FITCH AFFIRMS 4 LEADING POLISH BANKS; OUTLOOK STABLE

Fitch Ratings-Warsaw/London/Moscow-09 November 2016: Fitch Ratings has affirmed the Long-Term Issuer Default Ratings (IDRs) of Bank Pekao SA (A-), Bank Handlowy w Warszawie (Handlowy, A-), ING Bank Slaski (Bank Slaski, A) and Bank Zachodni WBK (BZ WBK, BBB+). Fitch has also affirmed the ratings of Pekao's mortgage bank subsidiary, Pekao Bank Hipoteczny (PBH, A-). All Long-Term IDRs are on Stable Outlook.

The Viability Rating (VR) of Handlowy has been upgraded to 'a-' from bbb+' while the VRs of other banks have been affirmed; Pekao at 'a-', and BZ WBK and Bank Slaski at 'bbb+'. A full list of rating actions is provided at the end of this commentary.

KEY RATING DRIVERS
IDRS, SUPPORT RATINGS, NATIONAL RATINGS AND SENIOR DEBT
The IDRs of Pekao are driven by the bank's intrinsic strength, as reflected in its VR. The IDRs of BZ WBK and, following its VR upgrade, Handlowy, are driven by their individual credit profiles, but also underpinned by potential shareholder support. The IDRs of Bank Slaski are driven by potential shareholder support.

The Support Ratings of the four banks reflect Fitch's view on potential support from the respective banks' shareholders. In Fitch's opinion, the probability of support is extremely high for Handlowy and Bank Slaski, and high for BZ WBK and Pekao. The banks' largest shareholders are, respectively, Citigroup Inc (A/Stable/a), ING Bank NV (A+/Stable/a+), Banco Santander S.A. (Santander, A-/Stable/a-) and UniCredit S.p.A. (UniCredit; BBB+/Negative/bbb+).

In mid-October, UniCredit confirmed that it was in talks with PZU SA and the Polish Development Fund (Polski Fundusz Rozwoju), regarding a possible sale transaction involving Pekao. The placement of Pekao's Support Rating on Rating Watch Negative reflects this potential sale and the expectation that Fitch's assessment of the new controlling shareholders' ability and propensity to provide extraordinary support, should a sale go through, will be lower than at present.

The ratings of PBH are equalised with those of its direct parent and share the same Stable Outlook, reflecting Fitch's view that it is a core subsidiary of Pekao.

VIABILITY RATINGS
The affirmations of the VRs of Pekao, BZ WBK and Bank Slaski are underpinned by their sound fundamental credit quality and by the absence of any major changes in their financial metrics over the last 12 months. The upgrade of Handlowy's VR reflects a reassessment of the benefits of the bank's conservative business model, low risk appetite, and strong capital and liquidity buffers for the bank's standalone credit profile.

The VRs of the four banks continue to reflect a strong capacity for ongoing viability. Their common rating strengths are a generally conservative risk appetite, strong capitalisation, sound asset quality and stable funding based on customer deposits. The higher (by one notch) VRs of Pekao and Handlowy reflect their higher capital ratios, extended track record of consistent performance (Pekao) and particularly low-risk business model (Handlowy).

The banks' results have been under pressure since 2013 from falling interest rates (with the repricing of assets lagging behind liabilities), subdued credit demand and inflated regulatory costs.

BZ WBK and Bank Slaski were able to mitigate these with loan book expansion and funding cost optimisation.

Fitch expects 2H16 results to show that revenue pressures have abated as margins gradually recover and lending growth remains positive, trends we believe will continue in 2017. However, the bank levy will continue to weigh on profitability. In 1H16, the bank levy absorbed between 9% (Handlowy) and 16% (Bank Slaski) of operating profit, but was largely offset by non-recurring income on transactions with Visa Europe.

HANDLOWY
Handlowy's overall franchise is narrower than peers, and the bank has a more moderate scale (about 3% market share by total assets at end-1H16). However, Handlowy has leading positions in its strategic segments, such as credit cards for private individuals and banking products and services for multinational companies.

Handlowy's risk appetite is the most conservative among rated Polish banks and reflects stability through-the-cycle, a focus on generally low-risk lending segments, tight underwriting standards and a robust control environment underpinned by stringent parental supervision.

At end-1H16, impaired loans fell to about 3.4% of gross loans (sector: 6.4%) and were around 85% covered by loan loss reserves (coverage stronger than at peers). Handlowy's non-loan exposures are of high quality, comprising debt securities (almost solely Polish sovereign risk) and cash and cash equivalents, and accounted for about half of the bank's balance sheet.

One of Handlowy's strategic goals is to maintain a highly liquid balance sheet and a large surplus of customer deposits over loans. At end-1H16, the gross loans/deposits ratio stood at about 60% and unencumbered liquid assets were sufficient to fully repay all wholesale liabilities and about 55% of customer deposits. Deposits are dominated by the non-retail segment (about a 70% share) but their stability is underpinned by long-term customer relationships.

Handlowy's capitalisation is a rating strength, with a Fitch Core Capital (FCC) ratio of about 18% at end-1H16. In assessing the bank's capitalisation, Fitch views favourably its conservative risk management, immaterial stock of unreserved impaired loans and healthy internal capital generation.

PEKAO
Capitalisation is a rating strength for Pekao and a key driver of its 'a-' VR. This strength is based on the bank's high capital ratios, conservative risk management, low unreserved impaired loans (around 10% of FCC at end-1H16), moderate concentrations in the loan book, low exposure to foreign currency mortgages, modest growth and healthy internal capital generation. At end-1H16, the FCC ratio stood at 19.3%; the highest among rated Polish peers.

Pekao's asset quality improved marginally faster than the sector over the last 18 months and the impaired loan ratio stood at 6.5% at end-1H16, despite Pekao being less active than some of its peers in writing off impaired loans. Coverage of impaired loans by provisions is reasonable at 72%.

The loan-to-deposit ratio is close to 100%, and liquidity is strong, benefitting from a stable funding position, based on balanced and diversified customer deposits, a low share of wholesale funding and an ample equity base.

The VR of Pekao is one notch above the IDR of its parent. The rating differential, with the potential to increase to two notches in case of a downgrade of UniCredit to 'BBB', reflects the low dependence of Pekao on group and wholesale funding, its robust domestic franchise and a strong domestic regulator, which in Fitch's view will likely continue to prevent any sizable upstreaming of capital to shareholders.

BZ WBK

The bank's solid capitalisation is reflected in a high FCC of almost 17% at end-3Q16, a material surplus over regulatory minimum capital ratios and healthy internal capital generation. Unreserved impaired and performing forborne loans represented a moderate almost 20% of FCC.

BZ WBK's appetite for loan growth is high, but the bank's strong risk control environment should limit excessive expansion or a material build-up of high-risk exposures. A full consolidation of Santander Consumer Bank (SCB, 60% stake acquired in 2014) has inflated the consolidated stock of impaired loans, but is positive for the bank's profitability.

BZ WBK's asset quality is moderately weaker than peers due to the bank's material exposure to legacy residential mortgages denominated in foreign currency (about 15% of consolidated gross loans, currently performing well) and commercial property loans (about 8%). At end-3Q16, the consolidated impaired loans ratio was 6.8% (or about 8.5% including forborne loans classified as performing) and the bank plans to reduce the figure to below 6% in 2017. Reserve coverage was reasonable at about 75% (coverage at SCB was considerably higher).

BZ WBK's funding profile is solid because the bank is self-funded by diversified deposits and its liquidity is strong. At end-3Q16, the consolidated gross loans/deposits ratio was almost 100% (BZ WBK itself at about 90%). Refinancing risk at SCB is low due to its own reasonable liquidity buffer, fairly easy access to the local wholesale market and customer deposits, the diversified maturity of its liabilities and the relatively short tenor of its loan book.

BANK SLASKI

Fitch believes that Bank Slaski's asset quality will remain strong in 2017, despite the bank's significant appetite for credit expansion (including in cash loans, though from a low base). This view is based on the bank's track record of conservative underwriting and strong risk controls. At end-3Q16, the bank's impaired loans ratio (2.8%) was notably below the domestic sector average (around 6.4%) and most peers. The ratio was partly diluted by rapid loan growth and moderate bad debt sales, but the inflow of new impaired loans also remained under control and comfortably below the bank's solid loss absorption capacity.

At end-3Q16, Bank Slaski maintained moderate buffers over local regulatory capital requirements, which reflected its growing risk-weighted assets (RWAs) and regular dividend payments. However, capitalisation is underpinned by prudent risk management, low unreserved impaired loans (around 7% of FCC at end-3Q16), resilient profitability and potential support available from the higher-rated parent. The FCC ratio stood at 16.9 % at end-3Q16.

Bank Slaski's strong funding profile is underpinned by a large customer deposit base (90% of total funding at end-3Q16), which was concentrated in granular and stable retail savings. The bank's comfortable liquidity position is supported by a sizeable pool of highly liquid assets (covering around a third of total customer deposits) and a modest loans/deposits ratio (86% at end-3Q16).

RATING SENSITIVITIES

IDRS, SUPPORT RATINGS, NATIONAL RATINGS AND SENIOR DEBT

The IDRs of Bank Slaski are sensitive to changes to potential support from its majority owner. As a result, the Outlook on the bank's Long-Term IDR reflects that on the parent.

An upgrade of Handlowy's and BZ WBK's Long-Term IDRs would be contingent on either an upgrade of their VRs, or their respective parents. A downgrade would also require a downgrade of both their VRs and their parents' IDRs.

The IDRs of Pekao are driven by its VR and share the same rating sensitivities. Pekao's Support Rating could be downgraded in case of a further material reduction of Unicredit's 40.1% stake in the bank. PBH's IDRs are likely to move in tandem with those of Pekao.

VIABILITY RATINGS
The VRs of the four banks would likely be resilient to a moderate deterioration in the operating environment. However, a marked and prolonged weakening in the Polish economy (not Fitch's base scenario) materially affecting the banks' asset quality, capitalisation and profitability, could lead to the VRs being downgraded.

The VRs of four banks will not be affected by the potential cost of the spread refund law. They either have negligible (Handlowy) or small (Pekao, Bank Slaski) exposures to foreign currency mortgages, or have enough loss absorption capacity in their income (BZ WBK) to absorb potential cost.

Upside for Handlowy's and Pekao's VRs is limited, given their already high VR levels (in line with Poland's sovereign IDRs) and limited franchise (Handlowy). A downgrade of Poland's sovereign rating would likely result in the downgrade of Pekao's and Handlowy's VRs. Pekao could also be downgraded in case of a weakening of its capital position or a significant increase in risk appetite.

Upgrades of the VRs of BZ WBK and Bank Slaski are unlikely unless the operating environment and the banks' standalone credit profiles improve, and their growth appetites moderate.

The rating actions are as follows:

Handlowy
Long-Term IDR: affirmed at 'A-'; Outlook Stable
Short-Term IDR: affirmed at 'F1'
Viability Rating: upgraded to 'a-' from 'bbb+'
Support Rating: affirmed at '1'
National Long-Term Rating: assigned at 'AA+(pol)'; Outlook Stable
National Short-Term Rating: assigned at 'F1+(pol)'

BZ WBK
Long-Term IDR: affirmed at 'BBB+', Outlook Stable
Short-Term IDR: affirmed at 'F2'
Viability Rating: affirmed at 'bbb+'
Support Rating: affirmed at '2'
National Long-Term Rating: affirmed at 'AA(pol)', Outlook Stable
Senior unsecured debt: affirmed at 'AA(pol)'

Bank Slaski
Long-Term IDR: affirmed at 'A'; Outlook Stable
Short-Term IDR: affirmed at 'F1'
Viability Rating: affirmed at 'bbb+'
Support Rating: affirmed at '1'

Pekao
Long-Term IDR: affirmed at 'A-', Outlook Stable
Short-term IDR: affirmed at 'F2'
Viability Rating: affirmed at 'a-'
Support Rating: '2' on Rating Watch Negative

PBH
Long-Term IDR: affirmed at 'A-', Outlook Stable
Short-Term IDR: affirmed at 'F2'
Support Rating: affirmed at '1'
National Long-Term Rating: affirmed at 'AA+(pol)', Outlook Stable
National Short-Term rating: affirmed at 'F1+(pol)'

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Applicable Criteria
Global Bank Rating Criteria (pub. 15 Jul 2016)
https://www.fitchratings.com/site/re/884135
National Scale Ratings Criteria (pub. 30 Oct 2013)
https://www.fitchratings.com/site/re/720082