MOODY'S
INVESTORS SERVICE

Credit Opinion: Bank Zachodni WBK S.A.

Global Credit Research - 24 Nov 2014

Warsaw, Poland

Ratings

Category	**Moody's Rating**
Outlook	Negative(m)
Bank Deposits	Baa1/P-2
Bank Financial Strength	D+
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa2
Parent: Banco Santander S.A. (Spain)	
Outlook	Stable
Bank Deposits	Baa1/P-2
Bank Financial Strength	C-
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Issuer Rating	Baa1
Senior Unsecured MTN -Dom Curr	(P)Baa1
Subordinate -Dom Curr	Baa2
Pref. Stock Non-cumulative	Ba1 (hyb)

Contacts

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Key Indicators

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

	[2]**9-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (PLN billion)	**129.9**	**105.6**	**60.0**	**59.9**	**53.2**	[4]**25.0**
Total Assets (EUR million)	**31,096.0**	**25,388.8**	**14,709.5**	**13,431.2**	**13,410.8**	[4]**23.4**
Total Assets (USD million)	**39,282.0**	**34,984.3**	**19,392.9**	**17,435.7**	**17,991.1**	[4]**21.6**
Tangible Common Equity (PLN billion)	**12.6**	**10.6**	**7.9**	**6.7**	**6.0**	[4]**20.3**
Tangible Common Equity (EUR million)	**3,020.4**	**2,558.9**	**1,932.4**	**1,493.8**	**1,518.2**	[4]**18.8**
Tangible Common Equity (USD million)	**3,815.6**	**3,526.1**	**2,547.6**	**1,939.2**	**2,036.7**	[4]**17.0**
Net Interest Margin (%)	**3.5**	**3.5**	**3.9**	**3.7**	**3.4**	[5]**3.6**
PPI / Average RWA (%)	**3.2**	**4.0**	**4.6**	**4.2**	**4.1**	[6]**3.2**
Net Income / Average RWA (%)	**2.0**	**2.4**	**2.9**	**2.7**	**2.4**	[6]**2.0**
(Market Funds - Liquid Assets) / Total Assets (%)	**-18.0**	**-21.1**	**-26.0**	**-26.5**	**-28.8**	[5]**-24.1**
Core Deposits / Average Gross Loans (%)	**119.6**	**118.5**	**116.5**	**128.3**	**119.9**	[5]**120.6**
Tier 1 Ratio (%)	**11.8**	**10.9**	**13.8**	**12.6**	**13.0**	[6]**11.8**
Tangible Common Equity / RWA (%)	**12.2**	**12.2**	**15.1**	**13.8**	**14.3**	[6]**12.2**
Cost / Income Ratio (%)	**47.4**	**50.5**	**43.9**	**50.3**	**49.9**	[5]**48.4**
Problem Loans / Gross Loans (%)	**--**	**7.9**	**5.4**	**5.5**	**6.9**	[5]**6.4**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**--**	**32.5**	**21.6**	**24.8**	**29.6**	[5]**27.1**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - 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 - transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Bank Zachodni WBK's (BZ WBK) deposit ratings of Baa1/Prime-2 incorporate two notches uplift from its standalone bank financial strength rating (BFSR) of D+, equivalent to a baa3 baseline credit assessment (BCA). The uplift is based on our assessment of (i) a high probability of systemic support for the bank in the event of need in light of its growing franchise in the Polish market, and (ii) a moderate probability of parental support by Banco Santander (Baa1/P-2 stable; C- stable/baa1).

BZ WBK's baa3 BCA is supported by (i) its expanding franchise in the Polish market, (ii) a good funding position in local currency, and (iii) adequate capitalisation, supported by high internal capital creation. The BCA is constrained by the bank's (i) exposure to the commercial real estate sector, although significantly decreased in the past years, and (ii) some dependence on medium-term wholesale FX funding due to the acquired FX mortgage portfolio.

Rating Drivers

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

- Largely self-funded profile in local currency underpinned by a large retail deposit base, but some dependence on medium-term wholesale FX funding due to the acquired FX mortgage portfolio

- Capitalisation is adequate

- Asset quality is slightly weaker than the system average

Rating Outlook

The long-term deposit rating of BZ WBK is on negative outlook. This takes into account the likely negative implications for investors of a pending Polish resolution and bail-in regime. The recent adoption of the Bank Recovery and Resolution Directive in the EU is the main force behind this likely change, which aims to shift the cost of bank failure from taxpayers to shareholders and unsecured creditors. Ultimately, because of these regulatory developments, Moody's government support assumptions for Polish banks (including BZ WBK) will likely decline during the outlook period.

The bank's standalone rating is on stable outlook.

What Could Change the Rating - Up

We do not expect immediate upward pressure on the bank's long-term deposit rating given the current negative outlook.

Upward pressure on the BCA over the medium-term could be envisaged should BZ WBK successfully continue to expand its franchise as one of the key players in the Polish market. Additional positive developments in the standalone post-merger risk-profile would include a decrease in industry and single-name concentration risks, improvement in asset quality and reduction on wholesale FX funding dependence.

What Could Change the Rating - Down

BZ WBK's standalone credit assessment could come under pressure if asset quality shows 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.

The bank's long-term rating could be downgraded in case there is a similar rating action on its parent and/or our systemic support assumptions are lowered.

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 SCB in July 2014, BZ WBK's total assets more than doubled between end-2012 to Q3 2014, to PLN 130 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, 9.2% and 8.7% as of September 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 976 branches (combined with SCB) as at Q3 2014.

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

Liquidity and funding constitute important rating drivers for BZ WBK given its good reliance on customer funds, with gross loan-to-deposit ratio increasing to 97.1%% as at Q3 2014. The bank also has comfortable liquidity buffer (liquid assets as a percentage of total assets stood at 30% at Q3 2014). These ratios compare favourably to the bank's Polish peer group.

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, 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 PLN 10.7 billion in 2013, 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, the majority of the currency gap remains managed by BZ WBK through the wholesale 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.

-- CAPITALISATION IS ADEQUATE

BZ WBK's reported a total capital ratio of 13.4% and Tier 1 ratio of 12.3% as at Q3 2014.

The bank has maintained a relatively high internal capital generation with reported annualised ROE close to 16% for the first nine months of 2014. However, we note that ROE declined from 18% in 2012, 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.

On 26 October 2014 the Polish Financial Supervision Authority (PFSA) published the results of the asset quality review (AQR) in accordance with the European Central Bank's methodology and the EU-wide stress tests results of 15 major Polish banks. The exercise was performed based on the banks' YE2013 financial reports.

BZ WBK was one of the banks examined in the AQR and the stress tests. According to the outcomes, BZ WBK passed all the tests and its AQR adjusted CET1 ratio amounted to 12.02%, its adjusted CET1 after the baseline scenario amounted to 13.35% and its CET1 after the adverse scenario amounted to 13.21%.

-- ASSET QUALITY IS SLIGHTLY WEAKER THAN THE SYSTEM AVERAGE

Similarly to some of its peers in the region, BZ WBK's risk profile has been influenced by its exposure to the commercial real estate segment which, however, declined significantly for the past few years. This segment (internally classified as property) accounted for 13.5% of gross loans at year-end 2013.

The ratio of non-performing loans of BZ WBK increased to about 8% in Q3 2014, from 7.5% in Q2, driven by the consolidation of SCB, which is slightly higher than the average for the Polish banking sector of 7.4%.

Nevertheless, we recognise that during the same period the coverage ratio increased to 64.6%, from 57.7%.

Global Local Currency Deposit Rating (Joint Default Analysis)

We assign a long-term deposit rating of Baa1 to BZ WBK.

In light of BZ WBK's good nationwide market share and importance to the Polish banking system, we assess the probability of systemic support for BZ WBK in the event of need as high. In addition, the probability of parental support from Banco Santander is considered as moderate. These assumptions result in a two-notch uplift from the bank's BCA of baa3.

Foreign Currency Deposit Rating

We assign a Baa1 long-term foreign currency deposit rating to BZ WBK.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model 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.

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (70%)						**C-**	
Factor: Franchise Value						**D+**	
Market share and sustainability			**x**				
Geographical diversification				**x**			
Earnings stability				**x**			
Earnings Diversification [2]							
Factor: Risk Positioning						**C-**	
Corporate Governance [2]							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management		**x**					
- Risk Management			x				
- Controls	x						
Financial Reporting Transparency		**x**					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information			x				
Credit Risk Concentration					**x**		
- Borrower Concentration					x		
- Industry Concentration		x					
Liquidity Management		**x**					
Market Risk Appetite			**x**				
Factor: Operating Environment						**D+**	
Economic Stability				**x**			
Integrity and Corruption				**x**			
Legal System			**x**				
Financial Factors (30%)						**B-**	
Factor: Profitability						**A**	
PPI % Average RWA (Basel II)	4.27%						

Net Income % Average RWA (Basel II)	2.67%						
Factor: Liquidity						**B+**	
(Market Funds - Liquid Assets) % Total Assets	-24.54%						
Liquidity Management		x					
Factor: Capital Adequacy						**A**	
Tier 1 Ratio (%) (Basel II)	12.41%						
Tangible Common Equity % RWA (Basel II)	13.47%						
Factor: Efficiency						**B**	
Cost / Income Ratio		48.25%					
Factor: Asset Quality						**D+**	
Problem Loans % Gross Loans				6.28%			
Problem Loans % (Equity + LLR)			26.66%				
Lowest Combined Financial Factor Score (9%)						**D+**	
Economic Insolvency Override						**Neutral**	
Aggregate BFSR Score						**C**	
Aggregate BCA Score						**a3**	
Assigned BFSR						**D+**	
Assigned BCA						**baa3**	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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