Fitch Ratings

Fitch Affirms 4 Leading Polish Banks; Outlook Stable

Fitch Ratings-Warsaw/London-23 November 2015: Fitch Ratings has affirmed the Long-term Issuer Default Ratings (IDRs) of Bank Pekao SA, Bank Handlowy w Warszawie (Handlowy), ING Bank Slaski (Bank Slaski) and Bank Zachodni WBK (BZ WBK). Fitch has also affirmed the ratings of Pekao's mortgage bank subsidiary, Pekao Bank Hipoteczny (PBH). The Viability Rating (VR) of BZ WBK was upgraded to 'bbb+' from ' bbb' while the VRs of other banks are affirmed.

A full list of rating actions is provided at the end of this commentary.

KEY RATING DRIVERS -
IDRS, SUPPORT RATINGS, NATIONAL RATINGS AND SENIOR DEBT: ALL BANKS
The Support Ratings of Handlowy, Bank Slaski, BZ WBK and Pekao, and the Issuer Default Ratings (IDRs) of each of these banks, with the exception of Pekao, reflect Fitch's view on potential support from the banks' shareholders. In Fitch's opinion, there is an extremely high probability of support for Handlowy and Bank Slaski, and a high probability of support for BZ WBK and Pekao. The banks' majority owners are, respectively, Citigroup Inc (A/Stable/a), ING Bank NV (A/Stable/a), Banco Santander S.A. (Santander, A-/Stable/a-) and UniCredit S.p.A. (UniCredit; BBB+/Stable/bbb+).

The IDRs and Long-term National rating of BZ WBK are also underpinned by the bank's VR, which is currently at the same level as the support-driven Long-term IDR.

The upgrade of Handlowy's Short-term IDR to 'F1' from 'F2' reflects Citigroup's robust liquidity position.

Fitch believes that Handlowy, Bank Slaski, BZ WBK and Pekao are strategically important subsidiaries for their respective parents, even though their presence in the broader CEE region, with the exception of UniCredit, is limited. Fitch expects that continued parent support will provide a floor for the four banks' Long-term IDRs at one notch below those of their parents.

Pekao's IDRs are based on its intrinsic strength, as reflected in its VR of 'a-' (see below). PBH's ratings are equalised with those of its direct parent and share the same Stable Outlook, reflecting Fitch's view that it is a core subsidiary of Pekao.

KEY RATING DRIVERS - VIABILITY RATINGS: ALL BANKS

The VRs reflect the banks' generally strong financial metrics, sound management and performance and the largely supportive operating environment, given solid current and expected GDP growth in Poland. The upgrade of BZ WBK's VR reflects the bank's improved capitalisation and continued track record of sound performance following the consolidation of other group assets, and its solid financial metrics relative to those of peers.

At the same time, the VRs of each bank face moderate downward pressure from potential new regulatory measures. These include primarily the planned introduction (most likely in 2016) of a special bank tax rate of 39bps of total assets and the possible conversion of Swiss franc mortgages which would involve significant losses for the sector. In 9M15 the ratio of operating profit to average total assets equalled 1.7% (Handlowy), 1.4% (Bank Slaski), 2.2% (BZ WBK) and 1.8% (Pekao). BZ WBK is somewhat more exposed than peers to an onerous conversion of Swiss franc mortgages (which comprise 14% of its loan portfolio), but has a slightly greater ability to absorb the bank tax through its income statement. The potential conversion would incur a small cost for Bank Slaski and Pekao, because Swiss franc mortgages represent only 2% and 4%, respectively, of their gross loans. Handlowy is not exposed to Swiss franc mortgages.

HANDLOWY
Handlowy's VR of 'bbb+' is underpinned by robust capitalisation, ample liquidity, conservative risk management, modest level of impaired loans and a stable funding base. The rating also reflects the bank's limited franchise, less diversified business model (specialising in corporate banking and credit cards for individuals) and moderate scale.

Handlowy's capitalisation is a rating strength and reflects the bank's conservative risk management, high coverage of impaired loans by reserves, reasonable loan book concentrations and healthy internal capital generation. At end-3Q15, Handlowy's FCC ratio stood at 18%.

The bank has successfully cleaned up its bad debt portfolio and reduced its impaired loans to 3.9% of total loans at end-3Q15 (end-2013: 7%), which was one of the lowest in Poland. Coverage of impaired loans by loan loss reserves was conservative at 80%. Handlowy's loan impairment charges were positive (ie there have been net charge reversals) in 9M15, 2014 and 2013, driven by a seasoned legacy portfolio, sales of sour loans and the high quality of new loans.

At end-3Q15, customer deposits represented 73% of total funding and were dominated by corporate deposits, most of which are stable. Handlowy treats large seasonal deposits from companies (on average about USD1bn, or 15% of deposits at end-3Q15) and interbank deposits (mainly from the parent) as non-core funding sources, the outflow of which are fully covered by the bank's ample liquid assets.

The bank's strategy is to maintain a highly liquid balance sheet, underpinned by a large stock of cash and unencumbered domestic debt securities (mostly Polish sovereign risk). At end-3Q15, liquid assets accounted for 36% of total assets and its gross loans/ deposits ratio of 71% was one of the lowest in the sector.

BANK SLASKI

Bank Slaski's strong 'bbb+' standalone profile is underpinned by conservative risk management, robust asset quality, ample liquidity, a stable funding base and solid capitalisation. The VR also reflects the bank's rapid credit growth, which strengthens its franchise, but may not be sustainable in the long-term due to growing capital constraints.

Fitch expects Bank Slaski's asset quality will remain strong in 2016, despite a significant appetite for credit expansion. The rapid loan growth in 9M15 and 2014, coupled with the sale of bad debts, diluted the bank's impaired loans ratio to a low 3.2% at end-3Q15 (end-2013: 4.6%). However, the inflow of new impaired loans also remained under control and notably below the bank's solid loss absorption capacity. Bank Slaski's conservative underwriting standards, diversified loan book and a supportive operating environment should help contain default rates at low levels as the portfolio seasons after rapid growth.

Bank Slaski's capitalisation is a rating strength and is underpinned by a modest stock of unreserved impaired loans (only 7% of FCC at end-3Q15) and healthy internal capital generation. However, the latter could come under pressure due to the combined effect of the bank's ambitious expansion plans, dividend payout policy and the raised minimum capital ratios for Polish banks. At end-3Q15, Bank Slaski's FCC ratio of 17.3% was not directly comparable with peers' because the bank benefited from the advanced internal ratings-based method to calculate capital requirements for the non-retail portfolio.

Bank Slaski's strong liquidity position is underpinned by a large portfolio of liquid, unencumbered domestic debt securities (mostly Polish sovereign risk). At end-3Q15, Bank Slaski's funding was almost 86% based on customer deposits (mostly sourced from granular and stable retail savings). The bank's gross loans/ deposits ratio of 84% was considerably lower than those of peers.

BZ WBK

The upgrade of BZ WBK's VR to 'bbb+' reflects the improved capitalisation and loss absorption capacity as well as a track record of solid internal capital generation and financial ratios following the integration and consolidation of other banks.

BZ WBK's FCC improved to 15.6% at end-3Q15 from 14.9% in 2014, and regulatory ratios, which do not include 9M15 profit, were 13.5% and 13.9% for Core Tier 1/Tier1 and Total CAR respectively. The bank has around PLN1bn (or around 100bps equivalent of the Tier 1 ratio) of undistributed dividend from 2014 included in both FCC and regulatory Tier 1 capital. It is likely that this dividend will be paid out, but will be replaced by 2015 retained income, assuming a 50% payout from 2015 profits. The quality of BZ WBK's capital is sound, underpinned by a low uncovered impaired loans/FCC ratio of 15% at end-3Q15.

BZ WBK reported a net interest margin (NIM) of 3.5% in 9M15 (3.8% in 2014), which given the competitive market and low interest rate environment, is viewed by Fitch as sound performance. It partly reflects a greater share of its higher-margin consumer business, including as a result of the consolidation of Santander Consumer Bank. Its risk-adjusted (ie net of impairment charges) NIM of 2.9% was, however, also firmer than those of close peers.

Return on equity (ROE; excluding integration costs and one-off gains related to the Aviva transaction) fell in 9M15 by around 100bps from 2014, but remained solid at 14%. The drop reflected a higher equity base and lower leverage, as operating return on assets (ROA) was almost unchanged. Fitch expects profitability to be under pressure in 2016, similarly as for other Polish banks, due to persistently low interest rates and the likely additional regulatory and fiscal burden, which will be difficult to pass on to customers.

The underlying trend in BZ WBK's asset quality over 9M15 was positive; however, the impact of the legacy portfolio from the acquired Kredyt Bank and the moderately weaker Santander Consumer Bank weighed on the reported impaired loans ratio. This stood at 8.1% as of end-3Q15, higher than its close peers'. Coverage of impaired loans by provisions was reasonable at 69%, which is higher than the average for the market of 57%. Single name and sector concentrations in the loan book are low.

BZ WBK's exposure to foreign currency mortgages is moderate, at 15% of the consolidated loan book at end-1H15. Performance of this part of the loan book is sound, but it exposes the bank to tail risks related to costs of potential solutions the domestic authorities may propose for foreign currency borrowers.

Liquidity is adequate, benefitting from the bank's stable funding position, based on diversified, predominantly retail, customer deposits (84% of total funding at 3Q15). The loan-to-deposit ratio was close to 100%.

PEKAO
The VR of Pekao reflects mainly its strong standalone credit profile, underpinned mainly by strong capitalisation, but also reflecting: i) a solid franchise; ii) rather resilient performance, resulting in healthy internal capital generation; iii) sound asset quality; iv) strong liquidity and a stable funding base; and v) low exposure to risks related to foreign currency mortgages.

The VR of Pekao (a-) is one notch above the VR-driven IDR of its parent. This reflects Pekao's low dependence on group and wholesale funding, its robust domestic franchise and a strong domestic regulator.

Capitalisation is a rating strength and reflects conservative risk management, sufficient coverage of impaired loans by reserves, moderate concentrations in the loan book, low exposure to foreign currency mortgages and healthy internal capital generation. At end-3Q15, the FCC ratio stood at 19.5%.

Pekao's profitability has been resilient in recent years as the bank has been able to compensate falling NIM with a shift in the asset mix to a bigger share of higher-margin consumer and SME lending, accelerated volume growth, strict cost control and contained risk costs.

Despite pressures on revenues, Fitch expects Pekao to deliver solid profitability for 2015. Net profit is likely to drop moderately compared with 2014, but the bank should maintain double-digit ROE despite still low leverage. Next year is likely to be somewhat more challenging due to the still low interest rate environment and potential additional fiscal/regulatory levies.

Pekao's asset quality improved slightly faster than for the market over the last 12 months and the impaired loan ratio stood at 6.8% at end-3Q15, despite Pekao, unlike some of its peers, not being an active seller of NPL portfolios. Coverage of impaired loans by specific provisions is at a reasonable level of close to 70%, which is better than the average for the market of 59%.

The loan-to-deposit ratio is close to 100%, but liquidity is strong, benefitting from a stable funding position, based on balanced, diversified customer deposits, a low share of wholesale funding and an ample equity base.

RATING SENSITIVITIES - IDRS, SUPPORT RATINGS, NATIONAL RATINGS AND SENIOR DEBT: ALL BANKS
The IDRs of Handlowy and Bank Slaski are sensitive to a strengthening or weakening of potential support from their majority owners. As a result, Outlooks on their respective Long-term IDRs reflect those on their parent institutions.

An upgrade of BZ WBK's IDRs would be contingent on either (i) a further upgrade of the VR; or (ii) an upgrade of Santander. A downgrade of BZ WBK's IDRs would result from (i) a downgrade of the VR; and (ii) a downgrade of Santander.

The Stable Outlook on Pekao's Long-term IDR reflects the outlook for the bank's standalone risk profile, as well as the Stable Outlook on Poland's sovereign ratings. A weakening of Pekao's standalone profile or a downgrade of the sovereign ratings could result in a downgrade of Pekao. An upgrade of Pekao would be contingent on both a sovereign upgrade and a further strengthening of the bank's standalone profile. PBH's IDRs are likely to move in tandem with those of Pekao.

RATING SENSITIVITIES - VIABILITY RATINGS: ALL BANKS
VRs could come under pressure if banks' profitability or capitalisation is materially weakened by the government's planned bank levy (all four banks) or a redenomination of foreign currency mortgages (BZ WBK), or both. The VRs of all four banks could also suffer if there is a marked and prolonged weakening in the Polish economy, which Fitch does not expect at present.

Upgrades of the banks' VRs are unlikely in the short term because of (i) weakening profitability (at all four banks); (ii) rapid credit expansion (Bank Slaski); (iii) limited franchise (Handlowy) (iv) the potential cost of the administrative solution for foreign currency borrowers (BZ WBK); and (v) the already high level of the VR (Pekao).

A downgrade of Poland's sovereign rating would most likely result in the downgrade of Pekao's VR. Under Fitch's base case scenario, Pekao's VR would not be impacted by a one-notch downgrade of UniCredit's Long-term IDR, given the agency's view of only moderate contagion risk from negative developments at UniCredit. This reflects Pekao's low dependence on group and wholesale funding, its robust domestic franchise and a strong domestic regulator.

The rating actions are as follows:

Handlowy
Long-term IDR: affirmed at 'A-'; Outlook Stable
Short-term IDR: upgraded to 'F1' from 'F2'
Viability Rating: affirmed at 'bbb+'
Support Rating: affirmed at '1'

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'

Pekao
Long-term IDR: affirmed at 'A-', Outlook Stable
Short-term IDR: affirmed at 'F2'
Viability Rating: affirmed at 'a-'
Support Rating: affirmed at '2'

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

BZWBK
Long-term IDR: affirmed at 'BBB+', Outlook Stable
Short-term IDR: affirmed at 'F2'
Viability Rating: upgraded to 'bbb+' from 'bbb'
Support Rating: affirmed at '2'
National Long-term rating: affirmed at 'AA-(pol)', Outlook Stable
Senior unsecured debt: affirmed at 'AA-(pol)'

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Applicable Criteria
Global Bank Rating Criteria (pub. 20 Mar 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?

rpt_id=863501)
National Scale Ratings Criteria (pub. 30 Oct 2013)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=720082)

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