurers rated 'BBB' or higher. The group continues to benefit from unlimited protection on TPML. In previous years, PZU placed one of the largest motor quota shares in the industry, but the improved capital position of the group resulted in its cancellation. Upper protection on the catastrophe excess of loss program is PLZ700 million, which--in combination with the catastrophe reserves--provides cover in excess of the maximum probable maximum loss. The attachment point for the program was raised in recent years due to increasing costs, which may lead to a slight increase in volatility. The last major flood was of the Oder river in 1997 and, despite extensive damage and a two-wave flood scenario, the total gross loss was PLZ340 million.

Prospective.

Once the ownership issue is resolved, Standard & Poor's would expect any excess capital within the group to be released. Nevertheless, capital adequacy is expected to remain strong with no deterioration in capital quality.

■ Financial Flexibility

Table 4 PZU/Financial Statistics				
	--Year ended Dec. 31--			
(Mil. PLZ)	2003	2002	2001	2000
Consolidated				
Total assets	34,304.7	30,369.3	25,677.3	20,826.3
Change in total assets (%)	13.0	18.3	23.3	0.0
Total adjusted equity	6,468.3	5,377.8	3,950.1	2,487.9
Change in adjusted equity (%)	20.3	36.1	58.8	0.0
Total capital	6,468.3	5,377.8	3,950.1	2,497.7
Group solvency measure (x)	3.6	3.0	2.5	1.8
Reinsurance exposure ratio (%)	23.8	31.9	42.3	61.3
Investment leverage (incl. policyholder capital) (%)	43.6	32.9	46.6	152.9
Liquid assets/technical reserves (%)	125.3	119.9	115.2	107.4
Non-life				
Reinsurance utilization ratio (%)	7.4	6.8	16.6	20.0
Technical reserves/net premiums written (%)	134.8	119.4	114.4	109.8
Loss reserves/net premiums written (%)	86.1	75.9	74.4	64.9
Net technical reserves/gross technical reserves (%)	81.0	77.8	74.0	74.4
Net claims reserves/net claims incurred (%)	121.1	114.0	102.9	97.0
Net claims paid/net claims incurred (%)	84.7	84.9	78.1	80.9
PLZ--Polish zloty.				

The PZU group demonstrates adequate financial flexibility. The group has substantial debt and reinsurance capacity, but the availability of funding from existing shareholders is likely to be low.

PZU has minimal requirements for additional external funding, with sufficient capitalization to meet expected growth and access to reinsurance capacity if required. Nevertheless, 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. At present, the likelihood of equity funding is minimal. However, an IPO is likely once the shareholding issue is resolved.

■ Analytical E-Mail Addresses

tatiana_grineva@standardandpoors.com

david_laxton@standardandpoors.com

InsuranceInteractive_Europe@standardandpoors.com

Published by Standard & Poor's, a Division of The McGraw-Hill Companies, Inc. Executive offices: 1221 Avenue of the Americas, New York, NY 10020. Editorial offices: 55 Water Street, New York, NY 10041. Subscriber services: (1) 212-438-7280.