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Ratings

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Bank Polska Kasa Opieki S.A.

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Bank Polska Kasa Opieki S.A.

SACP	bbb+
Anchor	bbb-
Business Position	Strong, +1
Capital and Earnings	Strong, +1
Risk Position	Adequate, 0
Funding	Average
Liquidity	Strong
Funding and Liquidity	0

\+

Support	0
ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating
BBB+/Stable/A-2

Major Rating Factors

Strengths:	Weaknesses:
• Strong franchise in the Polish banking market, which benefits the bank's funding position. • Strong capitalization and solid earnings capacity. • Better-than-average credit loss experience and low exposure to foreign currency mortgage loans.	• Some single-name concentration in the loan book, albeit decreasing. • Lack of international diversification. • Uncertainty about future strategy and potential political influence due to the new ownership structure

Outlook: Stable

The stable outlook on Bank Polska Kasa Opieki S.A. (Pekao) reflects S&P Global Ratings' view that the bank's stand-alone credit profile (SACP), and especially its strong capitalization, will remain intact in the next two years. Despite the change in its shareholder structure, Pekao will maintain its conservative growth strategy, in our view, and continue to hold sufficient capital buffers to withstand any adverse developments in its operating environment. Furthermore, its exposure to Swiss franc-denominated mortgage loans is comparatively low.

We will review the potential for group support from Pekao's new owners once we have more clarity about their strategy with and level of control over the bank.

We could revise the outlook on Pekao to negative if we took a similar rating action on the sovereign. A downgrade could occur if we observed any disadvantageous influence on the bank from its new owners that could weaken its strong capital position or negatively influence its business and underwriting standards.

A positive rating action is remote at this stage, even in the context of potential group support. This is because we are unlikely to rate Pekao above our foreign currency sovereign rating on Poland (foreign currency BBB+/Stable/A-2, local currency A-/Stable/A-2), considering the bank's sizable sovereign exposure and high dependence on economic conditions in Poland.

Rationale

The rating on Pekao reflects the 'bbb-' anchor that we apply to commercial banks operating in Poland. It also incorporates our view of the bank's strong business position, strong capital and earnings, adequate risk position, average funding, and strong liquidity. We assess the SACP for Pekao at 'bbb+', the highest of the banks we rate in Poland.

We believe that the prospect of extraordinary government support for the Polish banking sector is uncertain and do not incorporate any uplift above the bank's SACP for government support. Furthermore, our assessment of Pekao's additional-loss absorbing capacity (ALAC) does not currently lead us to add any uplift to the rating.

Anchor: 'bbb-' for banks operating in Poland

We use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating on a bank. The anchor for a commercial bank operating in Poland is 'bbb-'.

In our view, the Polish economy is well-diversified and resilient, and it has a strong manufacturing sector with a competitive workforce. The country's export sector benefits from the floating exchange-rate regime's ability to adjust. We therefore expect these factors will support sound real GDP growth of 3.6% in 2017 and 3.1% in 2018. We see the housing market in Poland as well-balanced between supply and demand, and we expect housing prices will gradually increase in the medium to long term. The main, long-term credit risks continue to stem from banks' still-elevated mortgages in Swiss francs, and in the shorter term, from specific sectors, such as construction and mining.

In our view, banking regulation in Poland is in line with international standards, and we expect the central bank and financial supervisor will act independently from the government, despite the government's increased involvement in the banking sector. Although Polish banks' underlying business stability remains sound, the banks' asset tax and regulatory costs will continue to burden the sector's profitability in the medium term. The tax exemption on government debt has led to an increasing role of domestic banks in sovereign financing. We note increased, proactive state ownership in the Polish banking sector, with the government controlling the country's two largest universal banks, and with some smaller, state-controlled banks, accounting for a market share of almost 40%. This could lead to competitive market distortion. The banking industry continues to be mostly deposit-financed, with a developing domestic debt capital market. However, large banks also demonstrate access to foreign markets for larger issues, if needed.

Table 1

Bank Polska Kasa Opieki S.A. Key Figures					
		--Fiscal year ended Dec. 31--			
(Mil. PLN)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	169,937	173,619	168,149	166,998	157,895
Customer loans (gross)	131,402	128,207	122,982	114,777	106,390
Adjusted common equity	20,459	20,106	20,220	20,253	20,223
Operating revenues	3,573	7,156	7,183	7,441	7,650
Noninterest expenses	1,573	3,112	3,668	3,391	3,568
Core earnings	1,105	2,814	2,456	2,856	2,766

*Data through June 30. PLN--Polish zloty.

Business position: Solid franchise in Poland and conservative management strategy

Pekao benefits from its strong market position in Poland and solid franchise, which has given it broad access to retail funding and resulted in stable market shares in both loans and deposits. We anticipate that the new owners will maintain a prudent growth strategy supporting Pekao's sound franchise and financial position. We therefore assess Pekao's business position as strong.

With total assets of Polish zloty (PLN) 170.5 billion (about €40.3 billion) as of June 30, 2017, Pekao is the second-largest bank in the Polish banking sector, with estimated market shares of 11% each in customer loans and customer deposits. Pekao's revenue mix is well-balanced between retail and commercial banking activity, with shares of 55%-60% and 30%-35% in revenues, respectively. The bank holds a strong position in corporate business, where its market shares are 16%-17% in lending and deposits. Pekao's product offering is complemented by its mutual funds business, with a volume of PLN17 billion (€4 billion) and where the bank holds a market share of 13% in Poland.

In our view, Pekao's geographic diversification is limited. We consider this to be a common feature of most Polish banks, and we do not expect Pekao to expand abroad.

The recent change in the bank's ownership structure and management board creates some uncertainties about the bank's strategic focus. On Dec. 8, 2016, UniCredit SpA announced the sale of its 32.8% stake in Pekao to Powszechny Zaklad Ubezpieczen S.A. and Polish Development Fund S.A., which was completed in June 2017. We expect Pekao will continue following a balanced growth model and demonstrate a successful track record in keeping costs under control and maintaining a lower-than-system average risk appetite. We anticipate obtaining more clarity on the new shareholders' strategy with regard to Pekao's subsidiaries and the impact on the bank's franchise and strategy by the end of 2017 at the latest.

Table 2

Bank Polska Kasa Opieki S.A. Business Position					
		--Fiscal year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Loan market share in country of domicile	10.97	10.92	11.43	11.58	11.16
Deposit market share in country of domicile	11.27	11.63	11.67	12.42	12.92
Total revenues from business line (mil. PLN)	3,573	7,424	7,195	7,443	7,686
Commercial banking/total revenues from business line	34.00	27.94	30.70	28.31	26.53
Retail banking/total revenues from business line	57.75	53.99	56.01	57.67	63.33
Commercial and retail banking/total revenues from business line	91.76	81.92	86.71	85.98	89.87
Trading and sales income/total revenues from business line	0.33	6.54	5.95	5.96	6.05
Asset management/total revenues from business line	6.18	10.51	5.45	6.76	2.51
Other revenues/total revenues from business line	1.73	1.03	1.90	1.30	1.57
Investment banking/total revenues from business line	0.33	6.54	5.95	5.96	6.05
Return on equity §	7.94	9.84	9.67	11.45	11.90

*Data through June 30. §Includes annual contribution to Bank Guarantee Fund. PLN--Polish zloty.

Capital and earnings: Strong capitalization, supported by solid earnings capacity

We regard Pekao's capital and earnings as strong. This assessment primarily reflects our expectation that its capitalization, as measured by our projected risk-adjusted capital (RAC) ratio before diversification adjustments, will remain in the range of 10.5%-11.0% over the next 18-24 months, compared with 11.0% as of year-end 2016.

In our projected RAC ratio for Pekao in the next 18-24 months, we incorporate the following assumptions:

- Annual growth of 2%-3% in operating revenues;
- Cost of credit risk in the range of 40 basis points (bps)-45 bps in 2017-2019, staying significantly below the system average;
- Increasing net earnings in the range of PLN2.3 billion-PLN2.6 billion in 2017-2019;
- A still-high dividend payout ratio at close to 100% of net income (2016: 100%); and
- Above-market growth in loan volumes in retail and SME business, which will result in a moderate increase in our projected ratio of the bank's risk-weighted assets in 2017-2018.

We expect the faster-than-system-average increase in business volume and the repricing and reshifting of loan portfolio will result in a recovery in net interest income in 2017. In addition, we expect the bank will be able to maintain its outstanding cost-to-income ratio, which was 45.4% in the first half of 2017 (the bank targets 42% by 2020), by continuing to optimize its cost base. We estimate that the tax on certain financial institutions will cost Pekao PLN450 million-PLN500 million in 2017-2019, compared with PLN450 million in 2016, based on the increase in the bank's total assets.

We view Pekao's quality of capital--consisting only of core Tier 1 capital in the form of share capital, a capital surplus, and reserves--to be high. We believe that the bank's earnings capacity will remain strong, owing to relatively stable operating revenues, planned cost cuts, and our expectation of low loan losses. This is reflected in our three-year average earnings buffer of 155-160 bps for the bank, which compares favorably with its rated peers.

We note that Pekao's common equity Tier 1 (CET1) ratio and total capital ratio both stood at 17.95% at the consolidated level as of June 30, 2017. These ratios comfortably meet the regulatory requirements of a CET1 ratio of at least 11.0% and a total capital ratio of 14.0%.

Table 3

Bank Polska Kasa Opieki S.A. Capital And Earnings

		--Fiscal year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Tier 1 capital ratio	17.95	17.64	17.66	17.30	18.60
S&P Global Ratings' RAC ratio before diversification	N.M.	11.03§	11.81	12.58	14.57
S&P Global Ratings' RAC ratio after diversification	N.M.	8.81§	10.60	11.69	14.12
Adjusted common equity/total adjusted capital	100.00	100.00	100.00	100.00	100.00
Double leverage	N.M.	N.M.	N.M.	N.M.	N.M.
Net interest income/operating revenues	63.00	61.24	58.01	59.96	58.90
Fee income/operating revenues	32.34	27.38	27.92	27.47	28.01
Market-sensitive income/operating revenues	0.50	9.22	9.23	9.38	9.84
Noninterest expenses/operating revenues	44.02	43.49	51.07	45.57	46.64
Preprovision operating income/average assets	2.32	2.36	2.09	2.48	2.64
Core earnings/average managed assets	1.28	1.64	1.46	1.75	1.79

*Data through June 30. §According to S&P Global Ratings' "Risk-Adjusted Capital Framework Methodology," published July 20, 2017, on RatingsDirect. RAC--Risk-adjusted capital. N.M.--Not meaningful.

Table 4

Bank Polska Kasa Opieki S.A. Risk-Adjusted Capital Framework Data

(Mil. PLN)	**Exposure***	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global Ratings' RWA**	**Average S&P Global Ratings' RW (%)**
Credit risk					
Government and central banks	52,159	6,502	12	13,249	25
Institutions and CCPs	6,977	2,031	29	2,061	30
Corporate	78,917	50,319	64	86,803	110
Retail	72,535	41,943	58	51,195	71
Of which mortgage	40,821	22,426	55	19,123	47
Securitization§	0	0	0	0	0
Other assets†	5,792	4,152	72	10,936	189
Total credit risk	216,379	104,947	49	164,244	76
Credit valuation adjustment					
Total credit valuation adjustment	--	0	--	0	--
Market risk					
Equity in the banking book	372	577	155	3,956	1,063
Trading book market risk	--	550	--	825	--
Total market risk	--	1,127	--	4,781	--
Operational risk					
Total operational risk	--	6,169	--	13,266	--

Table 4

Bank Polska Kasa Opieki S.A. Risk-Adjusted Capital Framework Data (cont.)

(Mil. PLN)	Basel III RWA		S&P Global Ratings' RWA	% of S&P Global Ratings' RWA
Diversification adjustments				
RWA before diversification	112,243		182,291	100
Total diversification/concentration adjustments	--		46,002	25
RWA after diversification	112,243		228,293	125
(Mil. PLN)	**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings' RAC ratio (%)**
Capital ratio				
Capital ratio before adjustments	19,955	17.6	20,106	11.0
Capital ratio after adjustments‡	19,955	17.6	20,106	8.8

*Exposure at default. §Securitization xxposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. PLN--Polish zloty. Sources: Company data as of Dec. 31, 2016, S&P Global Ratings.

Risk position: Sound asset quality and loan loss track record but some single-name concentration

In our view, Pekao's risk position balances the bank's comparatively favorable asset quality metrics and track record of credit losses--when compared with the industry average--with some concentration in the loan book. As result, we assess the bank's risk position as adequate.

Pekao's loan portfolio of PLN131.4 billion (€30.6 billion) as of June 30, 2017, is balanced between retail loans, representing about 47%, and corporate loans, representing 53% of the total portfolio. We believe that the share of retail lending will continue to increase as a result of Pekao's strategic focus. The bank has, in our view, maintained high underwriting standards, which have enabled it to preserve better-than-system-average asset quality. Pekao's reported gross non-performing loans (NPLs) represented a stable 5.9% of total customer loans as of June 30, 2017, compared with 6.8% for the Polish banking system. We believe that Pekao could sell some additional NPL portfolios, leading to further improvement in asset quality.

Additionally, the bank benefits from its better-than-peers track record of credit losses. We anticipate that Pekao will contain credit losses at 40 bps-45 bps in 2017-2018 (below our estimate of 60 bps for the sector), after 39 bps in the first half of 2017, benefiting from a more benign domestic economic environment. We consider the bank's level of reserve coverage of nonperforming assets to be one of the highest among peers, especially taking into account the bank's bias toward the corporate sector, with a ratio at close to 73% as of June 30, 2017.

Based on the adjustments we make for concentrations in our risk-adjusted capital framework, we think single-name risks exist, owing to Pekao's corporate focus. However, we acknowledge that the share of bank's 20 largest exposures is gradually decreasing.

We see as positive that the bank's loans in foreign currency remain lower than the system average, representing about 17% of the total loan book on June 30, 2017. Another positive factor is Pekao's residual stock of foreign currency-denominated mortgages, representing a limited PLN4.2 billion or 3.2% of total loans (or about 9% of the retail mortgage loans) as of June 30, 2017, which remains substantially below the market average. We consider that a potential forced conversion of Swiss franc-denominated loans into local currency represents a political risk for domestic banks, including Pekao. However, given Pekao's limited exposure, we think the potential costs would be manageable for the bank.

Table 5

Bank Polska Kasa Opieki S.A. Risk Position

		--Fiscal year ended Dec. 31--			
(%)	2017*	2016	2015	2014	2013
Growth in customer loans	4.98	4.25	7.15	7.88	6.63
Total diversification adjustment / S&P Global Ratings' RWA before diversification	N.M.	25.24§	11.49	7.59	3.22
Total managed assets/adjusted common equity (x)	8.34	8.66	8.35	8.28	7.84
New loan loss provisions/average customer loans	0.38	0.41	0.44	0.51	0.64
Net charge-offs/average customer loans	N.M.	N.M.	N.M.	N.M.	N.M.
Gross nonperforming assets/customer loans + other real estate owned	5.88	5.99	6.51	7.17	7.44
Loan loss reserves/gross nonperforming assets	73.14	72.12	70.96	67.77	63.54

*Data through June 30. §According to S&P Global Ratings' "Risk-Adjusted Capital Framework Methodology," published July 20, 2017, on RatingsDirect. RWA--Risk-weighted assets. N.M.--Not meaningful.

Funding and liquidity: Funding position dominated by a stable customer deposit base and strong liquidity

We consider Pekao's funding as average, based on the bank's sound franchise and proximity to customers, which should continue to provide it with a relatively stable and granular inflow of core customer deposits (95% of funding as of June 30, 2017).

Pekao's loan-to-deposit ratio was 94% on June 30, 2017, which compares favorably with the industry average and with most peers in Central and Eastern Europe. The deposit base's structure is well-balanced between corporate and retail clients, and does not show single-name concentration risk, despite the bank's corporate focus. Additionally, the funding position is balanced, with a long-term funding ratio of 98% as of June 30, 2017. The bank does not depend on interbank funding, which we consider positive. Therefore, we expect Pekao will maintain its favorable, stable funding ratio in the range of 110%-120% (117% as of June 30, 2017) over the next two years.

Pekao's sizable securities portfolio of PLN29 billion, which mainly comprises Polish government securities, represents a comfortable liquidity buffer. By our measures, Pekao's one-year liquidity ratio (broad liquid assets to short-term wholesale funding), at 10.8x as of June 30, 2017, is commensurate with our assessment of the bank's liquidity as strong. We think that in financial crises Pekao would benefit from customers' flight to quality and its strong liquidity coverage would allow it to withstand a lack of access to wholesale funding for more than 12 months.

Table 6

Bank Polska Kasa Opieki S.A. Funding And Liquidity

		--Fiscal year ended Dec. 31--			
(%)	2017*	2016	2015	2014	2013
Core deposits/funding base	95.4	94.2	90.9	91.0	91.3
Customer loans (net)/customer deposits	93.6	89.9	93.3	88.6	85.9

Table 6

Bank Polska Kasa Opieki S.A. Funding And Liquidity (cont.)					
		--Fiscal year ended Dec. 31--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Long-term funding ratio	98.0	97.6	94.9	94.8	95.5
Stable funding ratio	117.2	122.8	116.5	124.5	129.9
Short-term wholesale funding/funding base	2.3	2.8	6.0	6.1	5.3
Broad liquid assets/short-term wholesale funding (x)	10.8	10.0	4.2	5.2	6.6
Net broad liquid assets/short-term customer deposits	23.4	26.2	21.0	26.8	32.5
Short-term wholesale funding/total wholesale funding	49.9	48.2	65.7	67.3	61.2
Narrow liquid assets/3-month wholesale funding (x)	N/A	N/A	N/A	5.0	6.7

*Data through June 30. N/A--Not applicable.

Support: No rating uplift for external support

We do not include any uplift for external support in our ratings on Pekao.

After UniCredit's announced disposal of its 32.8% stake in Pekao to PZU and PFR, we removed Pekao's group status within UniCredit on Dec. 12, 2016. The sale was completed in June 2017, following the necessary regulatory and antitrust approvals. We will review the potential for group support from Pekao's new owners once we have more clarity about their strategy with regard to and their level of control over the bank. For now, we do not include any uplift from Pekao's SACP for group support.

Our view of uncertain extraordinary government support for the Polish banking sector follows the country's full implementation of the EU Bank Recovery and Resolution Directive, including bail-in powers, in October 2016.

Still, we view the Polish resolution regime as effective because, among other factors, we believe it contains a well-defined bail-in process under which authorities would permit nonviable systemically important banks to continue critical functions as going concerns following a bail-in of eligible liabilities. That said, the ALAC levels we estimate at Pekao, consisting mainly of excess capital above our threshold for a strong capital and earnings assessment, are currently not sufficient for us to consider an additional notch of uplift.

Additional rating factors:

No additional rating factors affect the rating.

Related Criteria

- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And

Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment Update: August, Aug. 16, 2017
- Banking Industry Country Risk Assessment: Poland, June 20, 2017
- Management Board Changes Have No Immediate Impact On Polish Bank Pekao Ratings And Outlook, June 14, 2017
- Polish Bank Pekao Outlook Revised To Stable And 'BBB+/A-2' Ratings Affirmed On Announced Disposal By UniCredit, Dec. 12, 2016
- Ratings On Polish Banks Pekao And mBank Affirmed After Review Of Government Support, Oct. 18, 2016

Anchor Matrix

Industry Risk	**Economic Risk**									
	1	2	3	4	**5**	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	**bbb-**	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of August 28, 2017)		
Bank Polska Kasa Opieki S.A.		
Counterparty Credit Rating		BBB+/Stable/A-2
Counterparty Credit Ratings History		
12-Dec-2016	*Foreign Currency*	BBB+/Stable/A-2
30-Jun-2015		BBB+/Negative/A-2
14-Feb-2012		BBB+/Stable/A-2
12-Dec-2016	*Local Currency*	BBB+/Stable/A-2
30-Jun-2015		BBB+/Negative/A-2
14-Feb-2012		BBB+/Stable/A-2

Ratings Detail (As Of August 28, 2017) (cont.)	
Sovereign Rating	
Poland (Republic of)	
Foreign Currency	BBB+/Stable/A-2
Local Currency	A-/Stable/A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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