MOODY'S
INVESTORS SERVICE

Credit Opinion: Bank Zachodni WBK S.A.

Global Credit Research - 20 Nov 2015

Warsaw, Poland

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-2
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A2(cr)/P-1(cr)

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Key Indicators

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

	[2]9-15	[2]12-14	[3]12-13	[3]12-12	[3]12-11	Avg.
Total Assets (PLN billion)	135.1	134.0	105.5	60.0	59.9	[4]22.6
Total Assets (EUR million)	31,820.0	31,171.0	25,381.8	14,709.5	13,431.2	[4]24.1
Total Assets (USD million)	35,518.9	37,718.5	34,974.7	19,392.9	17,435.7	[4]19.5
Tangible Common Equity (PLN billion)	16.2	13.1	10.6	7.9	6.7	[4]24.9
Tangible Common Equity (EUR million)	3,823.8	3,036.6	2,560.4	1,932.4	1,493.8	[4]26.5
Tangible Common Equity (USD million)	4,268.3	3,674.5	3,528.1	2,547.6	1,939.2	[4]21.8
Problem Loans / Gross Loans (%)	8.1	8.4	7.9	5.4	5.5	[5]7.1
Tangible Common Equity / Risk Weighted Assets (%)	--	12.3	12.2	15.1	13.8	[6]12.3
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	36.4	41.9	39.9	23.9	27.0	[5]33.8
Net Interest Margin (%)	3.2	3.4	3.5	3.9	3.7	[5]3.5
PPI / Average RWA (%)	--	3.3	4.0	4.6	4.2	[6]3.3
Net Income / Tangible Assets (%)	1.8	1.6	1.6	2.4	2.1	[5]1.9
Cost / Income Ratio (%)	47.1	47.3	50.5	43.9	50.3	[5]47.8
Market Funds / Tangible Banking Assets (%)	12.6	12.0	8.2	4.0	6.8	[5]8.7
Liquid Banking Assets / Tangible Banking Assets (%)	26.7	30.2	29.9	29.3	32.6	[5]29.7
Gross loans / Due to customers (%)	101.8	95.8	91.2	88.0	84.2	[5]92.2

Source: Moody's

[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] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Bank Zachodni WBK's (BZ WBK) deposit ratings are A3/Prime-2, and the bank's baseline credit assessment (BCA) is baa3.

BZ WBK's baa3 BCA is supported by (i) its expanding franchise in the Polish market, (ii) a good liquidity profile, and (iii) adequate capitalisation, supported by high internal capital creation. The BCA is constrained by the bank's (i) asset quality, slightly weaker than the system average, and (ii) some dependence on medium-term wholesale FX funding due to its FX mortgage portfolio.

The A3/Prime-2 deposit ratings are underpinned by the bank's BCA, our assumptions of high affiliate support from its parent, Banco Santander (deposits A3 positive; BCA baa1), and the Advanced Loss Given Failure (LGF) analysis.

Furthermore, we assign a Counterparty Risk Assessment (CR Assessment) of A2(cr)/P-1(cr) to BZ WBK.

Rating Drivers

- Third largest franchise in the Polish market, following the acquisition of Kredyt Bank and Santander Consumer Bank

- Asset quality is slightly weaker than the system average

- Capitalisation is adequate, supported by high internal capital creation

- Self funding profile underpinned by a large retail deposit base, 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.

What Could Change the Rating - Up

Upward pressure of BZ WBK's ratings would be largely conditional on an improvement in asset quality, while maintaining or improving its capital base, profitability, funding and liquidity..

What Could Change the Rating - Down

BZ WBK's ratings could come under pressure if asset quality shows significant 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.

DETAILED RATING CONSIDERATIONS

THIRD LARGEST FRANCHISE IN THE POLISH MARKET, FOLLOWING THE ACQUISITION OF KREDYT BANK AND SANTANDER CONSUMER BANK

Following the acquisition of Kredyt Bank in January 2013 and Santander Consumer Bank (SCB), which was acquired from BZ WBK's parent, in July 2014, BZ WBK's total assets more than doubled between end-2012 to end 2014, with the bank reporting PLN 135 billion total assets as of September 2015. As a result, BZ WBK became the third-largest bank in Poland with market shares of customer deposits and loans of, respectively, 10% and 9.6% as of September 2015. 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 14% of the assets of BZ WBK) helped to expand the bank's presence in consumer lending. As of September 2015, BZ WBK has a well-balanced loan book, with retail loans accounting for 52% of total loans (and mortgages making up 35% of all loans).

In addition, the bank has a good presence across Poland, supported by a wide branch network, comprised 752 branches as of September 2015.

ASSET QUALITY IS SLIGHTLY WEAKER THAN THE SYSTEM AVERAGE

The ratio of non-performing loans of BZ WBK decreased to 8.1% in Q3 2015, from 8.4% as of year-end 2014. This level remains higher than the average for the Polish banking sector of 7.2%. At the same time, the non-performing loan coverage ratio improved slightly to 59.2%, from 58.4% as of year-end 2014. We expect the improving trend to continue, and as a result we adjust up the asset risk score to ba2.

BZ WBK has also inherited a legacy of CHF mortgages from Kredyt Bank and SCB, which now make up around 14% of its loan book as of September 2015 (CHF loans increased to around PLN 13.9 billion in Q3 2015, from PLN 2 billion in 2012). While this creates a contingent risk for the bank's asset quality, particularly in the face of the now floating Swiss franc exchange rate, the size of this portfolio is relatively modest in the context of the overall loan book, and also slightly lower than the average exposure in the Polish banking sector.

CAPITALISATION IS ADEQUATE, SUPPORTED BY HIGH INTERNAL CAPITAL CREATION

BZ WBK reported a consolidated Total Capital ratio (TCR) of 13.9% and Common Equity Tier 1 (CET1) ratio of 13.5% as at September 2015, an increase from 12.9% and 12.5% as of year-end 2014 following full retention of 2014 profits.

At the end of October 2015, the Polish Financial Supervision Authority (KNF) imposed addition capital requirements to those Polish banks exposed to foreign currency mortgages. BZ WBK, being one of the affected banks, now has to hold an additional 0.72 percentage points buffer (split between CET1 and TCR), bringing the minimum required CET1 and TCR at 9.54% and 12.72 %, respectively. In addition, KNF has announced that it will introduce an additional 1.25 percentage points capital conservation buffer from 1 January 2016.

The bank has maintained relatively high internal capital generation, with estimated annualised ROE at 13.4% and ROA of around 1.8% during the first nine months of 2015, excluding the one off income from sale of stake in the AVIVA insurance business.

In addition, the Polish banking sector faces significant risk from implementation of a law to convert Swiss franc mortgage loans on unfavourable terms for banks and possible introduction of a bank levy and/or a financial transaction tax. While at the moment there is no certainty regarding any particular measures, the political party Law and Justice (PiS), which won the recent elections, has indicated the intention to act in this direction. As a result, we adjust down the profitability score to a3.

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

Liquidity and funding constitute important rating drivers for BZ WBK given its significant reliance on customer funds, with its gross loan-to-deposit ratio at 101.8% as of September 2015, up from 95.7% as of year-end 2014. The increase was due to loan growth outpacing deposit growth.

The bank also has comfortable liquidity buffer (liquid assets as a percentage of tangible assets stood at 27% at Q3 2015) which, however, we expect to reduce slightly to sustain loan growth. As a result, we adjust down the liquid resources score to baa2.

BZ WBK has a funding gap due to the CHF mortgage portfolio. As of Q3 2015, the bank is financing majority of the currency mismatches (78% of the total) related to this portfolio through the derivatives market, in the form of medium-term swap instruments with varied maturities. In our view, this exposes the bank to the volatile nature of the derivatives market in situations of increased market uncertainty. To reflect this form of off-balance-sheet financing, we adjust down the funding structure score to baa2.

BZ WBK'S RATINGS ARE SUPPORTED BY POLAND'S STRONG- MACRO PROFILE

Poland's Macro Profile balances the country's very high economic and institutional strengths against its moderate susceptibility to event risk. While operating conditions for banks in Poland are relatively benign, the banking system continues to carry a sizeable, albeit declining, burden of foreign-currency mortgages, which carries higher credit and funding risks, constraining the banks' good financial fundamentals.

Notching Considerations

AFFILIATE SUPPORT

We assess a moderate probability of parental support for BZ WBK from its parent Banco Santander.

This leads to an adjusted BCA of baa2, one notch above the bank's BCA of baa3.

LOSS GIVEN FAILURE

BZ WBK operates in Poland, which is an EU-member country. As such, under the Bank Resolution and Recovery Directive (BRRD) it is subject to an Operation Resolution Regime, similar to other EU countries. Poland is expected to adopt a national version of the directive in the course of 2015. As a result, in accordance with our methodology, we apply our advanced LGF analysis, considering the risks faced by the different debt and deposit classes across the liability structure should the bank enter resolution. 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, 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) two notches above the Adjusted BCA, reflecting a very low loss-given failure.

GOVERNMENT SUPPORT

We believe there is 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, we do not incorporate any systemic support from Polish authorities to BZ WBK's deposit ratings.

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.

The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss, therefore we focus purely on subordination and take no account of the volume of the instrument class.

ABOUT MOODY'S BANK 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 Factors

Bank Zachodni WBK S.A.

Macro Factors	
Weighted Macro Profile	Strong -

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	8.1%	ba3	↑	ba2	Expected trend	
Capital						
TCE / RWA	12.3%	baa2	←→	baa2	Expected trend	
Profitability						
Net Income / Tangible Assets	1.8%	a2	↓	a3	Expected trend	
Combined Solvency Score		baa3		baa3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	12.0%	a3	←→	baa2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	30.2%	a3	↓	baa2	Expected trend	
Combined Liquidity Score		a3		baa2		

Financial Profile	**baa3**

Qualitative Adjustments	**Adjustment**
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**

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