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Research Update:

Spain-Based Banco Popular Espanol Long-Term Rating Lowered To 'BBB+' On Bank Criteria Change; Still On Watch Negative

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Overview

- Following a review under Standard & Poor's revised bank criteria (published Nov. 9, 2011), we have lowered our long-term rating on Spain-based Banco Popular Español S.A. (Popular) to 'BBB+' from 'A-'. The long- and short-term ratings remain on CreditWatch with negative implications.
- Our ratings on Popular factor in a 'bbb' anchor for banks operating almost exclusively in Spain, and our view of the bank's adequate business position, adequate capital and earnings, moderate risk position, average funding, and adequate liquidity.
- The ratings on Popular benefit from two notches of uplift for potential extraordinary government support in a crisis.
- The negative CreditWatch primarily mirrors that on the Kingdom of Spain. It also reflects our view that the potential acquisition and integration of Banco Pastor S.A. (Pastor) may further erode what we view as Popular's already constrained financial profile.
- We aim to resolve the CreditWatch on Popular after any associated resolution of the CreditWatch on Spain and after reviewing a complete set of business and financial information on the transaction.

Rating Action

As previously announced on Dec. 15, 2011, Standard & Poor's Ratings Services has lowered its long-term counterparty credit rating on Spain-based Banco Popular Español S.A. (Popular) to 'BBB+' from 'A-'. The long-term rating remains on CreditWatch with negative implications, where it was placed on Oct. 11, 2011. The 'A-2' short-term rating remains on CreditWatch with negative implications, where it was placed on Dec. 8, 2011.

In addition, we lowered the issue rating on Popular's dated subordinated debt to 'BB+' from 'BBB+', and affirmed our 'BB-' issue rating on Popular's preferred stock. All issue ratings remain on CreditWatch with negative implications, where they were placed on Oct. 11, 2011.

Rationale

Our ratings on Popular factor in a 'bbb' anchor for banks operating almost exclusively in Spain, and our view of the bank's "adequate" business position, "adequate" capital and earnings, "moderate" risk position, "average" funding, and "adequate" liquidity, as our criteria define these terms.

We assess Popular's stand-alone credit profile (SACP) at 'bbb-'.

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) methodology and our economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Spain is 'bbb'. The BICRA for Spain is group '4', under our criteria (see "BICRA On Spain Maintained At Group '4'," published Nov. 9, 2011). One of the factors we base the BICRA score on is our evaluation of economic risk, which we assess at '5'. The correction of the imbalances accumulated in Spain during the boom years is still underway and will continue affecting the banking system, in our view. Asset quality deterioration, mostly concentrated in the real estate sector, continues, and Spanish banks' provisioning efforts will in our view remain high. We believe the private sector's ongoing deleveraging will constrain Spain's already weak growth prospects. With regard to industry risk, which we evaluate at '3', our assessment of Spain's banking industry balances the system's high reliance on foreign funding with our view of the overall stable competitive environment in which Spanish banks operate.

In our view, Popular's "adequate" business position benefits from its sound domestic market position, as it ranks as the fifth-largest banking group in Spain. In addition, Popular enjoys a stable domestic franchise in retail banking, particularly in the small and midsize enterprise (SME) and individuals segments, which represent the bank's core business. We consider that Popular's main business strength resides in its loyal and stable customer base, where it has a deep product penetration and that represents the bank's main financing source. In the years leading up to the economic downturn in Spain, Popular placed a great emphasis on accelerated growth in its strategic plan, in our view. In our opinion, this has heightened its vulnerability to persistently weak economic conditions.

We assess Popular's capital and earnings as "adequate." Following our recent review of economic risk under the BICRA methodology for Spain, we expect that the bank's risk-adjusted capital (RAC) ratio, before diversification, will stand at about 7% at year-end 2012. We believe that the bank's organic capital generation should be sufficient to allow it to achieve its stated capital targets. We anticipate that extraordinary capital gains will allow the bank to significantly enhance its bottom-line results. That said, we believe that Popular's recurrent operating performance will likely remain moderate, albeit positive, in coming quarters, as it absorbs still substantial provisioning costs at a time when funding costs will likely remain high.

We view Popular's risk position as "moderate," owing to its comparatively high degree of credit risk compared with the industry average. We believe that Popular will accumulate a high level of problematic assets compared with the Spanish banking system average. Our assessment is based on our opinion that

Popular's total nonperforming assets (NPAs)--including nonperforming loans (NPLs), charge-offs, repurchased and repossessed fixed assets—-may peak at around €19.5 billion from €14.7 billion at year-end 2010. We also think that Popular only tightened its underwriting standards to mitigate the impact of a tough economic environment after the cycle turned. As our RAC framework is calibrated on average industry risk, we believe that our RAC ratio for Popular does not adequately capture the degree of credit risk associated with certain segments of the bank's loan book.

We assess Popular's funding as "average" and its liquidity "adequate," as the bank remains mainly retail funded (total customer deposits accounted for more than 50% of total funding on June 30, 2011) and has progressively reduced its commercial gap in the last few years. Moreover, Popular has built up significant liquidity reserves in the form of assets eligible for discounting at the European Central Bank, which we believe would be sufficient to cover the bank's short-term wholesale refinancing requirements in case of need.

The long-term rating on Popular is two notches higher than its SACP, reflecting our opinion of a "moderately high" likelihood of timely and sufficient extraordinary financial support from the Spanish government (Kingdom of Spain; AA-/Watch Neg/A-1+). We base our view on Popular's "high" systemic importance in Spain and our assessment of the Spanish government as "supportive" of its banking system.

In accordance with our updated hybrid criteria, the 'BB+' issue ratings on Popular's dated subordinated debt stand one notch below the SACP, and the 'BB-' issue ratings on its preferred stock debt stand three notches below the SACP. According to our criteria, we assign issue ratings to a bank's nondeferrable subordinated debt instruments by notching down from our assessment of its SACP, as the issuer credit rating incorporates government support that doesn't accrue, in our view, to these instruments.

CreditWatch

The CreditWatch status reflects that, under our criteria, with all other factors remaining the same, we would reduce the uplift factored into the long-term rating on Popular for government support to one notch from two notches if we lowered the long-term rating on Spain by one notch. (For further details, see table 22 in "Banks: Rating Methodology And Assumptions," published on Nov. 9, 2011.)

The negative CreditWatch also reflects our view that the potential acquisition of Banco Pastor S.A. (Pastor, not rated) may further erode the bank's financial profile.

We aim to resolve the CreditWatch placement after any associated resolution of the CreditWatch on Spain and upon completion of the transaction, after having reviewed the complete set of business and financial information on Pastor.

The long-term rating on Popular is two notches higher than the SACP based on government support. If the sovereign rating is lowered by one or two notches we would lower the long-term rating on the bank by one notch. If the sovereign ratings are affirmed, all other things being equal, we will likely affirm the ratings on Popular.

As part of our CreditWatch resolution, we will also analyze the impact that the acquisition and integration of Pastor could have on Popular's financial profile. If, as a result, we lowered our assessment of Popular's SACP, this could trigger a downgrade of the bank.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Watch Neg/A-2
SACP	bbb-
Anchor	bbb
Business Position	Adequate (0)
Capital and Earnings	Adequate (0)
Risk Position	Moderate (-1)
Funding and Liquidity	Average and adequate (0)
Support	2
GRE Support	0
Group Support	0
Sovereign Support	2
Additional Factors	0

Related Criteria And Research

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Group Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011

Ratings List

Downgraded

	To	From
Banco Popular Espanol S.A.		
Counterparty Credit Rating	BBB+/Watch Neg/A-2	A-/Watch Neg/A-2

Certificate Of Deposit	BBB+/Watch Neg/A-2	A-/Watch Neg/A-2
Banco Popular Espanol S.A.		
Subordinated (1 issue)	BB+/Watch Neg	BBB+/Watch Neg
BPE Finance International Ltd.		
Senior Unsecured (4 issues)	BBB+/Watch Neg	A-/Watch Neg
BPE Financiaciones S.A.		
Senior Unsecured (3 issues)	BBB+/Watch Neg	A-/Watch Neg
Subordinated (3 issues)	BB+/Watch Neg	BBB+/Watch Neg
Popular Capital Europe B.V.		
Subordinated (1 issue)	BB+/Watch Neg	BBB+/Watch Neg

Ratings Affirmed

Banco Popular Espanol S.A.	
Commercial Paper (1 issue)	A-2/Watch Neg
Popular Capital S.A.	
Preferred Stock (4 issues)	BB-/Watch Neg
Popular Preference (Cayman) Ltd.	
Preference Stock (2 issues)	BB-/Watch Neg

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