MOODY'S
INVESTORS SERVICE

Credit Opinion: Bank Zachodni WBK S.A.

Global Credit Research - 30 May 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	Ba2 (hyb)

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Key Indicators

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

	[2]3-14	[2]12-13	[2]12-12	[2]12-11	[2]12-10	Avg.
Total Assets (PLN billion)	111.6	105.6	60.0	59.9	53.2	[3]20.4
Total Assets (EUR million)	26,789.7	25,388.8	14,709.5	13,431.2	13,410.8	[3]18.9
Total Assets (USD million)	36,922.8	34,984.3	19,392.9	17,435.7	17,991.1	[3]19.7
Tangible Common Equity (PLN billion)	10.6	10.1	7.9	6.7	6.0	[3]15.2
Tangible Common Equity (EUR million)	2,547.1	2,432.5	1,932.4	1,493.8	1,518.2	[3]13.8
Tangible Common Equity (USD million)	3,510.5	3,351.9	2,547.6	1,939.2	2,036.7	[3]14.6
Net Interest Margin (%)	3.2	3.5	3.9	3.7	3.4	[4]3.5
PPI / Average RWA (%)	3.3	4.0	4.6	4.2	4.1	[5]4.1
Net Income / Average RWA (%)	2.1	2.4	2.9	2.7	2.4	[5]2.5
(Market Funds - Liquid Assets) / Total Assets (%)	-20.1	-21.1	-26.0	-26.5	-28.8	[4]-24.5
Core Deposits / Average Gross Loans (%)	110.1	118.5	116.5	128.3	119.9	[4]118.7
Tier 1 Ratio (%)	11.3	10.9	13.8	12.6	13.0	[5]12.3
Tangible Common Equity / RWA (%)	11.9	11.6	15.1	13.8	14.3	[5]13.3
Cost / Income Ratio (%)	49.2	50.5	43.9	50.3	49.9	[4]48.8
Problem Loans / Gross Loans (%)	--	7.9	5.4	5.5	6.9	[4]6.4
Problem Loans / (Equity + Loan Loss Reserves) (%)	--	33.5	21.6	24.8	29.6	[4]27.4

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel II & 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 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-/baa1 stable).

BZ WBK's baa3 BCA is supported by (i) its expanding franchise in the Polish market, (ii) comfortable funding position, and (iii) stable capitalisation supported by high internal capital creation. The BCA is constrained by the bank's (i) exposure to the property and real estate segment, albeit gradually declining, and (ii) potential challenges in executing the remaining part of the merger with Kredyt Bank, acquired in 2013.

Rating Drivers

- A rapidly growing franchise in the Polish market through the acquisition of Kredyt Bank and a runner-up to the two largest banks in the system

- Largely self-funded profile underpinned by a large retail deposit base, with an ongoing dependence on medium-term wholesale funding due to the acquired FX mortgage portfolio

- Capitalisation is adequate, although capital ratios have declined after the consolidation with Kredyt Bank

- Asset quality in line with its peers, with NPLs increasing post-merger, but exposures to real estate and construction segments above the market average

Rating Outlook

The outlook on the long term deposit rating remains negative.

The negative outlook takes into account the recent adoption of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) regulation in the EU. In particular, this reflects that, with the legislation underlying the new resolution framework now in place and the explicit inclusion of burden-sharing with unsecured creditors as a means of reducing the public cost of bank resolutions, the balance of risk for banks' senior unsecured creditors has shifted to the downside. Although our support assumptions are unchanged for now, the probability has risen that they will be revised downwards to reflect the new framework. For further details, please refer to our Special Comment entitled "Reassessing Systemic Support for EU Banks," published on 29 May 2014.

The bank's BCA remains on stable outlook.

What Could Change the Rating - Up

Upward pressure on the BCA over the medium-term could be envisaged in case of BZ WBK successfully expands its franchise and becomes a credible challenger to PKO Bank Polski (A2 negative; C-/baa2 negative) and Pekao SA (A2 negative; C-/baa1 stable) - the current two dominant 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 (particularly in the real estate segment) and establishing a sustainable track-record as a dominant player in the retail segment.

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

What Could Change the Rating - Down

BZ WBK's standalone credit assessment could come under pressure if asset quality deteriorates further, which is likely to have a negative effect on profitability and capital creation levels. Moreover, a relatively large, albeit decreasing, exposure to commercial real estate has some potential of undermining so far robust profitability of the bank. Inability to maintain its currently favourable loan-to-deposit ratio would also be an important rating driver.

The bank's long-term rating could be downgraded in case there is a similar rating action on its parent or alternatively we consider that systemic support assumptions have further weakened in the current environment due to the evolving regulatory environment in the EU.

DETAILED RATING CONSIDERATIONS

-- A RAPIDLY GROWING FRANCHISE IN THE POLISH MARKET THROUGH THE ACQUISITION OF KREDYT BANK AND A RUNNER-UP TO THE TWO LARGEST BANKS IN THE SYSTEM

Following the merger with Kredyt Bank in January 2013, BZ WBK became the third-largest bank in Poland with market shares of customer deposits and loans of 8.3% and 7.4% as of March 2014, respectively. The bank has a well-established franchise in corporates, focusing on large and medium-sized clients, where we expect competition to remain high. The acquisition of Kredyt Bank has also significantly boosted the bank's mortgage franchise which was lagging behind its peers (Home mortgage loans increased from PLN 8 billion in 2012 to PLN 25.3 billion in 2013). In recent years, the bank has also been actively focusing on Corporate, SMEs, Personal Lending and Investment Banking.

The bank's retail franchise is supported by the fact that it has the third-largest branch network in Poland, which comprised 830 branches as at Q1 2014. However, it faces stiff competition from the two largest players in the market - PKO BP and Bank Pekao SA which still maintain significantly higher retail customer penetration and branch coverage.

-- SELF FUNDING PROFILE UNDERPINNED BY LARGE RETAIL DEPOSIT BASE, ALTHOUGH ONGOING DEPENDENCE ON WHOLESALE FUNDING FOR THE ACQUIRED FX MORTGAGE PORTFOLIO

Liquidity and funding constitute important rating drivers for BZ WBK given its strong reliance on customer funds (net loan-to-deposit ratio of 87.7% as at Q1 2014, practically unchanged year-on-year) and comfortable liquidity buffer (liquid assets as a percentage of total assets stood at 30% at year-end 2013). These ratios compare favourably to the bank's Polish peer group.

In addition, we note that BZ WBK's funding position, with little reliance on wholesale markets and no parent funding, is in line with Banco Santander's strategy of maintaining self-funding subsidiaries. Prior to the merger Bank Zachodni had limited exposure to FX mortgage loans and was able to fund the bulk of it with its FX deposits. However, following the merger with Kredyt bank the bank's total FX loan portfolio increased to PLN 25 billion in 2013 from PLN 12 billion in 2012.

In the medium-term this risk is mitigated by an agreement with KBC (the former owner of Kredyt Bank), based on which the Belgian group committed to provide CHF1.5 billion cash collateralised funding and PLN1.5 billion medium-term swap FX facilities to BZ WBK. BZ WBK has already pre-hedged part of the CHF funding lines maturing in 2015 with long-term swaps, and is expecting to secure replacement for the rest in the near future.

-- CAPITALISATION IS ADEQUATE, ALTHOUGH CAPITAL RATIOS HAVE DECLINED AFTER THE CONSOLIDATION WITH KREDYT BANK

BZ WBK's capitalisation has declined after the merger with Kredyt Bank, with total capital ratio of 13.8% and Tier 1 ratio of 11.3% as at Q1 2014, down from 16.6% and 14.3% in 2012 respectively. The reason for the decline is the increased capital requirements related to the merger and relatively weak pre-merger capitalisation of Kredyt Bank.

Nevertheless, the bank has maintained a relatively high internal capital generation trend with average ROE around 17% for the last 3 years, although we note that ROE declined slightly to 15.7% in 2013, from 18% in 2012, following Kredyt Bank's acquisition. In addition we note that high ROE rates were offset by a relatively high dividend payout ratio of around 50% during recent years.

-- ASSET QUALITY IN LINE WITH ITS PEERS, WITH NPLS INCREASING POST-MERGER, BUT EXPOSURE TO REAL ESTATE AND CONSTRUCTION SEGMENTS ABOVE THE MARKET AVERAGE

Like its peers in the region, BZ WBK's risk profile has been influenced by a relatively sizeable exposure to the commercial real estate segment which has been declining for the past few years. This segment (internally classified as property) accounted for 13.5% of gross loans and 83% of total regulatory capital as at year-end 2013.

Following the merger with Kredyt Bank and acquisition of a comparatively weaker portfolio, BZ WBK's combined

NPL ratio increased to 7.5% as at Q1 2014 from about 5.5% at year-end 2012, with provisioning coverage of NPLs at 56.1% as of Q1 2014.

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.

After the acquisition by the Banco Santander probability of parental support in case of need is considered as moderate.

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**	**Improving**
PPI % Average RWA (Basel II)	4.30%						
Net Income % Average RWA (Basel II)	2.68%						
Factor: Liquidity						**B+**	**Weakening**
(Market Funds - Liquid Assets) % Total Assets	-27.08%						
Liquidity Management		x					
Factor: Capital Adequacy						**A**	**Weakening**
Tier 1 Ratio (%) (Basel II)	13.10%						
Tangible Common Equity % RWA (Basel II)	14.37%						
Factor: Efficiency						**B**	**Neutral**
Cost / Income Ratio		48.05%					
Factor: Asset Quality						**D+**	**Neutral**
Problem Loans % Gross Loans				5.97%			
Problem Loans % (Equity + LLR)			25.35%				
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.