Credit Opinion: Bank Zachodni WBK S.A.

Global Credit Research - 09 May 2012

Warsaw, Poland

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Baa1/P-2
Bank Financial Strength	D+
Baseline Credit Assessment	(baa3)
Adjusted Baseline Credit Assessment	(baa2)

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Key Indicators

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

	[2]**12-11**	[2]**12-10**	[2]**12-09**	[2]**12-08**	[3]**12-07**	**Avg.**
Total Assets (PLN billion)	**59.9**	**53.2**	**54.1**	**57.4**	**41.3**	[4]**9.7**
Total Assets (EUR million)	**13,431.2**	**13,410.8**	**13,168.0**	**13,944.4**	**11,491.2**	[4]**4.0**
Total Assets (USD million)	**17,435.7**	**17,991.1**	**18,892.6**	**19,383.4**	**16,800.7**	[4]**0.9**
Tangible Common Equity (PLN billion)	**6.7**	**6.0**	**5.3**	**4.5**	**3.9**	[4]**14.6**
Tangible Common Equity (EUR million)	**1,493.8**	**1,518.2**	**1,296.8**	**1,083.6**	**1,074.4**	[4]**8.6**
Tangible Common Equity (USD million)	**1,939.2**	**2,036.7**	**1,860.6**	**1,506.3**	**1,570.9**	[4]**5.4**
Net Interest Margin (%)	**3.7**	**3.4**	**2.8**	**3.4**	**3.6**	[5]**3.4**
PPI / Avg RWA (%)	**4.4**	**6.5**	**3.8**	**3.6**	**--**	[6]**4.6**
Net Income / Avg RWA (%)	**2.9**	**3.8**	**2.2**	**2.2**	**--**	[6]**2.8**
(Market Funds - Liquid Assets) / Total Assets (%)	**-26.5**	**-28.8**	**-21.9**	**-20.8**	**-24.2**	[5]**-24.4**
Core Deposits / Average Gross Loans (%)	**128.3**	**119.9**	**113.8**	**140.2**	**139.1**	[5]**128.3**
Tier 1 Ratio (%)	**--**	**13.8**	**12.3**	**10.1**	**--**	[6]**12.1**
Tangible Common Equity / RWA (%)	**14.4**	**15.2**	**12.8**	**10.1**	**--**	[6]**13.1**
Cost / Income Ratio (%)	**50.3**	**49.9**	**50.0**	**51.6**	**53.4**	[5]**51.0**
Problem Loans / Gross Loans (%)	**5.5**	**6.9**	**5.5**	**2.9**	**2.8**	[5]**4.7**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**24.8**	**29.6**	**27.7**	**17.7**	**14.0**	[5]**22.8**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

The standalone bank financial strength rating (BFSR) of D+ assigned to Bank Zachodni WBK SA (BZ WBK), with a stable outlook, maps to baa3 on the long-term scale. The rating reflects BZ WBK's established franchise in the corporate segment, comfortable funding position, and above average capitalisation supported by strong internal capital creation. The rating is constrained by the uncertainties surrounding the recent announcement of BZ WBK's intention to merge its operations with Kredyt Bank (unrated), bank's relatively high exposure to the risky real estate financing segment, and its underdeveloped retail franchise.

BZ WBK's long-term global local currency (GLC) deposit rating of Baa1 is based on (i) our assessment of a high probability of systemic support for the bank in the event of need in light of its large franchise in the Polish market, and (ii) a moderate probability of parental support by the Banco Santander (Aa3/P-1/B-; on review for downgrade) given the limited history of support by the parent.

These considerations result in a two notches of uplift from BZ WBK's baa3 stand-alone rating.

Rating Drivers

- The proposed merger with Kredyt Bank may put pressure on the fundamentals of BZ WBK in the short-term by incorporating an entity with weak profitability and efficiency that would require considerable effort from the management to turn around

- One of the largest corporate franchises in the Polish market with a stable customer base and a strong multi channel distribution network

- Strong funding profile and good liquidity buffer with loan-to-deposit ratio of 83.9% and liquid assets to total assets at 34% as of end-2011

- Above average capitalization levels with CAR at 15.1% as of end-2011 and strong capital creation with an average ROE of 16.9% in the last 3 years

- Sizeable albeit decreasing exposures to real estate development and land financing with very high non - performing assets

Rating Outlook

All ratings have a stable outlook.

What Could Change the Rating - Up

An upward pressure on the standalone rating could be envisaged in case of a successful merger between BZ WBK and Kredyt Bank and a subsequent creation of the 3rd largest banking group in the country which would effectively compete for business with PKO BP and Pekao SA - the current two dominant players in the Polish market. Demonstration of these trends are likely to be a medium-term objective, however. At the same time, BZ WBK would have to ensure its strong funding, liquidity and profitability metrics are not significantly jeopardized by combining its operations with a relatively weaker Kredyt Bank.

Should the proposed merger fail to go ahead, for any external reasons, we believe that BZ WBK's rating is correctly positioned in relation to its immediate rated peer group and we do not see an immediate upward pressure on the rating. Nevertheless, any positive developments in the standalone profile would include a decrease in industry and single-name concentration risks, significant improvement in asset quality (particularly in the real estate segment) and broadening its franchise in the retail segment.

What Could Change the Rating - Down

A downgrade of BZ WBK's standalone rating could be triggered in a situation where the merger with Kredyt Bank creates significant immediate pressure on profitability and funding profile. The latter specifically refers to BZ WBK's ability to fund the large FX mortgage portfolio of Kredyt Bank in wholesale markets, after the expiry of the loan facilities currently provided by KBC to its subsidiary.

In addition to the proposed merger, BZ WBK's standalone rating could come under pressure if asset quality deteriorates further having 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.

Recent Results and Developments

On 28 February 2012, Grupo Santander announced its intention to enlarge its Polish operations by merging Bank Zachodni WBK (96.25% ownership in the bank) with Kredyt Bank (80% held by KBC Bank NV), targeting a market share of over 10% in the Polish Banking system. The timeline for completion of the merger is expected to last until the end of 2012 and is contingent on the approval of the Polish banking regulatory authorities (KNF). If successful, the merger would create the 3rd largest banking group in Poland.

BZ WBK reported IFRS consolidated net income of PLN1.23 billion (EUR276.6 million) as of end-2011, up by 17.8% year-on-year. The trend was underpinned by higher net interest income which increased by 13.6% year-on-year, which was achieved on the back of a similar increase in gross loans (15.1% year-on-year). Improved performance was also helped by lower provisioning requirements, which decreased 12.8% year-on-year to PLN366.9 million.

Total assets were at PLN59.8 billion (EUR13.5 billion) for the same period up by 12.6% from end-2010 mainly due to the aforementioned increase in gross loans, which was closely funded by 11.6% in deposits.

The bank's Capital Adequacy ratio was at 15.1% slightly down from 15.8% at end-2010.

DETAILED RATING CONSIDERATIONS

Detailed rating considerations for BZ WBK are as follows:

Bank Financial Strength Rating

The standalone bank financial strength rating (BFSR) of D+ assigned to Bank Zachodni WBK SA (BZ WBK), with a stable outlook, maps to baa3 on the long-term scale. The rating reflects BZ WBK's established franchise in the corporate segment, comfortable funding position, and above average capitalisation supported by strong internal capital creation. The rating is constrained by the uncertainties surrounding the recent announcement of BZ WBK's intention to merge its operations with Kredyt Bank (unrated), bank's relatively high exposure to the risky real estate financing segment, and its underdeveloped retail franchise.

Franchise Value

In light of the recent developments, should the proposed merger between Bank Zachodni and Kredyt Bank crystalize, we expect the franchise value to be one of the principal rating drivers of BZ WBK's standalone credit strength in the medium term.

Currently, BZ WBK is the fifth-largest bank in Poland by assets with market shares of customer deposits and loans of 5.5% and 4.2% at end-2011, respectively. The bank has a well-established franchise in corporates, focusing on large and medium-sized clients, where competition is strongest. However, in recent years, the bank has also been actively focusing on SMEs, as well as Investment Banking. In 2011 corporate activities represented 26% of BZ WBK's pre-tax income.

In terms of investment banking (13.6% of pre-tax income for FY 2011), BZ WBK remains very active in asset management and mutual funds, although we note that the bank suffered a significant outflow of funds (35.8%) in 2011. As a result the bank lost some of its market share, which stood at approximately 7% as of end-2011, compared to 11% the year before.

The bank has been expanding its relatively underdeveloped retail segment by growing its mortgage lending operations. As at end-2011, mortgages represented 20% of the total loan portfolio and grew by 9.8% year-on-year basis. Majority of the mortgages (67%) are denominated in Polish Zloty, with the remaining 33% denominated primarily in Euro. Retail activities represented 50% of BZ WBK's pre-tax income in 2011. This represents a significant increase from 29% share in 2010; which was achieved due to the expansion of the retail loan portfolio, but also weaker performance of the corporate segment.

The bank's retail franchise is supported by the fact that it has the third-largest branch network in Poland, which comprised 622 branches at end-2011. However, it faces stiff competition in the retail segment and still lags behind its immediate peers in terms of retail customer penetration.

Liquidity

Liquidity and funding constitute important rating drivers for BZ WBK given its strong reliance on customer funds (loan-to-deposit ratio of 83.9% as of end-2011) and comfortable liquidity buffer (liquid assets as a percentage of total assets stood at 34% as of end-2011). These ratios compare favourably the bank's Polish peer group.

In addition, we note that BK WBK's funding position, with little reliance on wholesale markets and parent funding, is in line with Banco Santander strategy of maintaining self-funding subsidiaries Bank Zachodni currently has limited exposure to FX loans and was able to fund a bulk of it with its FX deposits. However, in light of the proposed merger the funding and liquidity position may come under pressure due to FX funding needs required for the large FX loan portfolio (PLN14.6 billion) of Kredyt Bank.

The latter will be partly mitigated by the agreement between Banco Santander and KBC, based on which the Belgian group will provide a 2 to 3 years continuous albeit gradually declining funding support to BZ WBK toward the FX portfolio of Kredyt Bank.

Capital Adequacy

BZ WBK has strong capital adequacy, as measured by its total capital ratio of 15.1% at end-2011, slightly down from 15.7% at end-2010. The bank is expected to pay out a dividend in 2012 which is expected to represent less than 50% of 2011 profits. We note that BZ WBK also paid out dividend from 2010 and 2009 profits (63% and 34% of its net income. respectively).

Despite these dividend payouts we take comfort that BZ WBK's capitalisation remains robust, as the bank had a strong internal capital generation capacity (average ROE of 16.9% in the last 3 years). This was achieved due to the bank's strong profitability metrics (Net Income over RWA and NIM of 2.86% and 3.68%, respectively for FY2011).

Asset Quality

Like its peers in the region, BZ WBK's risk profile has been adversely affected by the ongoing downturn influenced by a high level of exposure to the commercial real estate segment. This segment (internally classified as property investment and construction development) accounted for 18% of gross loans and 160% of total capital as at end-2011.

The bank's borrower concentration remains one of our concerns as it is stands at approximately 119% of total capital and is highly concentrated in the real estate sector.

We note that the bank managed to improve the quality of its portfolio in 2011, as the NPL ratio decreased to 5.5% during FY2011, from 6.9% in 2010. This trend was underpinned both by the reduction in the total amount of impaired loans (8% year on year), as well as an increase in gross loans.

Overall, BZ's asset quality and coverage ratios compares favourably with its peer group.

Global Local Currency Deposit Rating (Joint Default Analysis)

We assign a long-term GLC deposit rating of Baa1 to BZ WBK. The rating reflects the bank's standalone rating of baa3 and is supported by Poland's government bond rating of A2. 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 given the relatively short history of support. Under the Joint Default Analysis (JDA) methodology, these considerations result in two-notch uplift in the long-term GLC deposit rating to Baa1 from the baa3 BCA.

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+**	**Neutral**
Market Share and Sustainability			**x**				
Geographical Diversification				**x**			
Earnings Stability				**x**			
Earnings Diversification [2]							
Factor: Risk Positioning						**C**	**Neutral**
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+**	**Neutral**
Economic Stability				**x**			
Integrity and Corruption				**x**			
Legal System			**x**				
Financial Factors (30%)						**B-**	
Factor: Profitability						**A**	**Neutral**
PPI / Average RWA - Basel II	4.93%						
Net Income / Average RWA - Basel II	2.96%						
Factor: Liquidity						**B+**	**Neutral**
(Mkt funds-Liquid Assets) / Total Assets	-25.72%						
Liquidity Management		x					
Factor: Capital Adequacy						**A**	**Neutral**
Tier 1 Ratio - Basel II	--	--	--	--	--		
Tangible Common Equity / RWA - Basel II	14.13%						
Factor: Efficiency						**B**	**Neutral**
Cost / Income Ratio		50.08%					
Factor: Asset Quality						**D+**	**Neutral**
Problem Loans / Gross Loans				5.98%			
Problem Loans / (Equity + LLR)			27.36%				
Lowest Combined Score (9%)						**D+**	

Economic Insolvency Override						--	
Aggregate Score						C	
Assigned BFSR						D+	

[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