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DBRS Comments on Banco Popular Español S.A. 2Q10 Earnings; Ratings Unchanged

Industry: Fin.Svc.--Banks & Trusts

DBRS has today commented that its ratings of Banco Popular Español S.A. (Banco Popular or the Group) remain unchanged after the Group's 2Q10 results announcement. DBRS rates the Banco Popular's Senior Unsecured Long-Term Debt & Deposits at AA with a Negative trend. The Group reported positive earnings, as it has throughout this crisis, driven by recurring revenue generation and continued cost containment. Profit attributable to the controlling company was EUR 151 million in 2Q10, following net profits of EUR 204 million in 1Q10 and EUR 218 million in 2Q09. In DBRS's view, the solid performance illustrates the resiliency of Banco Popular's franchise during a period of considerable economic stress.

While net profits declined on a linked-quarter basis, Banco Popular managed to maintain solid revenues. The largest driver of revenues was net interest income of EUR 618 million, which declined 7.6% sequentially, but held up well despite significant declines in interest rates. The Group has historically maintained wider spreads on its loan book than its peers, mainly due to its focus on catering to customers' needs, particularly in attractive customer segments of small- and medium-sized entities (SMEs), corporates and professionals. The Group's net interest margin dropped to 2.01% in 2Q10 from 2.20% in 1Q10 and from 2.42% in 2Q09, which was partially attributable to increased funding costs. Fees and commissions improved quarter-over-quarter (QoQ) by 7.2% due to increased banking fees, which are trending upward.

Sequentially, expenses increased by 5.5% to EUR 302 million, mainly due to increased costs related to the rent payments on leased branches, as increased provisions on real estate assets were offset by profits from real estate sales, such as sale and leaseback of branches. Despite the increase in expenses, Banco Popular has maintained a leading cost-to-income ratio of 32.6%. High levels of efficiency combined with recurring revenues helped the Group deliver solid pre-provision profit, or income before provisions and taxes (IBPT), of EUR 564 million in 2Q10, as compared to EUR 605 million in 1Q10 and EUR 723 million in 2Q09, enabling it to absorb still-elevated credit costs.

While DBRS sees the Group having success in its core franchise, as indicated by another quarter of solid results, credit quality still remains a challenge. The Group's non-performing loan (NPL) ratio rose to 5.04% in 2Q10 from 4.91% in the prior quarter and 4.39% in 2Q09. Positively, this ratio is



still below the average for Spanish banks (5.47% at the end of May) and the rapid increase in this metric has slowed, with additions to delinquent balances declining 63% in 1H10 as compared to 1H09. The Group has provisioned accordingly, while also utilizing some of its generic provisions, which were built up during cyclical upturns and are meant to be utilized during cyclical downturns. Credit impairments of EUR 411 million, which absorbed 73% of IBPT in the quarter, declined from a peak of EUR 672 million in 4Q09, which absorbed 97% of IBPT. DBRS is of the view that Banco Popular's strong franchise and its earnings generation resiliency are likely to enable it to weather the expected level of stress, despite continued earnings pressure.

DBRS views Banco Popular's liquidity position as solid, given its ability to generate deposits and continued ability to access wholesale funding markets. Customer deposits increased by 20.6% year-over-year (YoY) to EUR 66.3 billion, funding 52% of the balance sheet and reducing the loan-to-deposit ratio to 158% in 2Q10 from 180% a year earlier. Of its EUR 29.4 billion of wholesale funding, 77% is long-term and is diversified by type of instrument, including covered bonds, medium-term notes, subordinated debt and securitisations. Despite pressure on short-term funding markets, the Group can still roll its debt at maturity, but at much higher rates than historical norms. Current pricing to roll short-term funding is too expensive relative to alternative sources, such as private placements and interbank funding, especially given Banco Popular's success in raising deposits. Appropriately, the Group has been utilising these alternative sources of short-term funding to maintain its stable liquidity position.

Banco Popular improved its core capital ratio YoY to 8.58% at 2Q10 from 7.37% and its Tier 1 ratio rose to 9.14% from 8.71% over the same time period. The Group's solvency was further reaffirmed by the European stress tests, which were released on 23 July. As of 31 December 2009, Banco Popular had a Tier 1 ratio of 9.1%, which was reduced to 7.5% under an adverse stress scenario and 7.0% when an additional sovereign shock was added to the adverse scenario. The Group passed the stress test with a sizable cushion over regulatory minimums.

While Banco Popular's franchise strength, recurring earnings generation, and solid capital and liquidity have enabled it to cope with the stress in the current environment, the Group remains exposed to an elevated level of credit problems, which continue to weigh on profitability. Additionally, the sustained weakness in the economy and continued difficulties in the Spanish banking sector have the potential to weigh on results as well, which is reflected in the Negative trend.

Notes:

All figures are in Euros unless otherwise noted.



The applicable methodologies are Global Methodology for Rating Banks and Banking Organisations, and Enhanced Methodology for Bank Ratings – Intrinsic and Support Assessments which can be found on our website under Methodologies.

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