FITCH REVISES PEKAO OUTLOOK TO NEGATIVE; AFFIRMS 4 LEADING POLISH BANKS

Fitch Ratings-Warsaw/London-20 October 2017: Fitch Ratings has revised the Outlooks on the Long-Term Issuer Default Ratings (IDR) of Poland-based Bank Pekao SA (Pekao) and its mortgage bank subsidiary, Pekao Bank Hipoteczny (PBH), to Negative from Stable. At the same time, Fitch has affirmed the Long-Term IDRs of Pekao (A-) and Pekao Bank Hipoteczny (A-), Bank Zachodni WBK (BZ WBK, BBB+), Bank Handlowy w Warszawie (A-) and ING Bank Slaski (A). The Long-Term IDRs of BZ WBK, Handlowy and Bank Slaski are on Stable Outlook.

The Viability Ratings (VR) have been affirmed at 'a-' (Handlowy and Pekao) and at 'bbb+' (BZ WBK and Bank Slaski). A full list of rating actions is provided at the end of this commentary.

The Outlook Revision for Pekao reflects Fitch's expectation that the bank's capital ratios are likely to gradually moderate. In Fitch's view, capitalisation is Pekao's main rating advantage over some of its direct peers.

The affirmation of the VRs of the four banks and the IDRs of BZ WBK, Handlowy and Pekao reflect no major changes to their financial metrics over the past 12 months. The affirmation of Slaski's IDRs reflects Fitch's opinion of an extremely high probability that the bank would be supported by its parent, if needed.

KEY RATING DRIVERS
IDRS, NATIONAL RATINGS AND SENIOR DEBT
The IDRs of BZ WBK (and its senior debt rating), Handlowy and Pekao are driven by the banks' intrinsic strength, as reflected in their VRs. The IDRs of BZ WBK and Handlowy are also underpinned by potential shareholder support. The IDRs of Bank Slaski are driven by potential shareholder support.

The Stable Outlooks on BZ WBK and Handlowy reflect broadly balanced risks related to their credit profiles and their respective parents. The Stable Outlook on Bank Slaski reflects that on its parent.

Handlowy's Short-Term IDR of 'F1' is the higher of the two possibilities corresponding to its Long-Term IDR of 'A-'. This reflects its strong coverage of short-term liabilities by liquid assets, stable funding base and potential ordinary support from Citigroup.

The ratings of PBH are equalised with those of Pekao and share the same Negative Outlook, reflecting Fitch's view that it is a strategically important subsidiary of Pekao.

SUPPORT RATINGS AND SUPPORT RATING FLOOR
The Support Ratings (SRs) of '1' for Handlowy and Bank Slaski and '2' for BZ WBK reflect Fitch's view of an extremely high and high, respectively, probability of support from the banks' respective shareholders. Handlowy, Bank Slaski and BZ WBK are owned, respectively, by Citigroup Inc. (A/Stable/a), ING Bank N.V. (A+/Stable/a+) and Banco Santander, S.A. (A-/Stable/a-).

In our opinion, Poland is a strategically important market for Citigroup, ING Bank and Santander. The banks' synergies with their respective parents are strong and underpinned by long track records in supporting their parents' objectives, which is likely to continue, and a high level of management and operational integration. In our opinion, any required support for the three banks would be immaterial relative to their respective parents' ability to provide it. Our opinion reflects the owners' solid credit profiles and the small size of their Polish subsidiaries relative to their respective parents.

The resolution of the Rating Watch Negative for Pekao's SR and downgrade to '5' from '2' reflects the change in ownership of the bank and Fitch's view that shareholder support can no longer be relied upon. Pekao is effectively state-controlled, through a joint minority stake held by PZU (20% stake, largest Polish insurer, state-controlled) and PFR (12.8% stake, fully state-owned development fund). The remaining shares are widely held and the bank is listed on the Warsaw Stock Exchange.

The Support Rating Floor of 'No Floor' and the SR of '5' for Pekao also reflects Fitch's opinion that, although potential sovereign support for the bank is possible, it cannot be relied upon. This is underpinned by the EU's Bank Recovery and Resolution Directive, transposed into Polish legislation, which requires senior creditors to participate in losses, if necessary, instead of or ahead of a bank receiving sovereign support.

VIABILITY RATINGS
The four banks' common rating strengths include well-established domestic market franchises, stable business models, conservative risk appetites, strong capitalisation, sound asset quality, solid profitability and robust funding and liquidity. The higher (by one notch) VRs of Handlowy and Pekao reflect their higher capital buffers and a particularly low-risk business model (Handlowy).

At end-1H17, Pekao was the second-largest bank by total assets, followed by BZ WBK (third) and Bank Slaski (fifth). Handlowy's market share is considerably smaller (11th), but its franchise and the strength of customer relationships in its strategic segments are solid. The banks' stable business models are evidenced in limited variability in their performance through the cycle.

The four banks' conservative risk appetites are underpinned by prudent underwriting standards, robust risk controls and limited (moderate at Handlowy) exposure to market risks. In our opinion, Handlowy's risk appetite is lower due to its more selective lending than peers', shown in the bank's modest credit losses through the cycle and a high balance-sheet concentration in low risk assets (mainly Polish government debt). Growth appetite is stronger at Bank Slaski and BZ WBK, but both banks' control environments are adapted to meet higher business volumes. We also believe that the overall risk appetite at Pekao has not changed materially since the ownership change.

Fitch views capitalisation as strong due to high Fitch Core Capital (FCC) ratios, modest unreserved impaired loans, solid recurring profitability, conservative risk profiles and potential ordinary capital support from the banks' respective parents (except for Pekao). We view capitalisation at Handlowy and Pekao as stronger due to their higher surpluses over regulatory minimum ratios and low risk appetite (Handlowy). However, we believe that Pekao's capital surplus could reduce in the medium term as we expect that the bank's new controlling shareholders will aim to maximise returns to shareholders. At end-1H17, the FCC ratios equaled about 19% at Handlowy and Pekao, about 17% at BZ WBK and about 16% at Bank Slaski.

We believe that asset quality at the four banks will remain strong in the next 12 to 24 months. This reflects conservative origination of new loans, the supportive economic environment and further gradual progress in cleaning legacy bad debts. The banks' sound asset quality reflects their well-diversified credit risk exposures, low (Bank Slaski and Handlowy) to moderate (BZ WBK and Pekao) levels of impaired loans and solid reserve coverage. In our opinion asset quality at BZ WBK could be moderately more vulnerable compared with peers due to its exposure to legacy residential mortgages denominated in foreign currency (mainly Swiss francs; about 13% of total gross loans at end-1H17) and significant unsecured consumer lending. At end-1H17, the impaired loan ratios equaled about 3% at Bank Slaski and Handlowy and about 6% at BZ WBK and Pekao, compared with the sector average of about 6%.

We expect results for 2017 to show that revenue pressures have abated as margins gradually recover on the back of growing loan books, increased lending in higher-yielding market segments and low funding costs. The potential cost related to the presidential proposal for the restructuring of foreign-currency mortgages could moderately affect BZ WBK's results, although it would be negligible for the other three banks.

All banks' solid profitability is underpinned by their moderate variability in earnings and small credit losses through the cycle, healthy margins and reasonable cost-efficiency. Profitability is sufficiently strong to support near-term growth and provide material loss-absorption capacity. The ratio of operating profit/risk-weighted assets shrank in the past three years at Handlowy (2.3% in 1H17), was broadly stable at Pekao (2.6%) and was gradually improving at Bank Slaski (3.1%) and BZ WBK (3.4%) as they both offset margin pressure by significant credit growth.

The banks' robust funding and liquidity reflects their high self-financing capacity (based on stable customer deposits), strong coverage of short-term liabilities by liquid assets and potential ordinary parental support (BZ WBK, Handlowy and Bank Slaski). Handlowy's particularly ample liquidity underpins its stronger funding and liquidity profile. At end-1H17, the gross loans/deposits ratio was 63% at Handlowy, 88% at Bank Slaski and about 100% at BZ WBK and Pekao (sector average: 100%).

RATING SENSITIVITIES
IDRS, SUPPORT RATINGS, NATIONAL RATINGS AND SENIOR DEBT
The IDRs of Bank Slaski are sensitive to changes in potential support from its majority owner. BZ WBK's and Handlowy's IDRs could be upgraded if their parents are upgraded or if their VRs are upgraded. A downgrade of both banks would require a downgrade of both their VRs and their parents' IDRs. Pekao's IDRs are sensitive to changes in its VR. PBH's IDRs are likely to move in tandem with those of Pekao.

VRs
The VRs of the four banks are likely to be resilient to a moderate deterioration in the operating environment. However, a marked and prolonged weakening in the Polish economy (not Fitch's base scenario) that materially affects the banks' asset quality, capitalisation and profitability could lead to the VRs being downgraded.

The upside for Handlowy's VR is limited, given its already high level (one notch above the bank's operating environment) and the bank's limited franchise. A downgrade of Poland's sovereign rating would likely result in the downgrade of Pekao's and Handlowy's VRs.

Pekao's VR could be downgraded if the bank's capital cushion over the regulatory minimum is materially reduced or management states its intention to do so to increase the bank's returns. A downgrade is also likely in case of a significant increase of Pekao's risk appetite. Pekao plans to announce its updated strategy in mid-November 2017.

Upgrades of the VRs of BZ WBK and Bank Slaski are unlikely unless the operating environment and the banks' standalone credit profiles improve, and their growth appetites moderate.

SUPPORT RATING AND SUPPORT RATING FLOOR
The Support Ratings of Handlowy, BZ WBK and Bank Slaski, and the floors they provide for the subsidiaries' Long-Term IDRs, are sensitive to changes in the parent banks' Long-Term IDRs, or to Fitch's view of the parents' propensity or ability to support their subsidiaries. Fitch does not expect the three banks' strategic roles in their groups to diminish in the medium term.

The rating actions are as follows:

Handlowy
Long-Term IDR: affirmed at 'A-'; Outlook Stable
Short-Term IDR: affirmed at 'F1'
Viability Rating: affirmed at 'a-'
Support Rating: affirmed at '1'
National Long-Term Rating: affirmed at 'AA+(pol)'; Outlook Stable
National Short-Term Rating: affirmed at 'F1+(pol)'

BZ WBK
Long-Term IDR: affirmed at 'BBB+', Outlook Stable
Short-Term IDR: affirmed at 'F2'
Viability Rating: affirmed at 'bbb+'
Support Rating: affirmed at '2'
National Long-Term Rating: affirmed at 'AA(pol)', Outlook Stable
Senior unsecured debt: affirmed at 'AA(pol)'

Bank Slaski
Long-Term IDR: affirmed at 'A'; Outlook Stable
Short-Term IDR: affirmed at 'F1'
Viability Rating: affirmed at 'bbb+'
Support Rating: affirmed at '1'
National Long-Term Rating: affirmed at 'AAA(pol)'; Outlook Stable
National Short-Term Rating: affirmed at 'F1+(pol)'

Pekao
Long-Term IDR: affirmed at 'A-', Outlook revised to Negative from Stable
Short-Term IDR: affirmed at 'F2'
Viability Rating: affirmed at 'a-'
Support Rating: '2': removed from Rating Watch Negative and downgraded to '5'
Support Rating Floor: assigned at 'No Floor'

PBH
Long-Term IDR: affirmed at 'A-', Outlook revised to Negative from Stable
Short-Term IDR: affirmed at 'F2'
Support Rating: affirmed at '1'
National Long-Term Rating: affirmed at 'AA+(pol)', Outlook revised to Negative from Stable
National Short-Term rating: affirmed at 'F1+(pol)'

Contact:
Primary Analysts
Michal Bryks, ACCA (BZ WBK, Handlowy, Bank Slaski)
Director
+48 22 338 6293
Fitch Polska SA
Krolewska 16,
00103
Warsaw

Artur Szeski (Pekao, PBH)
Senior Director

+48 22 338 6292
Fitch Polska S.A.
Krolewska 16,
00103
Warsaw

Secondary Analysts
Agata Gryglewicz (Handlowy, Bank Slaski)
Associate Director
+48 22 330 6970

Jakub Kopiec, CFA (BZ WBK, Pekao, PBH)
Analyst
+48 22 330 6702

Committee Chairperson
James Watson
Managing Director
+7 495 956 6657

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Global Bank Rating Criteria (pub. 25 Nov 2016)
https://www.fitchratings.com/site/re/891051
National Scale Ratings Criteria (pub. 07 Mar 2017)
https://www.fitchratings.com/site/re/895106