

CREDIT OPINION

1 March 2017

Update

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RATINGS

Bank Zachodni WBK S.A.

| | |
|-------------------|--------------------------------|
| Domicile | Warsaw, Poland |
| Long Term Deposit | A3 |
| Type | LT Bank Deposits - Fgn Curr |
| Outlook | Stable |

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Bank Zachodni WBK S.A.

Semiannual update

Summary Rating Rationale

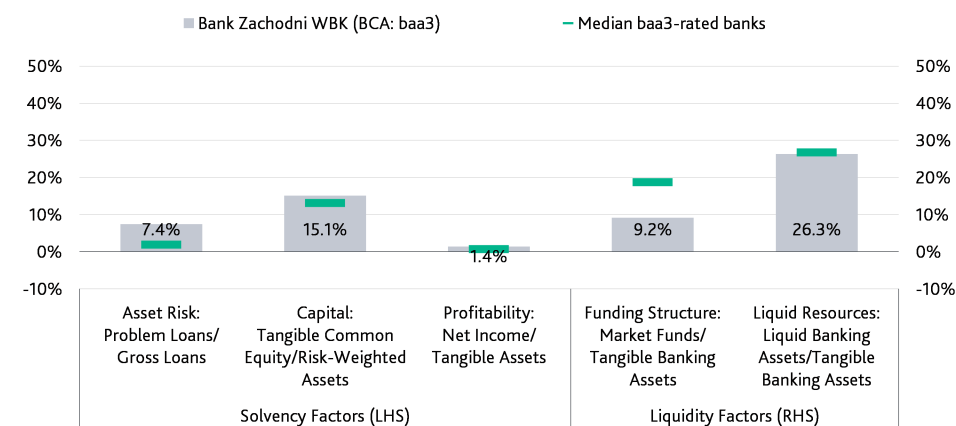
Bank Zachodni WBK's (BZ WBK) A3/Prime-2 deposit ratings incorporate: (1) the bank's standalone baseline credit assessment (BCA) of baa3, (2) our assumption of moderate parental support from Banco Santander (Deposits A3 stable; BCA baa1) which results in one notch uplift from the bank's BCA, (3) the results of our Advanced Loss Given Failure (LGF) analysis, which takes into account the severity of loss faced by the different liability classes in resolution, and which leads to two notches of rating uplift for BZ WBK's deposit ratings, and (4) our assumption of low likelihood of support from the Polish Government (A2, negative) in case of need, which does not result in additional uplift.

The bank's Counterparty Risk Assessment (CR Assessment) is A2(cr)/P-1(cr).

BZ WBK's BCA of baa3 is supported by Poland's Macro Profile of Strong-, and reflects the bank's (i) expanding franchise in the Polish market, (ii) improved asset quality and strong profitability, and (iii) good liquidity profile. At the same time, the bank's capitalisation, although at a good level, may come under pressure from faster lending growth and potential government initiatives on CHF mortgages.

Exhibit 1

Rating Scorecard - Key Financial Ratios



Source: Moody's Financial Metrics

Credit Strengths

- » Third largest banking franchise in the Polish market
- » Asset quality is improving, and is in line with peers
- » Capitalisation is adequate, but pressure may arise from faster lending growth and potential government initiatives on CHF mortgages
- » Profitability is strong, but is facing challenges
- » Good liquidity buffer

Credit Challenges

- » Moderate exposure to Swiss-Franc mortgages
- » Deposit funded profile, but some dependence on medium-term wholesale FX funding due to the FX mortgage portfolio

Rating Outlook

The outlook for BZ WBK's ratings is stable, reflecting our expectation that the bank will maintain its stand-alone credit profile as well as its liability structure which affects the loss given failure in resolution over the medium term.

Factors that Could Lead to an Upgrade

Upward pressure of BZ WBK's ratings would be largely conditional on continuous improvement in asset quality, while maintaining or improving its regulatory capital, profitability, funding and liquidity. Alterations in the bank's liability structure may change the amount of uplift provided by our Advanced LGF analysis and lead to a higher notching from the bank's adjusted BCA, thereby positively affecting deposit ratings and CRA.

Factors that Could Lead to a Downgrade

BZ WBK's ratings could come under pressure in case of: (1) significant deterioration in asset quality, profitability and/or capital levels; and (2) substantial increase in market funding reliance. Furthermore, alterations in the bank's liability structure may change the amount of uplift provided by our Advanced LGF analysis and lead to a lower notching from the bank's adjusted BCA, thereby negatively affecting deposit ratings and CRA.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Key Indicators

Exhibit 2

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

| | 12-16 ² | 12-15 ² | 12-14 ² | 12-13 ³ | 12-12 ³ | Avg. |
|--|--------------------|--------------------|--------------------|--------------------|--------------------|-------------------|
| Total Assets (PLN billion) | 150.0 | 138.7 | 134.0 | 105.5 | 60.0 | 25.7 ⁴ |
| Total Assets (EUR million) | 34,074.6 | 32,336.2 | 31,171.0 | 25,381.8 | 14,709.5 | 23.4 ⁴ |
| Total Assets (USD million) | 35,940.3 | 35,126.7 | 37,718.5 | 34,974.7 | 19,392.9 | 16.7 ⁴ |
| Tangible Common Equity (PLN billion) | 17.4 | 17.5 | 13.1 | 10.6 | 7.9 | 21.9 ⁴ |
| Tangible Common Equity (EUR million) | 3,954.6 | 4,069.9 | 3,036.6 | 2,560.4 | 1,932.4 | 19.6 ⁴ |
| Tangible Common Equity (USD million) | 4,171.1 | 4,421.1 | 3,674.5 | 3,528.1 | 2,547.6 | 13.1 ⁴ |
| Problem Loans / Gross Loans (%) | 6.6 | 7.3 | 8.4 | 7.9 | 5.4 | 7.1 ⁵ |
| Tangible Common Equity / Risk Weighted Assets (%) | 15.1 | 15.4 | 12.3 | 12.2 | 15.1 | 14.3 ⁶ |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 31.9 | 32.2 | 41.9 | 39.9 | 23.9 | 33.9 ⁵ |
| Net Interest Margin (%) | 3.4 | 3.2 | 3.4 | 3.5 | 3.9 | 3.5 ⁵ |
| PPI / Average RWA (%) | 3.1 | 3.1 | 3.3 | 4.0 | 4.6 | 3.2 ⁶ |
| Net Income / Tangible Assets (%) | 1.4 | 1.5 | 1.6 | 1.6 | 2.4 | 1.7 ⁵ |
| Cost / Income Ratio (%) | 51.3 | 50.8 | 47.3 | 50.5 | 43.9 | 48.8 ⁵ |
| Market Funds / Tangible Banking Assets (%) | 9.2 | 11.1 | 12.0 | 8.2 | 4.0 | 8.9 ⁵ |
| Liquid Banking Assets / Tangible Banking Assets (%) | 26.3 | 26.8 | 30.2 | 29.9 | 29.3 | 28.5 ⁵ |
| Gross loans / Due to customers (%) | 95.9 | 98.8 | 95.8 | 91.2 | 88.0 | 93.9 ⁵ |

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] IFRS reporting periods have been used for average calculation [5] Compound Annual Growth Rate based on IFRS reporting periods [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Source: Moody's Financial Metrics

Detailed Rating Considerations

Third largest franchise in the Polish market

BZ WBK became the third-largest bank in Poland, following a number of acquisitions in recent years, with a reported 10% market share in both customer deposits and loans as of December 2016. The acquisition of Kredyt Bank has also significantly boosted the bank's mortgage franchise which was lagging behind its peers, while the consolidation of SCB (about 12% of the assets of BZ WBK) helped to expand the bank's presence in consumer lending. In addition, the bank has a good presence across Poland, supported by a wide branch network, comprised of 658 own branches, with additional 163 branches through SCB's network as of December 2016.

As of December 2016, BZ WBK has a well-balanced loan book, with retail loans accounting for 52% of total loans, with mortgage loans making up two thirds of this.

In 2016 the loan book of BZ WBK increased by 7.9%, outpacing the overall Polish market which increased by 5.2%, supported by the good macroeconomic environment and consumer sentiment. The bank reported a consistent increase in the loan book across main segments with consumer loans growing by 8%, mortgage loans by 11% and SME loans by 12%. On the other hand, growth in large corporate loans was noticeably lower, with a year-on-year increase of 2%.

One of the primary risks factors for the BZ WBK's credit profile is its exposure to foreign currency mortgages as CHF mortgages constitute 12.5% of the loan book. Nevertheless, [following recent comments by the chairman of the ruling Law and Justice party](#), it seems that this risk has decreased. In particular, he [indicated that the government would not force the conversion of Swiss franc mortgage loans](#) to Poland's local currency, the zloty, a reversal of the government's earlier announced intention. The turnaround in the stance is positive for exposed banks (among which is BZ WBK) because the initial conversion proposal would have been negative for financial stability and investor confidence. Separately, Poland's Financial Stability Committee (FSC) on macro-prudential supervision proposed its own [framework for restructuring foreign currency mortgage loans](#). The FSC's framework recommends, among other things, increasing the risk-weighted assets (RWAs) applied to foreign-currency mortgages to 150% from 100% currently, and imposing a loss-given-default floor in banks' internal rating-based RWA models. Therefore, we believe that the direction of the framework for addressing the CHF mortgage loans in Poland will likely involve [higher risk-weights for this loan class](#) as well as [reimbursement of spread which bank have charged over a "fair margin"](#).

Asset quality is improving, and is in line with peers

BZ WBK's asset quality will continue to improve gradually over the next 12 to 18 months owing to the growing economy that benefits borrowers' ability to service their debt and the bank's ongoing efforts to sell and write-off some of the non-performing loans (NPLs). We expect Poland's real GDP to grow by 2.9% and 2.8%, respectively, in 2017 and 2018.

The bank's NPL ratio declined in 2016, reaching 6.6% at year-end 2016, from 7.3% the year before, and 8.4% in 2014. The level is largely in line with the average for the Polish banking sector and also similar to its closest peers PKO BP (Deposits A2 neg, BCA baa2) and Bank Pekao (Deposits A2 neg(m), BCA baa1). The improvement is a result of the growing loan book combined with sales of impaired loans – throughout 2016 the bank sold PLN1.1 billion of NPLs (equivalent to 15% of year-end 2015 NPL portfolio). At the same time, we calculate that the NPL coverage ratio decreased marginally to 68.7%, from 70.6% in 2015.

BZ WBK has also inherited a legacy of CHF mortgages from Kredyt Bank and SCB, which made up 12.5% of its loan book as of December 2016 (the size of the CHF mortgage loans portfolio amounted to PLN 13.5 billion in 2016, from PLN 2 billion in 2012 as a result of the two acquisitions). Although this portfolio has performed well to date, with a NPL ratio of 1.4% for BZ WBK (compared to 3.7% for the sector), the depreciation of the Polish zloty against the Swiss franc of over 50% since 2008 has resulted in a substantial increase in the loan-to-value (LTV) of these loans, with BZ WBK reporting an average LTV for its CHF mortgages of 116% as of year-end 2016, creating a higher risk for the level of potential recovery in case of borrower defaults.

We expect that the effects of economic growth will have a positive, albeit gradual, impact on bank's asset quality, nevertheless risk related to CHF mortgages are still present. Therefore we assign ba2 asset risk score, in line with the macro adjusted score.

Capitalisation is adequate, but pressure may arise from faster lending growth and potential government initiatives on CHF mortgages

BZ WBK reported a consolidated Common Equity Tier 1 (CET1) ratio of 14.6 % and Total Capital ratio (TCR) of 15.1% as of December 2016, an increase compared to 14.1% and 14.6% as of year-end 2015. The bank's regulatory capital benefited from inclusion of PLN0.7 billion net income generated in the first half of 2016, approved by the regulator, as well as from the stable level of risk-weighted assets.

[In the second half of 2016, the Polish Financial Supervision Authority \(KNF\) designated BZ WBK as a systemically important bank](#) with an applicable capital buffer rate of 0.5%. It comes on top of a system-wide capital conservation buffer of 1.25% and a foreign-currency mortgage risk buffer of 0.63% (part of the Pillar 2 requirements, and applied on individual basis). Overall, the capital requirements for BZ WBK increased to a total of 11.22% for Tier 1 and 14.38% for TCR, which the bank is already covering with its year-end 2016 regulatory capital.

In December 2016, KNF has provided guidelines for dividend payout for Polish banks, which apart from capitalisation levels, also take into account the size of their foreign currency mortgage loans portfolio in relation to the total loan book as well as the proportion of foreign currency mortgages originated in 2007 and 2008. Effectively, BZ WBK's allowed distribution of 2016 profit decreased from 50%, permissible if only the capital criteria were to be applied, to approximately 20%. As of publication of this report, the bank has not announced final decisions with regards to profit sharing.

We expect that the strong loan growth and potentially higher risk-weighting for foreign-currency mortgages could lead to some decline in the capital ratios. In order to reflect this we adjust the capital score down by two notches to baa1.

Profitability is strong, but is facing challenges

BZ WBK has maintained good internal capital generation throughout 2016. The bank reported an increase in net interest income by 10.7% year-on-year to PLN 4.8 billion. This result was primarily underpinned by growing revenues from higher-yielding products, such as consumer and SME loans, combined with decreased cost of retail deposit funding. Indeed, the net interest margin amounted to 3.37% as of year-end 2016, compared to 3.21% the year before. At the same time, the bank's net fee and commission income declined by 1.2% to PLN 1.9 billion.

Since February 2016 Polish banks are required to pay annually a bank tax equal to 0.44 per cent of their adjusted assets. As a result, BZ WBK recognised a PLN 387 million cost during 2016. On the other hand, the effect of the tax cost was partially offset by the PLN 316 million of income which BZ WBK recorded for the sale of Visa Europe Limited. As a result, the bank reported a net income of PLN

2.3 billion, resulting in a ROE of 11.5% and a ROA of 1.7%, whereas the adjusted ratios, if we exclude the one-off income from the Visa transaction, would be 10.8% and 1.5%, respectively.

In addition to the bank tax, [the President's office has proposed a draft law](#) under which banks will be forced to reimburse foreign currency mortgage borrowers for the spreads charged over a "fair margin". According to the President's office original estimate the one-off cost of this initiative for the sector is around PLN 4 billion, which we estimate to be around a sizable one quarter of the annualised pre-tax profit of the sector for 2016.

We expect that the above mentioned system-wide developments will continue to put pressure on the profitability of the sector, including BZ WBK. Revenues from consumer and SME loans should support bank's profitability, nevertheless these segments are susceptible to elevated volatility in case of economic downturns. To reflect this expectation we adjust the profitability score down by two notches to baa2.

Deposit funded profile, but some dependence on medium-term wholesale FX funding due to the FX mortgage portfolio

BZ WBK is predominantly deposit funded, with deposits from retail customers accounting for 56% of the total deposits as of December 2016. The bank's loan to deposit ratio was 96% as of the same time, a slight improvement from 98.8% in 2015, driven by the deposit growth outpacing the increase in loans.

The bank also has comfortable liquidity buffer with liquid assets as a percentage of tangible assets at 26.3% at year-end 2016, little changed from 26.8% the year before.

BZ WBK has a funding gap due to the CHF mortgage portfolio. As of year-end 2016, the bank covered most of the currency mismatches related to this portfolio through medium-term swaps with varied maturities. In our view, this exposes the bank to the volatile nature of the derivatives market at times of increased market volatility. To reflect the risks from this form of off-balance-sheet financing, we adjust down the funding structure score by two notches to baa2.

Notching Considerations

Affiliate Support

We assess a moderate probability of parental support for BZ WBK from its parent Banco Santander, given the 69.4% ownership stake in the bank and Banco Santander's commitment to its Polish business. This assessment results in one notch of uplift from the baa3 BCA of BZ WBK to an adjusted BCA of baa2.

Loss Given Failure

BZ WBK is subject to the EU Bank Recovery and Resolution Directive (BRRD), which we consider to be an Operational Resolution Regime. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, a 26% proportion of junior deposits (EU average) and assign a 25% probability to deposits being preferred to senior unsecured debt. These are in line with our standard assumptions.

This results in a Preliminary Rating Assessment (PRA) of a3, two notches above the Adjusted BCA, reflecting a very low loss-given failure.

Government Support

We incorporate a low likelihood of government support for BZ WBK's deposits in the event of its failure. This reflects the operational resolution regime which is likely to restrict the ability of the government to provide such support, even if it were willing to do so, requiring losses to be imposed on even senior creditors and large depositors under many circumstances.

As a result, BZ WBK's deposit rating do not benefit from any systemic support from Polish authorities.

Counterparty Risk Assessment

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit

instruments. The CR assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

The CR Assessment of BZ WBK is positioned at A2(cr), three notches above the Adjusted BCA of baa2, based on the cushion against default provided to the senior obligations. In addition, the low probability of government support does not result in any uplift

About Moody's Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard 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 Methodology and Scorecard Factors

Exhibit 3

Bank Zachodni WBK S.A.

Macro Factors

| | | |
|-------------------------------|-----------------|-------------|
| Weighted Macro Profile | Strong - | 100% |
|-------------------------------|-----------------|-------------|

Financial Profile

| Factor | Historic Ratio | Macro Adjusted Score | Credit Trend | Assigned Score | Key driver #1 | Key driver #2 |
|---|----------------|----------------------|--------------|----------------|-----------------------------------|----------------|
| Solvency | | | | | | |
| Asset Risk | | | | | | |
| Problem Loans / Gross Loans | 7.4% | ba2 | ← → | ba2 | Expected trend | |
| Capital | | | | | | |
| TCE / RWA | 15.1% | a2 | ← → | baa1 | Capital retention | Expected trend |
| Profitability | | | | | | |
| Net Income / Tangible Assets | 1.4% | a3 | ← → | baa2 | Expected trend | |
| Combined Solvency Score | | baa2 | | baa3 | | |
| Liquidity | | | | | | |
| Funding Structure | | | | | | |
| Market Funds / Tangible Banking Assets | 9.2% | a3 | ← → | baa2 | Extent of market funding reliance | |
| Liquid Resources | | | | | | |
| Liquid Banking Assets / Tangible Banking Assets | 26.3% | baa2 | ← → | baa2 | Expected trend | |
| Combined Liquidity Score | | baa1 | | baa2 | | |
| Financial Profile | | | | baa3 | | |
| Business Diversification | | | | 0 | | |
| Opacity and Complexity | | | | 0 | | |
| Corporate Behavior | | | | 0 | | |
| Total Qualitative Adjustments | | | | 0 | | |
| Sovereign or Affiliate constraint: | | | | A2 | | |
| Scorecard Calculated BCA range | | | | baa2-ba1 | | |
| Assigned BCA | | | | baa3 | | |
| Affiliate Support notching | | | | 1 | | |
| Adjusted BCA | | | | baa2 | | |

Balance Sheet

| | in-scope (PLN million) | % in-scope | at-failure (PLN million) | % at-failure |
|-------------------------------|---------------------------|------------|-----------------------------|--------------|
| Other liabilities | 28,885 | 19.5% | 40,363 | 27.3% |
| Deposits | 112,523 | 76.1% | 101,046 | 68.3% |
| Preferred deposits | 83,267 | 56.3% | 79,104 | 53.5% |
| Junior Deposits | 29,256 | 19.8% | 21,942 | 14.8% |
| Senior unsecured bank debt | 1,674 | 1.1% | 1,674 | 1.1% |
| Dated subordinated bank debt | 404 | 0.3% | 404 | 0.3% |
| Equity | 4,438 | 3.0% | 4,438 | 3.0% |
| Total Tangible Banking Assets | 147,924 | 100% | 147,924 | 100% |

| Debt class | De jure waterfall | | De facto waterfall | | Notching | | LGF notching guidance versus BCA | Assigned LGF notching | Additional notching | Preliminary Rating Assessment |
|------------------------------|-----------------------------------|----------------|-----------------------------------|----------------|----------|----------|----------------------------------|-----------------------|---------------------|-------------------------------|
| | Instrument volume + Subordination | Sub-ordination | Instrument volume + Subordination | Sub-ordination | De jure | De facto | | | | |
| Counterparty Risk Assessment | 19.2% | 19.2% | 19.2% | 19.2% | 3 | 3 | 3 | 3 | 0 | a2 (cr) |
| Deposits | 19.2% | 3.3% | 19.2% | 4.4% | 2 | 2 | 2 | 2 | 0 | a3 |

| Instrument class | Loss Given Failure notching | Additional Notching | Preliminary Rating Assessment | Government Support notching | Local Currency Rating | Foreign Currency Rating |
|------------------|-----------------------------|---------------------|-------------------------------|-----------------------------|-----------------------|-------------------------|
| | | | | | | |
| Deposits | 2 | 0 | a3 | 0 | A3 | A3 |

Source: Moody's Financial Metrics

Ratings

Exhibit 4

| Category | Moody's Rating |
|-------------------------------------|----------------|
| BANK ZACHODNI WBK S.A. | |
| Outlook | Stable |
| Bank Deposits | A3/P-2 |
| Baseline Credit Assessment | baa3 |
| Adjusted Baseline Credit Assessment | baa2 |
| Counterparty Risk Assessment | A2(cr)/P-1(cr) |

Source: Moody's Investors Service

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