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Credit Opinion: Bank Zachodni WBK S.A.

Global Credit Research - 03 Jun 2015

Warsaw, Poland

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Deposits	A3/P-2
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa2

Contacts

Analyst	**Phone**
Simone Zampa/London	44.20.7772.5454
Elena Redko/Moscow	7.495.228.6060
Yves Lemay/London	44.20.7772.5454
Aleksandar Hristov/London	

Key Indicators

Bank Zachodni WBK S.A. (Consolidated Financials)[1]

	[2]**12-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (PLN billion)	**134.0**	**105.5**	**60.0**	**59.9**	**53.2**	[4]**26.0**
Total Assets (EUR million)	**31,171.0**	**25,381.8**	**14,709.5**	**13,431.2**	**13,410.8**	[4]**23.5**
Total Assets (USD million)	**37,718.5**	**34,974.7**	**19,392.9**	**17,435.7**	**17,991.1**	[4]**20.3**
Tangible Common Equity (PLN billion)	**13.1**	**10.6**	**7.9**	**6.7**	**6.0**	[4]**21.4**
Tangible Common Equity (EUR million)	**3,036.6**	**2,560.4**	**1,932.4**	**1,493.8**	**1,518.2**	[4]**18.9**
Tangible Common Equity (USD million)	**3,674.5**	**3,528.1**	**2,547.6**	**1,939.2**	**2,036.7**	[4]**15.9**
Problem Loans / Gross Loans (%)	**8.4**	**7.9**	**5.4**	**5.5**	**6.9**	[5]**6.8**
Tangible Common Equity / Risk Weighted Assets (%)	**12.3**	**12.2**	**15.1**	**13.8**	**14.3**	[6]**12.3**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**41.9**	**39.9**	**23.9**	**27.0**	**32.0**	[5]**32.9**
Net Interest Margin (%)	**3.4**	**3.5**	**3.9**	**3.7**	**3.4**	[5]**3.6**
PPI / Average RWA (%)	**3.3**	**4.0**	**4.6**	**4.2**	**4.1**	[6]**3.3**
Net Income / Tangible Assets (%)	**1.6**	**1.6**	**2.4**	**2.1**	**2.0**	[5]**1.9**
Cost / Income Ratio (%)	**47.3**	**50.5**	**43.9**	**50.3**	**49.9**	[5]**48.4**
Market Funds / Tangible Banking Assets (%)	**12.0**	**8.2**	**4.0**	**6.8**	**5.9**	[5]**7.4**
Liquid Banking Assets / Tangible Banking Assets (%)	**30.2**	**29.9**	**29.3**	**32.6**	**34.6**	[5]**31.3**
Gross Loans / Total Deposits (%)	**95.0**	**89.1**	**86.8**	**83.9**	**81.2**	[5]**87.2**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Bank Zachodni WBK's (BZ WBK) deposit ratings are A3/Prime-2, and the bank's baseline credit assessment (BCA) is baa3.

BZ WBK's baa3 BCA is supported by (i) its expanding franchise in the Polish market, (ii) a good liquidity profile, and (iii) adequate capitalisation, supported by high internal capital creation. The BCA is constrained by the bank's (i) asset quality, slightly weaker than the system average, and (ii) some dependence on medium-term wholesale FX funding due to its FX mortgage portfolio.

The A3/Prime-2 deposit ratings are underpinned by the bank's BCA, our assumptions of high affiliate support from its parent, Banco Santander (deposits Baa1 under review for upgrade; BCA baa1), and the Advanced Loss Given Failure (LGF) analysis.

Furthermore, we assign a Counterparty Risk Assessment (CR Assessment) of A2(cr)/P-1(cr) to BZ WBK.

BZ WBK'S RATINGS ARE SUPPORTED BY POLAND'S STRONG- MACRO PROFILE

Poland's Macro Profile balances the country's very high economic and institutional strengths against its moderate susceptibility to event risk. While operating conditions for banks in Poland are relatively benign, the banking system continues to carry a sizeable, albeit declining, burden of foreign-currency mortgages, which carries higher credit and funding risks, constraining the banks' good financial fundamentals.

Rating Drivers

- A rapidly growing franchise in the Polish market, through the acquisition of Kredyt Bank and Santander Consumer Bank

- Asset quality is slightly weaker than the system average

- Capitalisation is adequate, supported by high internal capital creation

- Self funding profile underpinned by a large retail deposit base, but some dependence on medium-term wholesale FX funding due to the FX mortgage portfolio

Rating Outlook

The outlook for BZ WBK's ratings is stable.

What Could Change the Rating - Up

Upward pressure of BZ WBK's ratings would be largely conditional on an improvement in asset quality, while maintaining or improving its capital base, profitability, funding and liquidity.

What Could Change the Rating - Down

BZ WBK's ratings could come under pressure if asset quality shows significant deterioration, which is likely to have a negative effect on profitability and capital creation levels. Inability to maintain its currently favourable loan-to-deposit ratio would also be an important element of rating pressure.

DETAILED RATING CONSIDERATIONS

A RAPIDLY GROWING FRANCHISE IN THE POLISH MARKET THROUGH THE ACQUISITION OF KREDYT BANK AND SANTANDER CONSUMER BANK

Following the acquisition of Kredyt Bank in January 2013 and Santander Consumer Bank (SCB), which was acquired from BZ WBK's parent, in July 2014, BZ WBK's total assets more than doubled between end-2012 to end 2014, to PLN 134.5 billion from PLN 60 billion. As a result, BZ WBK became the third-largest bank in Poland with market shares of customer deposits and loans of, respectively, 9.5% and 8.9% as of December 2014. The bank has a well-established franchise in corporates, focusing on large and medium-sized clients, where we expect competition to remain relatively high. The acquisition of Kredyt Bank has also significantly boosted the bank's mortgage franchise which was lagging behind its peers (mortgage loans more than tripled at YE 2013). The consolidation of SCB, which is about 14% of the assets of BZ WBK, also helped to expand the bank's presence in retail lending.

The bank's retail franchise is supported by its branch network in Poland, which comprised 788 branches as of December 2014.

ASSET QUALITY IS SLIGHTLY WEAKER THAN THE SYSTEM AVERAGE

Historically, BZ WBK's risk profile has been influenced by its exposure to the commercial real estate segment which has, however, declined significantly in recent years. This segment accounted for 10% of gross loans at year-end 2014.

The ratio of non-performing loans of BZ WBK decreased to 8.3% in Q1 2015, from 8.4% as of year-end 2014, which remains slightly higher than the average for the Polish banking sector of 7.5%. At the same period, the non-performing loan coverage ratio also marked a slight improvement to 59.1%, from 58.4% as of year-end 2014.

We expect the improving trend to continue, and as a result, we adjust up the asset risk score to ba2.

CAPITALISATION IS ADEQUATE, SUPPORTED BY HIGH INTERNAL CAPITAL CREATION

BZ WBK reported a total capital ratio of 12.9% and Tier 1 ratio of 12.5% as at December 2014. We note that the bank has announced that it will not distribute and dividend out of 2014 profits, which we see as favourable development which will help strengthen the capital position of BZ WBK

The bank has maintained relatively high internal capital generation, with reported annualised ROE at 14.4% and estimate ROA of around 1.5% during 2014. However, we note that ROE declined from 16.6% in 2013, due to the costs for the integration of the newly acquired operations. In addition, we note that high ROE ratios have not translated into equivalent capital increases, as the bank has maintained a relatively high dividend payout ratio of around 50% during recent years.

SELF FUNDING PROFILE UNDERPINNED BY LARGE RETAIL DEPOSIT BASE, BUT SOME DEPENDENCE ON MEDIUM-TERM WHOLESALE FX FUNDING DUE TO THE FX MORTGAGE PORTFOLIO

Liquidity and funding constitute important rating drivers for BZ WBK given its high reliance on customer funds, with its gross loan-to-deposit ratio at 95.7%% as of December 2014. The bank also has comfortable liquidity buffer (liquid assets as a percentage of total assets stood at 30% at Q4 2014) which, however, we expect to reduce slightly to sustain loan growth. As a result, we adjust down the liquid resources score to baa2.

In the past BZ WBK had limited exposure to FX loans and was able to fund the bulk of them with its FX deposits. However, as part of the acquisition of Kredyt Bank and SCB, BZ WBK took over a large CHF mortgage portfolio, as a result of which the bank's CHF on-balance sheet funding gap increased significantly (CHF loans increased to around PLN 13.9 billion in 2014, from PLN 2 billion in 2012).

As part of the acquisition agreement, KBC (the former parent of Kredyt Bank) committed to cover part of the FX mismatches with cash collateralised funding, subordinated debt and medium term swap facility. Nevertheless, around 62% of the currency gap remains managed through the derivatives market, in the form of medium-term FX derivatives. While this indicates that the bank is currently well hedged in FX, it is also required to maintain free liquidity reserves for collateral needs in case of unfavourable developments in the foreign currency markets. As a result, we adjust down the funding structure score to baa2.

Notching Considerations

AFFILIATE SUPPORT

We assess a moderate probability of parental support for BZ WBK from its parent Banco Santander.

This leads to an adjusted BCA of baa2, one notch above the bank's BCA of baa3.

LOSS GIVEN FAILURE

BZ WBK operates in Poland, which is an EU-member country. As such, under the Bank Resolution and Recovery Directive (BRRD) it is subject to an Operation Resolution Regime, similar to other EU countries. Poland is expected to adopt a national version of the directive in the course of 2015. As a result, in accordance with our methodology, we apply our advanced LGF analysis, considering the risks faced by the different debt and deposit classes across the liability structure should the bank enter resolution. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

This results in a Preliminary Rating Assessment (PRA) two notches above the Adjusted BCA, reflecting a very low loss-given failure.

GOVERNMENT SUPPORT

We believe there is low likelihood of government support for BZ WBK's deposits in the event of its failure. This reflects the operational resolution regime which is likely to restrict the ability of the government to provide such support, even if it were willing to do so, requiring losses to be imposed on even senior creditors and large depositors under many circumstances.

As a result, we do not incorporate any systemic support from Polish authorities to BZ WBK's deposit ratings.

COUNTERPARTY RISK ASSESSMENT

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

The CR Assessment of BZ WBK is positioned at A2(cr), three notches above the Adjusted BCA of baa2, based on the cushion against default provided to the senior obligations. In addition, the low probability of government support does not result in any uplift.

The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss, therefore we focus purely on subordination and take no account of the volume of the instrument class.

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Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Bank Zachodni WBK S.A.

Macro Factors	
Weighted Macro Profile	**Strong -**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	8.4%	ba3	↑	ba2	Expected trend	
Capital						
TCE / RWA	12.3%	baa2	←→	baa2	Stress capital resilience	
Profitability						

Net Income / Tangible Assets	1.6%	a3	↓	a3	Expected trend	
Combined Solvency Score		baa3		baa3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	12.0%	a3	↓	baa2	Extent of market funding reliance	Market funding quality
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	30.2%	a3	↓	baa2	Expected trend	Quality of liquid assets
Combined Liquidity Score		a3		baa2		

Financial Profile	**baa3**

Qualitative Adjustments	**Adjustment**
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

Sovereign or Affiliate constraint	A2
Scorecard Calculated BCA range	**baa2 - ba1**
Assigned BCA	**baa3**
Affiliate Support notching	**1**
Adjusted BCA	**baa2**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	2	0	a3	0	A3	A3

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