

## Rating Report

Report Date:  
11 October 2011  
Previous Report:  
23 February 2010



Insight beyond the rating.

# Banco Popular Español S.A.

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## The Company

Banco Popular Español S.A. is a commercial bank in Spain that provides universal banking services to individuals, small- and medium-sized enterprises and large corporations. The Group is headquartered in Madrid, Spain, and reported total assets of EUR 130 billion as of 30 June 2011.

## Recent Actions

**10 October 2011**  
Ratings placed Under Review with Negative Implications

**20 September 2011**  
Ratings Confirmed at AA (low); Trend revised to Negative

**18 August 2011**  
Government Guaranteed debt Ratings Confirmed at AA; Trend revised to Negative

**6 May 2011**  
Ratings Downgraded to AA (low) from AA; Trend revised to Stable

## Rating Table

| Issuing Entity             | Debt   | Rating    | Trend    |
|----------------------------|--|-----------|----------|
| Banco Popular Español S.A. | Senior Unsecured Long-Term Debt & Deposit        | AA (low)  | --       |
| Banco Popular Español S.A. | Subordinated Debt                                | A (high)  | --       |
| Banco Popular Español S.A. | Short-Term Debt & Deposit                        | R-1 (mid) | --       |
| Banco Popular Español S.A. | Senior Notes, Guaranteed by the Kingdom of Spain | AA        | Negative |

For a complete list of ratings, please see page 19

## Rating Rationale

On 10 October 2011, DBRS Inc. (DBRS) placed the ratings for Banco Popular Español, S.A. (Popular or the Group) Under Review with Negative Implications. Currently, the Senior Unsecured Long-Term Debt & Deposit rating is AA (low) and the Short-Term Debt & Deposit rating is R-1 (middle). This rating action does not apply to the rating on the Senior Notes, Guaranteed by the Kingdom of Spain, which remain at AA with a Negative trend, equal to DBRS's sovereign rating for the Kingdom of Spain.

The ratings of the Group incorporate DBRS's expectation of some form of timely systemic support for Popular in the event of a highly stressed scenario, which is reflected in the SA2 Support Assessment. Accordingly, the final rating of AA (low) is one notch above the Group's Intrinsic Assessment (IA) of A (high). (Continued on page 2)

## Rating Considerations

### Strengths

- (1) Strong commercial banking franchise focused on SMEs, corporates and professionals
- (2) Leveraging franchise to deliver high margin sustainable revenues
- (3) High operating efficiency reflects persistent strategy and underpins recurring earnings
- (4) Reinforced financial profile with more liquidity and bolstered capitalisation

### Challenges

- (1) Coping with elevated credit costs and high levels of NPAs driven by weakened economy
- (2) Overcoming increased funding costs and liquidity needs driven by stress on sovereign
- (3) Sustaining franchise momentum in slower growth environment
- (4) Strengthening resources and adapting to difficult and changing environment

## Financial Information

| Banco Popular Español SA<br>(EUR MM) | 6 Mos. End. | Fiscal Year Ended |            |            |
|--------------------------------------|-------------|-------------------|------------|------------|
|                                      | 6/30/2011   | 12/31/2010        | 12/31/2009 | 12/31/2008 |
| Total assets                         | 130,398     | 130,140           | 129,290    | 110,376    |
| Shareholders' Equity                 | 8,557       | 8,252             | 8,448      | 7,058      |
| Net interest income                  | 1,045       | 2,452             | 2,823      | 2,535      |
| Loan loss provisions*                | 597         | 1,275             | 1,752      | 998        |
| Net income                           | 305         | 590               | 766        | 1,052      |
| Efficiency ratio                     | 43.6%       | 38.2%             | 32.7%      | 37.5%      |
| Return on equity                     | 7.2%        | 7.2%              | 9.1%       | 15.6%      |
| Impaired loans % gross loans         | 6.3%        | 5.9%              | 5.5%       | 3.0%       |
| Core Tier 1 (As-reported)            | 9.8%        | 9.4%              | 8.6%       | 7.2%       |

\*LLP includes Impairments on financial assets

Source: DBRS Analysis, SNL Financial, Company Reports



## Rating Rationale (Continued from page 1.)

The rating action on 10 October, which placed Popular Under Review with Negative Implications, followed the Group's announcement that it made an offer to buy Banco Pastor, S.A. (Pastor), a financial institution based in Galicia, Spain with EUR 30 billion in assets at 2Q11. While recognising the offer is still pending shareholder and regulatory approvals, DBRS views this relatively sizeable merger at a time of increased stress in the financial markets and weakness in the Spanish economy as warranting a ratings review. The review will focus on the impact that this merger would have on the overall financial profile and credit worthiness of Popular, which had EUR 130 billion in assets at 2Q11.

While offering Popular a significant opportunity to expand its market position, a merger of this relative size is viewed by DBRS as more challenging in this difficult environment for Spanish banks. The economy remains weak and the real estate sector has not recovered, which is keeping credit costs elevated and valuations under pressure. Access to market funding has been pressured by heightened market concerns with the adequacy of liquidity and capitalisation of financial institutions. Globally, liquidity has come under pressure as counterparties are increasingly reluctant to provide the market with short-term funding. Additionally, banks are being pressured to have even larger capital cushions over the required minimum to be considered well-capitalised. Moreover, the Spanish banking sector is in the process of restructuring through mergers within the savings bank (*caja*) sector. This *caja* merger process has resulted in a new competitive landscape, creating some market disruption and uncertainty, while also creating opportunities for stronger, well-perceived banks such as Popular. While DBRS views Popular as continuing to take the appropriate steps to bolster its liquidity and capitalisation, DBRS will assess the Group's ability to absorb a sizeable financial institution, such as Pastor, given the still weak credit and economic conditions. Indicative of the potential burden, DBRS notes Pastor did not meet the European Banking Authority's (EBA) minimum capital requirements in the recent EU-wide stress tests under the adverse scenario, though the EBA recognises that Pastor would have met the minimum capital requirements under the adverse scenario if other mitigating measures recognised by the Bank of Spain were included.

In considering Popular's ability to successfully absorb Pastor, DBRS recognises the resiliency of Popular's franchise, its sustained profitability throughout the crisis, its strong operational capabilities with a still low cost/income ratio and its success in strengthening its liquidity and building up its capital. The Group has a powerful domestic franchise that continues to gain market share amidst the restructuring and consolidation of the financial system. DBRS has long viewed Popular's persistent strategy, which has been centred on organic growth, as a significant strength of the organisation. In taking on this relatively sizeable acquisition, the Group is taking a different path. This path offers important benefits by increasing its market position particularly in the northwest region of Spain where Pastor has a significant presence. Combined with Pastor, the Group will have a 16.8% market share in Galicia. But, it also requires Popular to succeed with a sizeable integration, where the Group has experience in integrating its own, smaller regional banks and its joint venture with Cr dit Mutuel. Important for a successful integration is Popular's ability to leverage its operating capabilities to achieve cost savings and synergies. DBRS views the costs and potential disruptions associated with the integration as likely to pressure results and add negative ratings pressure in the near-term.

DBRS's review will focus on the unfolding of Popular's strategy for integrating Pastor and the prospects for the financial fundamentals of the combined organisation. The review will incorporate the impact of the potential acquisition on the intrinsic strength of Popular, including its strategic direction that has focused on organic growth, but may evolve in light of the opportunities created from the restructuring of the Spanish banking sector. Should the potential merger be completed as proposed, DBRS will opine on the combined organisation's franchise and financial position. If DBRS perceives a significant deterioration in the financial profile of the combined entity, then DBRS could downgrade the rating by one notch or more to reflect the new risk profile.

### Intrinsic Assessment (IA)

Popular's IA, at A (high), is positioned one notch below the final rating of AA (low), reflects the Group's strong fundamentals. In confirming the ratings, DBRS recognises the resiliency of Popular's franchise, its sustained profitability throughout the crisis, its strong operational capabilities with a still low cost/income ratio and its success in strengthening its liquidity and building up its capital. The Group has a powerful domestic franchise that continues to gain market share amidst the restructuring and consolidation of the financial system. DBRS views the Group's positive franchise momentum as demonstrating Popular's ability to adjust to the adverse environment. By focusing predominantly on small- and medium-sized entities (SMEs), corporates and professionals, which are at the core of Popular's business model, the Group has leveraged its product, delivery



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and marketing capabilities to sustain its revenue growth. Popular maintains strong customer relationships through its localised branches. The Group's franchise strength is also evident in its ability to grow deposits and attract new customers.

In making this assessment, DBRS considers the ongoing crisis in the Euro zone, the continuing disruptions in the financial markets and the weak economic recovery in Spain. This negative external environment is expected to continue to pressure Popular's earnings generation ability going forward at a time when its contingency resources are more scarce. The environment is limiting growth and putting downward pressure on net interest margins, especially with the Group's enhanced level of liquidity. Although the cost of credit has stabilised, Popular still has substantial nonperforming assets and foreclosed real estate that could elevate credit costs again if the environment were to deteriorate rapidly. The pressure on the Group would be exacerbated if more severe stress in the financial markets emerges, particularly if the position of the Spanish sovereign were to deteriorate quickly. Absent such a severe scenario occurring, which could bring negative ratings pressure on Popular's ratings, DBRS expects that the Group's strong fundamentals will enable it to continue to weather the current stressed environment, even if it is prolonged.

From a ratings perspective, DBRS views the Group's sustained profitability throughout the crisis positively. Even with pressure from the prolonged market disruption, Popular has been able to maintain a relatively high net interest margin (NIM), sustain its non-interest income and preserve a low expense ratio, providing the Group with solid underpinnings for its recurring earnings. NIM has been pressured by lower rates, which reduced asset yields on mortgages with annual interest rate resets. Offsetting some of this pressure, the Group is achieving wider spreads on its loan book than its peers, mainly due to its loan mix, which contains more higher-yield lending, such as to SMEs, corporates and professionals (approximately 70% of the loan book at 2Q11) that reflects the Group's franchise strength, rather than lower-yielding residential mortgage lending. As such, the Group is able to reflect its higher funding costs in the pricing of its loans. Contributing to higher loan margins as well as fee income, Popular's focus on its customers is enabling the Group to tailor its offerings to its customer segments. A relatively high loan-to-asset ratio also supports net interest income, as the Group uses its balance sheet relatively efficiently. Popular's expense ratio was a very low 40.1% in 2Q11, although this is up from 30.6% at year-end 2007. While still a leader in efficiency, the Group has seen this advantage lessen; its cost/income ratio has risen as revenues have declined and its costs have risen due to higher expenses associated with managing the deterioration in credit performance, investments in technology and the cost of branch leases.

Despite the Group's proven earnings generation resiliency, DBRS expects that an extended period of stress would continue to pressure margins and credit costs will likely remain elevated. With some credit indicators still showing deterioration and the economy remaining weak, underlying credit costs are not yet declining. Popular's non-performing loan (NPL) ratio, as reported in its EUR 100 billion lending portfolio, increased to 5.58% at 2Q11, up 14 basis points (bps) quarter-over-quarter (QoQ) and up 54 bps from 2Q10, although still below the sector average (Note: NPL ratio is reported as non-performing loans / total risks). Leading this deterioration is the Group's exposure to construction and real estate, which totalled EUR 17.8 billion, or 14% of total assets, of which EUR 2.9 billion were non-performing at 2Q11.

Additionally, Popular has net acquired real estate assets of EUR 3.7 billion at 2Q11, or 2.8% of total assets, with coverage of 35% at 2Q11. DBRS views the Group as appropriately continuing to build reserve coverage, 90.6% against construction and real estate NPLs (including collateral and guarantees) at 2Q11 and now 35% against real estate assets at 2Q11.

Facing still disrupted financial markets, the Group appropriately continues to de-lever and improve its funding mix, liquidity and capitalisation. Customer deposits grew by 5.4% over the past year, increasing to EUR 65.9 billion at 2Q11, and are now funding 50% of total assets. Popular has also taken advantage of windows of opportunity and positive investor sentiment in the markets to issue medium- and long-term debt in excess of upcoming maturities, easing funding pressures for the remainder of 2011. Popular issued EUR 200 million of subordinated debt in July and EUR 250 million of subordinated debt in September. Reinforcing its liquidity, the Group has approximately EUR 11.2 billion of collateral available to pledge for central bank funding. Popular also boosted its capital ratios through its management of risk-weighted assets and retained earnings. Additionally, the Group increased capital in 4Q10 through share issuance to Crédit Mutuel, its partner in a new joint banking platform in Spain, and the distribution of core Tier 1 eligible convertible bonds to its retail investors. At 2Q11, the Group's core capital ratio was 9.84%, up 41 bps from the end of 4Q10 and up 126 bps from 2Q11.



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### **Support Assessment**

As the fifth largest banking group in Spain, Popular is viewed as systemically important by DBRS. Therefore, the ratings also incorporate DBRS's expectation of some form of timely systemic support for the Group in the event of a highly stressed scenario. This expectation has been confirmed by the extensive actions of the Spanish government in support of its banking system. Additionally, the Bank of Spain has proven to be a strong and decisive regulator, which, in conjunction with legislative action, has limited the Spanish banking system's need for systemic support thus far, freeing up resources for future support, if needed. DBRS's expectation of timely systemic support in case of need underpins an SA2 Support Assessment. The Group's AA (low) rating is consequently positioned one notch above its IA of A (high).

### **Rating Considerations Details**

#### **Strengths**

##### **(1) Strong commercial banking franchise focused on SMEs, corporates and professionals**

The Group has a strong commercial banking franchise with solid business and individual customer bases. By focusing predominantly on small- and medium-sized entities (SMEs), corporates and professionals, which are at the core of Popular's business model, the Group has leveraged its product, delivery and marketing capabilities to sustain its revenue growth. With a persistent strategy focused on meeting the needs of these customer segments, the Group is an effective competitor in the Spanish banking market. Popular maintains strong customer relationships through its extensive branch network. Popular has been particularly successful in the small enterprise segment, thanks to its high-quality tailored services and close customer relationships.

The Group's franchise strength is also evident in its ability to grow deposits and attract new customers. Popular's powerful domestic franchise continues to gain market share amidst the restructuring and consolidation of the financial system. DBRS views the Group's positive franchise momentum as demonstrating Popular's ability to adjust in various ways to the adverse environment. As fifth largest banking group in Spain, the bank is well-positioned with a market share of 5.64% of Spain's deposit market at June 2011, inclusive of commercial banks, savings banks and cooperatives. Spain has a relatively fragmented banking market that is not dominated by just a few banks, though the banking landscape is going through significant consolidation. With a broadly distributed network of 1,971 branches in Spain, Banco Popular has the local market presence to serve its targeted customer segments. Popular also operates successfully in Portugal and maintains a modest position in Florida in the U.S.

##### **(2) Leveraging franchise to deliver high margin sustainable revenues**

A critical strength is Popular's ability to generate reliable revenues from its attractive customer segments that reflect its focus on SMEs and banking for professionals and individuals. Even with pressure from the prolonged market disruption, Popular has been able to maintain a relatively high NIM and sustain its non-interest income, providing the Group with solid underpinnings for its recurring revenues. NIM has been pressured by lower rates, which reduced asset yields on mortgages with annual interest rate resets, and higher funding costs. Offsetting some of this pressure, the Group is achieving wider spreads on its loan book than its peers, mainly due to its loan mix, which contains more higher-yield lending, such as to SMEs, corporates and professionals (approximately 70% of the loan book at 2Q11) that reflects the Group's franchise strength, rather than lower-yielding residential mortgage lending. Additionally, the Group's loan book has a short duration, with 61% of loans having maturities of less than one year, allowing Popular to re-price its loan book quickly. This enables the Group to quickly adjust the pricing of its loans to its higher funding costs.

In meeting its customers' demands for a variety of banking services, Popular's broad customer relationships are also a source of fees and commissions, as the Group is expanding the range of its products and services. Contributing to higher loan margins as well as fee income, Popular's focus on its customers is enabling the Group to tailor its offerings to its customer segments. A relatively high loan-to-asset ratio also supports net interest income, as the Group uses its balance sheet relatively efficiently.

##### **(3) High operating efficiency reflects persistent strategy and underpins recurring earnings**

A key driver of Banco Popular's ability to generate strong recurring earnings is its exceptional success in achieving efficient operations. In DBRS's view, this success reflects the combination of the Group's operational skills, persistent strategy and business mix. Although still a leader in efficiency, the Group has seen this advantage lessen; its cost/income ratio has risen as revenues have declined and its costs have risen with higher expenses associated with managing the deterioration in credit performance, investments in technology and the cost of branch leases. Despite the ongoing challenges of maintaining its high level of efficiency, Popular



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continues delivering an industry leading low expense ratio (40% at 2Q11) allowing a higher proportion of the Group's revenues to be passed through to sustain its earnings. DBRS views this as a competitive advantage that is not readily emulated.

DBRS views the Group's success as integrally linked to its persistent strategy. Focusing on serving the needs of its core customer segments, the Group is able to streamline its operations and tune its activities, to avoid unnecessary costs. Even though it has an extensive branch network, it manages the typically higher costs of branches by keeping them leanly staffed and leveraging technology, but still delivering the required service. This reflects its success in combining a decentralised client-facing branch network with its centralised organisation. DBRS has long viewed Popular's persistent strategy, which has been centred on organic growth, as a significant strength of the organisation. In taking on the relatively sizeable acquisition of Pastor, the Group is taking a different path. This path offers important benefits by increasing its market position particularly in the northwest region of Spain where Pastor has a significant presence. Combined with Pastor, the Group will have a 16.8% market share in Galicia. But, it also requires Popular to succeed with a sizeable integration, where the Group has experience in integrating its own, smaller regional banks and its joint venture with Crédit Mutuel. Important for a successful integration is Popular's ability to leverage its operating capabilities to achieve cost savings and synergies.

#### **(4) Reinforced financial profile with more liquidity and bolstered capitalisation**

Facing still disrupted financial markets, the Group appropriately continues to deleverage and improve its funding mix, liquidity and capitalisation. Having generated positive earnings throughout the crisis, the Group has been able to strengthen its financial resources and enhance its ability to weather more sustained weakness in the environment. With a generally sound liquidity profile, the Group has enhanced its liquidity through increased deposits, lowered rollover risk, reduced reliance on more market sensitive funding and increased holdings of assets that can be used for liquidity purposes. Customer deposits grew by 5.4% over the past year, increasing to EUR 65.9 billion at 2Q11 and are now funding 50% of total assets. Popular has also taken advantage of windows of opportunity and positive investor sentiment in the markets to issue medium- and long-term debt in excess of upcoming maturities, easing funding pressures in the remainder of 2011. Reinforcing its liquidity, the Group has approximately EUR 11.2 billion of collateral available to pledge for central bank funding.

Popular also boosted its capital ratios through its management of risk-weighted assets and retained earnings. Additionally, the Group increased capital in 4Q10 through share issuance to Crédit Mutuel, its partner in a new joint banking platform in Spain, and the distribution of core Tier 1 eligible convertible bonds to its retail investors. At 2Q11, the Group's core capital ratio was 9.84%, up 53 bps from the end of 4Q10 and up 126 bps from 4Q09. Continued positive earnings and its stronger financial profile improve the Group's ability to successfully ride out another period of financial disruption.

#### **Challenges**

##### **(1) Coping with elevated credit costs and high levels of NPAs driven by weakened economy**

Elevated credit costs driven by the deterioration in the real estate and construction sector remains the biggest challenge for Spanish banks, including Popular. The Group still faces sustained pressure on its earnings from elevated credit costs and high levels of non-performing assets. Leading this deterioration is the Group's exposure to construction and real estate, which totalled EUR 17.8 billion, or 14% of total assets, of which EUR 2.9 billion were non-performing at 2Q11.

Further deterioration is expected as the economy is weak and unemployment remains around 20%; government fiscal actions to reduce Spain's deficit are likely to further weaken the economy. With high unemployment and pressure on business earnings, credit performance is more likely to deteriorate than improve. Popular's non-performing loan (NPL) ratio in its EUR 100 billion lending portfolio increased to 5.58% (as reported) at 2Q11, up 14 basis points (bps) QoQ and up 54 bps from 2Q10, although still below the sector average. Importantly, Popular's mortgage lending to private individuals continues to perform well, with a NPL ratio of 2.9% at 2Q11.

##### **(2) Overcoming increased funding costs and liquidity needs driven by stress on sovereign**

Stress on the Spanish sovereign and throughout the Euro zone is elevating funding costs and liquidity needs at Popular, which are pressuring its earnings. While large Spanish banks, including Popular, continue to have intermittent access to international financial markets, competition for deposits has raised deposit rates. Recently, the Spanish regulators have capped the maximum deposit rate that can be offered by banks, somewhat alleviating the strain from the competition for deposits. Spreads demanded by the market and the government's need for funding also continue to pressure funding costs. Popular has had some success in passing through



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increased funding spreads to its business borrowers, but this could become more difficult in a weakening economy as more borrowers come under stress.

Strong deposit growth has supported loan growth, but Banco Popular still makes sizable use of wholesale funding that could come under pressure, if financial markets continue to experience extended disruption. Continued success in growing deposits would reduce the Group's wholesale funding needs, although the deposit market is likely to remain very competitive as banks generally seek to bolster their funding profiles. Further progress with lengthening its wholesale funding maturities and reducing rollover risk through early 2012 would also strengthen the Group's funding profile and liquidity position. DBRS finds comfort in the Group's significant liquidity buffer of EUR 11.2 billion, which combined with currently available government guaranteed issuance capacity, covers Popular's funding maturities through at least 2013.

### **(3) Sustaining franchise momentum in slower growth environment**

Popular faces an environment that is likely to make sustaining its franchise momentum and preserving its earnings more difficult. DBRS expects Popular's earnings prospects to be constrained by the lack of growth in its home market, limiting the resources available to invest in its franchise. With slower revenue growth, the Group faces more difficult choices in allocating scarce resources and constraining what the businesses can devote to their franchises.

Positively, the significant disruptions affecting Spain's banking industry offers the Group opportunities to enhance its franchise by attracting new customers and finding ways to extend its product reach. Having weathered the extended crisis thus far, Popular is benefiting from its perceived strength in attracting new customers and building its business with existing customers. The challenge for the Group is to sustain this success. Popular has also seized the opportunity to expand its franchise reach through the recently announced proposal to acquire Pastor. While recognising the offer is still pending shareholder and regulatory approvals, DBRS views this relatively sizeable merger at a time of increased stress in the financial markets and weakness in the Spanish economy as a challenge for the Group.

### **(4) Strengthening resources and adapting to a difficult and changing environment**

Given the economic downturn in Spain, the continued stress on the sovereign, the sustained crisis in the Euro zone and the volatility in financial markets, Popular faces the challenge of ensuring that it can generate the resources to weather a more prolonged downturn than currently expected with more extensive deterioration in the sovereign. Popular has already taken steps to bolster both reserves and capital, but these efforts need to be sustained unless the environment improves. At the same time, Popular faces an evolving regulatory environment for banking that is demanding banks operate with more capital. This new environment will pressure Popular to adapt how it operates its business model to make more efficient use of capital.

The Spanish banking sector is in the process of restructuring through mergers within the savings bank (*caja*) sector. This *caja* merger process has resulted in a new competitive landscape domestically, creating some market disruption and uncertainty, while also creating opportunities for stronger, well-perceived banks such as Popular. The Bank of Spain is requiring increased capital levels across the sector, with the level of capital dependant upon whether the bank has some level of public ownership. Banco Popular has been required to bolster its capital ratios to reach a minimum Tier 1 Core capital ratio of 8% by the end of September; Popular had a Tier 1 Core capital ratio of 9.84% at 2Q11, sufficiently above the minimum regulatory requirement. Popular has had success in bolstering reserves and capital through retained earnings and various agreements, including a joint venture (JV) with Allianz, Allianz-Popular, and a JV with Crédit Mutuel. Navigating through this difficult and changing environment while continuing to bolster reserves and capital levels remain challenges for the Group, as well as for the sector as a whole.

## **Rating Drivers**

### **Factors with Positive Rating Implications**

Popular's ratings are currently constrained by the macro environment and the weakness of the Spanish sovereign. Positive ratings pressure would most likely arise from an improvement in the sovereign's position and a strong recovery in the Spanish economy.

### **Factors with Negative Rating Implications**

Ratings could come under pressure if the macroeconomic environment significantly deteriorates and the Spanish sovereign's position weakens further. A return to rapidly increasing NPLs and loan losses that impacts earnings, reduces reserves and weakens capital could also lead to a ratings downgrade. Significant deterioration in the financial profile of Popular, due to the combination with Pastor, could result in a ratings downgrade by one notch or more.



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## Franchise Strength

Popular is a banking group that focuses on commercial banking for businesses and individuals. It conducts the majority of its business in Spain, while also maintaining a modest presence in Portugal (Banco Popular Portugal) and a limited presence in the United States (Totalbank). The Group's core business is providing banking and other financial services to meet the needs of SMEs, corporates, micro companies (only 1-2 people staffed) and professionals (lawyers, doctors, etc.), as well as more affluent individuals. Well-positioned in these attractive segments with more limited presence in the mass market customer segment, Popular has been able to somewhat offset negative pressure on its net interest margin from the challenging environment.

### Position within the Spanish Banking Industry

With 12,272 employees, 1,971 branches in Spain and total assets of EUR 130 billion, of which approximately 90% are in Spain, at 2Q11, Popular is the fifth largest banking group in Spain by assets. Inclusive of the country's sizable saving bank sector, Popular is the 5<sup>th</sup> largest financial institution in Spain. On a consolidated basis, at year-end 2010, Popular had total customer loans EUR 96 billion and customer deposits of EUR 70 billion, giving the Group a 4.9% market share of the loans and 5.6% of deposits of the banking industry in Spain, inclusive of banks, savings banks and credit cooperatives. DBRS views these market shares as sizable given Spain's fragmented banking market, which is now in the process of consolidation. The scale and extensiveness of Banco Popular's branch network, as well as its numerous ATMs, means that it is well positioned to compete with other large banks.

The Spanish banking sector is in the process of restructuring, mainly through the consolidation of the privately-held savings banks (*cajas*), which are being required to form newly merged entities and raise capital per the Bank of Spain. So far, the restructuring has involved the reduction in the number of savings banks from 45 *cajas* to 18 *caja* groups as of March 2011. This number has further decreased in 2011 and is expected to continue to do so. The *cajas* have been required to raise capital levels to reach a core capital ratio of 8% or 10%, depending on the extent of private ownership. For those that need to raise capital, the *cajas* have created new bank entities and are in the process of transferring or have already transferred all assets and liabilities to these new banks. The capital raises required by the Bank of Spain can be achieved through either public listing of the new bank entity, private investment in the new bank entity, or the government-supported fund *Fondo de Reestructuración Ordenada Bancaria's (FROB)* investment in the new bank entity. These capital raises are required to be completed by end-September 2011. At end-2010, the Tier 1 capital of the Spanish financial system had increased to 9.5% from 7.6% at end-2007; this ratio has been further increased in 2011. This merger process has resulted in a new competitive landscape domestically, creating some market disruption and uncertainty. DBRS is of the view that, once the restructuring of the banking sector is completed, the Spanish banking system will be much stronger and will be much better capitalised.

Demonstrating its strength and the appeal of its capabilities, Popular is benefiting from a flight to quality and gaining market share, as some participants in the banking industry are under stress in the current environment and may be constrained in meeting the needs of their customers. This provides the Group with an opportunity to strengthen and diversify its revenue sources by expanding businesses and services that leverage its franchise, while adding diversity to its earnings. Popular has very limited involvement in investment banking or other capital markets related activities and has little appetite to expand in these businesses.

### Strategy

The Group's franchise development is underpinned by its good market reputation, as well as its prudent and targeted organic growth strategy that has emphasised service quality. As the crisis has been prolonged, Popular has focused on balance sheet management (deposit growth and selective lending), reinforcing liquidity and bolstering solvency. Popular has optimised its commercial network in Spain through the integration of regional subsidiaries in 2008 and 2009, as well as branch closures and branch mergers. Popular's strategy remains centered on organic growth, although future acquisitions are possible, depending on opportunities. The Group has stated that it has no plans for expanding aggressively internationally. Spain and Portugal are Popular's core markets.

The Group is also focused on building on long-standing strategic relationships to carry out its strategy. In 2010, Popular created a bank joint venture (JV) with Crédit Mutuel, which is jointly owned and controlled by both parties. Popular contributed 123 branches in Spain to the new bank; Crédit Mutuel purchased a 50% stake for EUR 312 million, allowing Popular to generate significant capital gains and bolster capital and increase provisioning. The Group has maintained a strong strategic relationship with Crédit Mutuel, to whom it sold Banco Popular France in April 2008. Since 2005, the two institutions have shared commercial agreements,

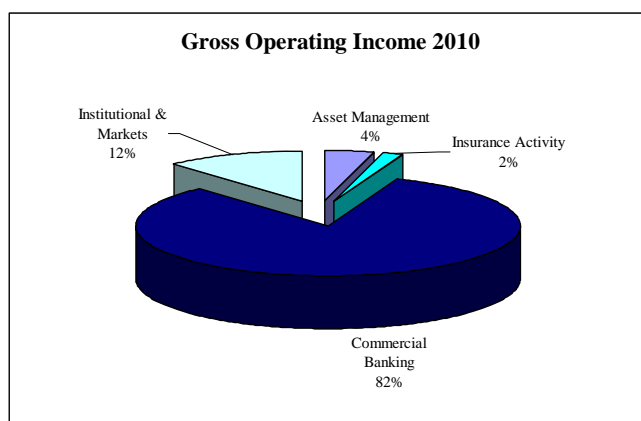
which were bolstered further in November 2009 and now include client referrals, operational agreements, cash management and pension payments.

In 1H11, Popular established an asset management JV with Allianz called Allianz-Popular, which is 40% owned by the Group and 60% owned by Allianz. Popular contributed all of its asset gathering businesses to the JV, allowing the Group to generate significant capital gains of EUR 490 million, which were used to increase real estate provisioning ahead of the Bank of Spain's calendar requirements. The Allianz-Popular JV will distribute life insurance products, pension funds and asset management products through Popular's extensive network. The Group has had a strategic relationship with Allianz since 1988 when it developed bancassurance businesses through Eurovida (51% Allianz/49% Popular) and Europensiones (49% Allianz/51% Popular) that are now included within the JV. At that time, Allianz also became a shareholder of the Group and has increased its stake over time, becoming one of Popular's core shareholders.

**Lines of Business**

Banco Popular operates in four major lines of business: Commercial Banking, Asset Management, Insurance, and Institutional & Markets (see Exhibit 1).

Exhibit 1



Source: DBRS, Company Reports

**Commercial Banking** is by far the largest business segment with substantially more revenues and assets than the other businesses. Commercial Banking contributed 82% of gross operating income in 2010. Commercial banking includes corporate banking and retail banking. In addition to offering products through its extensive branch network, Popular has expanded its reach through its Internet channel, bancopopular-e, and through its private banking network, Popular Banca Privada, which is owned 60% by the Group and 40% by Luxembourg Dexia-BIL bank. The Group formerly operated through a fourth network called Banco Popular Hipotecario, but created a new jointly owned and controlled bank (50%/50%) with Crédit Mutuel discussed above.

**Asset Management**, which includes private banking, pension plan management and mutual fund management, contributed 4% of the Group's gross operating income in 2010. Popular formed a JV in 1H11, Allianz-Popular, of which it is a 40% owner. Popular contributed 100% of its asset gathering businesses to the JV, as discussed above.

**Insurance** contributed 2% of Popular's gross operating income. The Group's extensive branch network distributes insurance products, supporting growth in insurance and reinsurance premiums collected and leveraging the customer franchise. The Group's insurance businesses, Eurovida and Europensiones, are now included in the Allianz-Popular JV.

**Institutional & Markets**, which includes activities that are not included in the prior three segments, contributed 12% of gross operating income in 2010, up from 10% in the prior year. The contribution was elevated by gains from the capital gains on the JV with Crédit Mutuel and net interest income from the Group's balance sheet management and its ALCO portfolio established in early 2009. Other activities include asset and liability transactions with credit institutions, trading portfolios, available-for-sale financial assets, asset and liability hedging derivatives, non-current assets for sale, participating interests, goodwill, held-to-maturity investment portfolio, asset and liability balances arising from pensions, raising of funds in wholesale markets and interbank



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markets. While active in facilitating customer transactions, Banco Popular has limited involvement in capital markets businesses.

### **International Reach**

Banco Popular Portugal (BP Portugal) is a wholly-owned subsidiary with about 9% of the Group's overall assets. The strategy for BP Portugal, which has 237 branch offices and 1,439 employees, is directed toward the Group's core business of commercial banking, with a focus on SMEs. Portugal contributed 6.1% of the Group's gross operating income in 2010. The parent bank, specialised banks and BP Portugal all operate on the same technology and administrative platforms, which helps optimise costs.

In the U.S., the Group owns TotalBank, which is located in Florida and caters principally to SMEs and individuals. TotalBank had 15 branches and 399 employees at the end of 2010. While this very modest acquisition enhanced Banco Popular's channels for serving its clients and is in line with Popular's strategy and conservative management parameters, the Florida economy has been one of the most severely affected by the financial crisis in the U.S. Even so, the successful addition of TotalBank, as well as the earlier integration of BP Portugal, has shown Popular's capacity to integrate acquisitions.

Expanding its international reach, the Group has established business alliances with local correspondent banks. Popular takes no direct risk, but is paid for recommending its clients to its business partners.

### **Earnings Power**

From a ratings perspective, DBRS views the Group's sustained profitability throughout the crisis positively. Popular generated profit attributable to the controlling company of EUR 590 million in 2010 and EUR 766 million in 2009. While down from pre-crisis levels when the Group generated net profits in excess of EUR 1 billion, Popular has nevertheless remained profitable. Revenues came under pressure in 2010, as Popular experienced increasing margin pressure with funding costs rising over the year mainly due to competition for deposits and higher rates on wholesale funding.

The largest component of revenues, net interest income, was EUR 2.5 billion in 2010, down 13.1% versus 2009. While Popular adjusted earlier in 2010 to lower rates, sustained lower rates in 2010 reduced asset yields on mortgages with annual interest rate resets. Offsetting some of this pressure, the Group is achieving wider spreads on its loan book than its peers, mainly due to its loan mix, which contains more higher-yield lending, such as to SMEs, corporates and professionals (approximately 70% of the loan book at 2Q11) that reflects the Group's franchise strength, rather than lower-yielding residential mortgage lending. With increased interest rates, deposits costs and credit spreads, funding costs have risen in 2011. The Group has been able to reflect some of its higher funding costs in the pricing of its loans. The Group's NIM was 1.66% at 2Q11, as compared to 1.75% at 4Q10 and 2.36% at 4Q09, but this has held up relatively well given the current environment. Driving the declining NIM is increased funding spreads, which jumped to 1.89% at 2Q11 from 1.62% at 4Q10 and 1.29% at 4Q09. Importantly, the Group continues to boost spreads on loans to offset this increase, which reached 3.55% at 2Q11 as compared to 3.37% at 4Q10 and 3.65% at 4Q09.

Although still a leader in efficiency, the Group has seen this advantage lessen; its cost/income ratio has risen as revenues have declined and expenses have risen due in part to increased expenses for managing deteriorating credits, as well as for branch leases and investing in the franchise. With an efficiency ratio that remains lower than that of peers, Banco Popular benefits from its ability to convert a larger portion of its revenues into net profits relative to less efficient banks. Despite success in controlling costs, weakening revenues over 2010 have reduced this advantage. Banco Popular achieved a still relatively low cost/income ratio of 35.2% in 2010, but this is up from 29.3% in 2009. In 1H11, this ratio increased further to 40.1%. Even with success in controlling expenses, for example through staff and branch reductions, the Group's operating costs have been on a slight upward trend due to increased leasing expenses associated with the sale and leaseback of branches and investment in technology. A return to revenue growth and continued vigilance on costs would likely reverse this deterioration and preserve the Group's advantage.

Sustained revenues and controlled expenses drove a strong IBPT of EUR 2.1 billion in 2010, although down from EUR 2.8 billion in 2009. This has helped the Group to absorb still elevated credit provisions of EUR 1.3 billion, or 61% of IBPT, in 2010 and credit provisions of EUR 1.7 billion, of 61% of IBPT, in 2009. In 2H11, Popular continued to generate solid IBPT of EUR 858 million, providing a cushion over provisioning expense of EUR 597 million. DBRS includes impairments on financial assets [EUR 578 million] and impairments on



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other assets [EUR 522 million], as well as any gains/losses on asset sales [EUR 503 million], in the expense for provisioning.

During 2009 and 2010, the Group offset provisions on real estate assets with profits from real estate sales and other transactions; the Group continued with its commitment to offset provisions on foreclosed real estate assets with further transactions in 1H11. In coping with the extended crisis, the Group has successfully used various resources, such as the sale/leaseback of branches and other opportunities for capital gains, which have bolstered its reserves and enabled it to absorb elevated credit impairments and asset write-downs. These actions, however, have utilised some of Popular's contingency resources, leaving it with fewer alternatives to cope with further deterioration.

## **Funding & Liquidity**

DBRS views Popular's liquidity profile as solid, given its ability to generate deposits and continued ability to access wholesale funding markets during periods of relative market stability. Despite this, the current environment adds pressure to the Group's liquidity position. The Group has made some use of the ECB, which has resulted in modest ECB reliance. It also took advantage of the government guaranteed debt program to issue EUR 3.5 billion in 2009. The Group benefits from its growing deposit base, diversified wholesale funding sources and effective liquidity management processes. In the current environment, the Group is benefitting from its reduced reliance on wholesale funding, as Popular has been increasing deposits and lending selectively, which has reduced the commercial gap. Wholesale funding reliance has declined from 55% of total funding at the end of 2007 to 44% of total funding at 2Q11 limiting the Group's needs to access the wholesale markets in a time of stress.

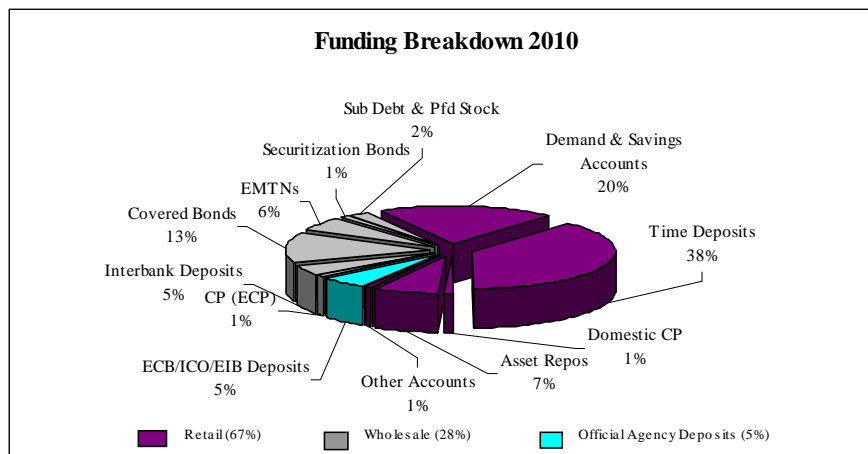
### **Customer Deposits**

Indicative of the benefits of its attractive customer franchise, Banco Popular continues to grow customer deposits, even in the difficult environment. Customer deposits grew 5.4% YoY to EUR 65.9 billion at 2Q11, mainly driven by a 10% increase in time deposits. Inclusive of securities that are distributed through the branch network, which includes convertibles, preferred shares and domestic CP, total retail funds stood at EUR 68.9 billion. By attracting more customer deposits, the Group has grown its deposit base at a faster rate than its customer loans, which increased by 0.9% over the same time period to gross loans of EUR 100.4 billion. As a result, the Group reports that its commercial gap, the gap between loans and deposits, has declined to EUR 30.1 billion at 2Q11, down from EUR 33.2 billion at 2Q10 and significantly lower than the pre-crisis level of EUR 48.8 billion at 2Q07. Customer deposits fund approximately 53% of total assets, which is a slight increase from 51.5% a year ago. Given the competition for deposits, sustaining strong deposit growth is likely to remain challenging and require Banco Popular's continued success with its core customer segments.

### **Wholesale Funding**

DBRS views positively that the Group's funding sources are diversified by type and maturity. The Group has reduced its reliance on commercial paper (CP), a source that is sensitive to market sentiment, with a decline of 77% year-over-year. Approximately 50% of Popular's CP outstanding has been issued domestically and is distributed through its branch network. DBRS views this as a more stable source of short-term funding, as it is largely placed within the Group's customer base as short-term notes. A significant portion of the Group's wholesale funding is issued with long-term maturities, such as through covered bonds, euronotes, securitisations, sub debt and preferred stock (combined, 22% of total funding) limiting rollover risk in the short-term (see Exhibit 2).

**Exhibit 2**



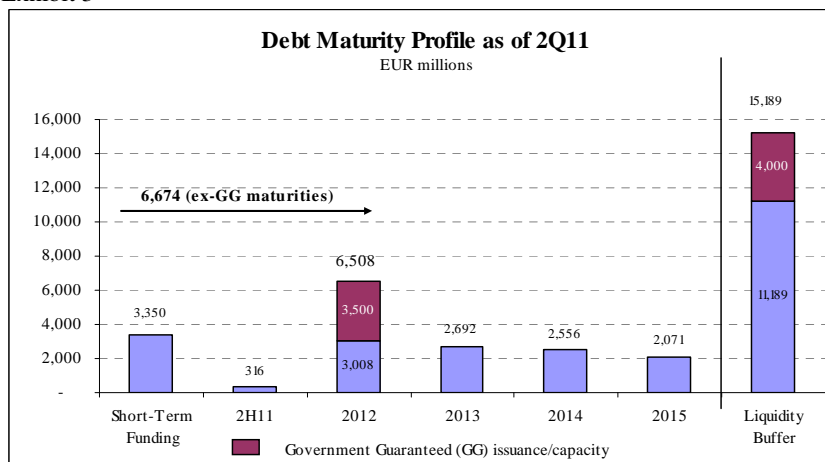
Total funding = EUR 101 billion  
Source: DBRS, Company Reports

DBRS views Popular’s debt maturity profile as manageable. The Group has a significant concentration of long-term debt maturities in 2012 of EUR 6.5 billion, largely because of its EUR 3.5 billion government guaranteed issuance maturing (see Exhibit 3). Excluding this, Popular has debt maturities of EUR 2 billion to EUR 3 billion each year from 2012 through 2015. The Group has largely covered its debt maturities in 2011 through EUR 2 billion of senior debt and covered bond issuances, with just EUR 316 million of EMTNs and securitisations that need to be refinanced in 2H11. To date, Banco Popular has been able to roll its funding at maturity, albeit at higher rates than historical norms, contributing to higher funding costs.

**Contingency Liquidity**

Reinforcing this liquidity, the Group has built up significant eligible collateral that is available to pledge for central bank and repo funding of EUR 11.2 billion, after haircuts, at 2Q11 (see Exhibit 3). This line of liquidity is available for discounting purposes at the ECB and various clearing houses, including the LCH London, Eurex Repo and LCH Paris, which DBRS views as diversifying the Group’s available funding sources in a stressed environment. Popular utilised EUR 1.9 billion in funding from the ECB at 2Q11, up from EUR 1.5 billion at the end of 2010 and is not included in the collateral available in the liquidity buffer. This EUR 11.2 billion of central bank- and clearing house-eligible collateral provides ample coverage for short-term maturities of approximately EUR 3.4 billion, which includes EUR 1.0 billion of CP and EUR 2.35 billion of interbank funding, and medium- to long-term debt maturities of EUR 316 million in 2H11 and EUR 3.0 billion in 2012, excluding government guaranteed debt maturities. With additional issuance capacity for government guaranteed debt of EUR 4 billion, in addition to securitisations and clearing house issuance, the Group maintains sufficient coverage for medium- to long-term debt maturities through at least 2013.

**Exhibit 3**



Source: DBRS, Company Reports



## Risk Profile

While it is under stress in the current environment, in DBRS's view, Banco Popular's risk profile is reflective of its business mix and well-positioned franchise. As indicated by the Group's success in managing through the current crisis, Banco Popular has effective risk management processes that address the major categories of risk: credit, market, cross-border, operational, structural balance sheet risk, reputational and liquidity. Banco Popular's risk profile is dominated by the credit risk encompassed within its commercial banking activities.

### Credit Exposures

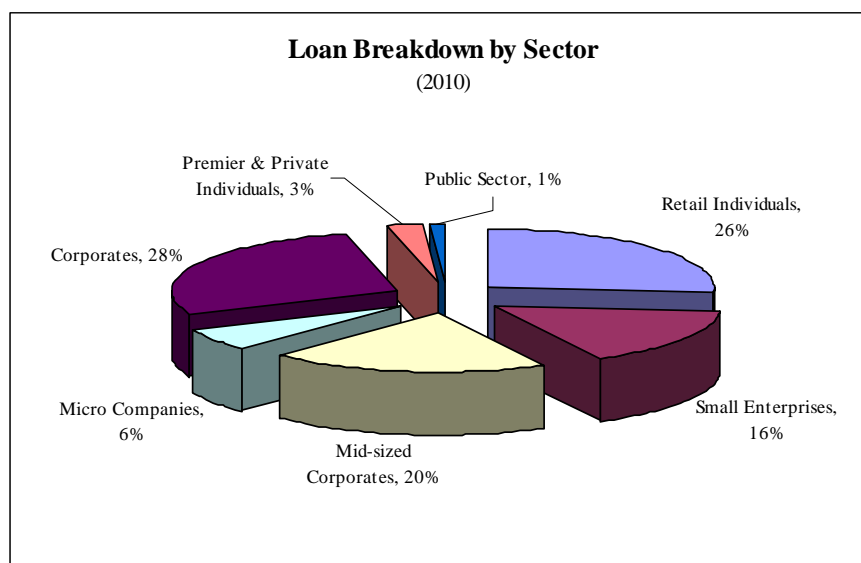
Credit exposures in commercial banking consist primarily of loans and receivables, as well as commitments and other contingent exposures. Including credit lines that can be drawn by third parties, these risks amounted to EUR 144.6 billion at 31 December 2010, a decline of 1.7% from the prior year. The majority of the risk exposure is in Spain, with limited exposure in Portugal and minimal exposure in the U.S. Popular's loan portfolio is predominantly mid-sized corporate loans and small enterprises (36%), corporates (28%) and retail individuals (26%) (see Exhibit 4).

Popular has established policies under which it extends credit and takes on credit risk exposure. Generally, the Group has a relatively conservative approach to credit and tends to be selective regarding the repayment capacity of customers to which it lends. It has developed risk rating processes and default projections to manage its exposures. As part of Popular's strategy to mitigate risk with increased stress in real estate markets, growth in mortgage lending has been reduced since 2008, while being selective in its business origination to limit its exposure to low-profitability and high-risk transactions and/or customers.

To serve the needs of its customers, Banco Popular has grown its lending portfolio by 0.9% YoY to EUR 100.4 billion in 2Q10, even with the weak demand and tighter risk approval policies. The Group's loan portfolio has significant exposure to businesses, particularly SMEs, which are a strategic focus for Popular. Of the Group's EUR 92 billion of direct risk in Spain, 71% was to the business lending segment, which includes EUR 44 billion in direct risk to small & micro-businesses and medium-sized businesses and EUR 29 billion in direct risk to big businesses. To mitigate risk, a substantial portion of lending is secured. In Spain, business lending backed by mortgage collateral and other guarantees was 47% of the total loan book at the end of 2010.

Additionally, 29% of Popular's direct risk in Spain was to private individuals. Importantly, 84% of the risk is in mortgage loans which are collateralised with 87% having a loan-to-value (LTV) ratio of 80% or lower. Most of the Group's mortgages to individuals are collateralised by primary residences.

Exhibit 4



Total Loan Portfolio = EUR 100.4 billion  
Source: DBRS, Company reports

### Market and Interest Rate Risk

Market risk for the Group is primarily interest rate risk with very modest trading risk, given the Group's limited involvement in capital markets activities. This risk is monitored through the Treasury area. One measure of this risk is Value-at-Risk (VaR), which the Group reports based on a 99% confidence level, 1 day time period. Indicative of the Group's low market risk, it reported aggregate VaR of just EUR 493 thousand in 2010, up slightly from EUR 436 thousand in 2009 but down significantly from EUR 1.7 million in 2008.

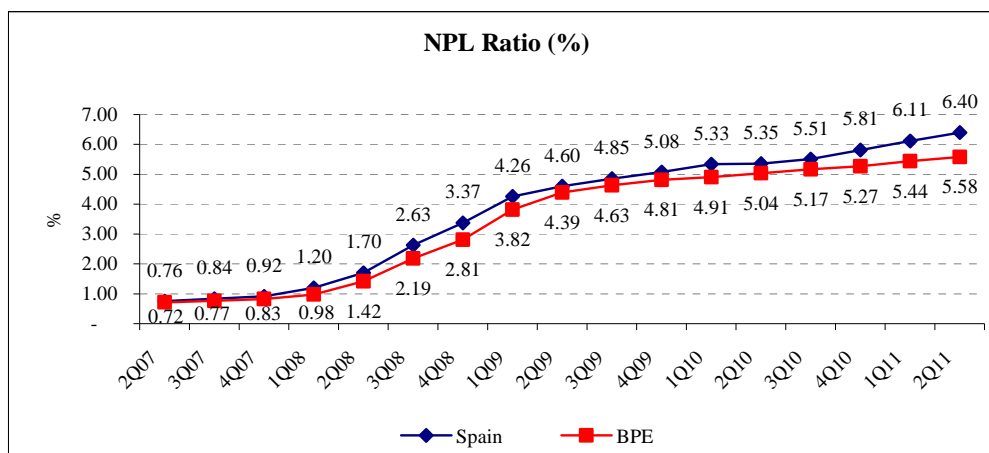
The Asset & Liability Committee (ALCO) plays an important role in Banco Popular's management of its balance sheet, interest rate risk and liquidity. ALCO evaluates the balance sheet sensitivity versus the interest rate curve, utilising various scenarios. The Committee sets short- and medium-term policies for managing rates and spreads. To manage structural balance sheet risk in 2010, the Group managed an investment portfolio of EUR 12.6 billion, composed mainly of public debt, government guaranteed bonds, covered bonds, senior unsecured debt, and securitisations to balance its demand deposit funding. With Banco Popular capturing more deposits than its loan growth, there was an opportunity to build up this ALCO structural portfolio. As loan demand picks up when the recovery strengthens, DBRS expects that the ALCO portfolio will shrink.

### Asset Quality

Despite the Group's proven earnings generation resiliency, DBRS expects that an extended period of stress would continue to pressure margins and credit costs will likely remain elevated. Popular's non-performing loan (NPL) ratio in its EUR 100 billion lending portfolio increased to 5.58% at 2Q11, up 14 basis points (bps) quarter-over-quarter (QoQ) and up 54 bps from 2Q10, although still below the sector average. Leading this deterioration is the Group's exposure to construction and real estate, which totalled EUR 17.8 billion, or 14% of total assets, of which EUR 2.9 billion was non-performing at 2Q11. Importantly, Popular's mortgage lending to private individuals continues to perform well, with a NPL ratio of 2.8% at the end of 2010.

While signs of improving trends are emerging, such as declining net additions to non-performers, the Group's asset quality remains significantly worse than pre-crisis levels, when the Group's NPL ratio was below 2%. While DBRS views Popular's level of non-performing loans as significantly elevated, the Group's ratio appears to have leveled off after a dramatic increase in late 2008/early 2009, which coincided with the deterioration in real estate markets in Spain (see Exhibit 5). Contributing to this deterioration, the unemployment rate has soared to 20.9% at June 2011 compared to a more typical 8-10% rate for the country. Banco Popular continues to face a challenging environment with a weak economy and very elevated unemployment.

Exhibit 5



Source: DBRS, Company reports, Banco de España

DBRS views the deterioration in Popular's credit metrics as having broadly paralleled that of Spain's banking industry. As the Group's NPL ratio increased from 0.83% in 4Q07 to 2.81% in 4Q08 to 4.81% in 4Q09, the banking industry average rose from 0.92% to 3.37% to 5.08% over the same time frame. Since 4Q09 Popular's ratio has diverged somewhat from the industry average, remaining close to 100 bps below the average at the most recent reporting date. Given the stressed macroeconomic environment, DBRS observes that Banco Popular is benefiting from the mix of its business and its credit policies. It is better positioned relative to some of its domestic competitors that are currently struggling, particularly among the savings banks.

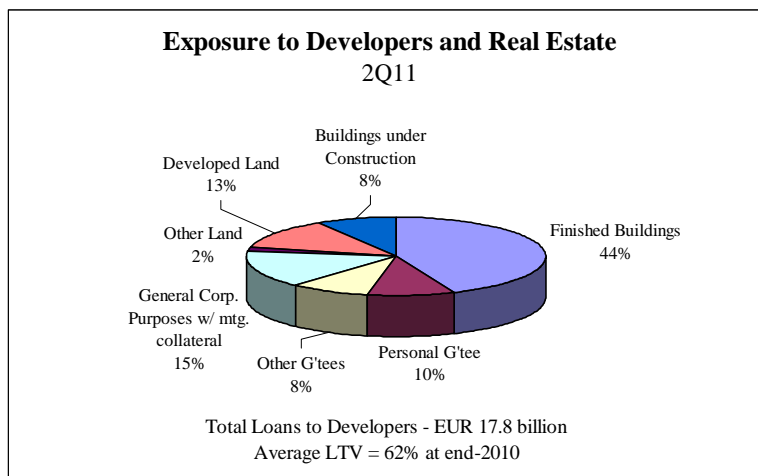
DBRS views steps that the Group is appropriately taking are contributing to the improvement. Banco Popular has significantly increased the resources devoted to managing its credit exposures and its customers. Included on this team are senior officers who have the experience and expertise to make the appropriate decisions regarding restructurings. By helping clients to solve credit problems, customer relationships can be improved and maintained over the long-term. Popular is especially focused on maintaining relationships with SMEs.

*Exposure to Construction and Real Estate*

DBRS views the Group's exposure to the Construction and Real Estate segment, which includes exposure to real estate developers, as sizeable but manageable. Popular's EUR 17.8 billion of exposure to this segment is backed by collateral of 22% of total exposure, after haircuts. With only 13% of this exposure for developed land and 2% for other land, DBRS views this portfolio as having moderate exposure to the generally riskiest segments of real estate lending (see Exhibit 6). DBRS views Popular's exposure to buildings under construction and finished building, 52% of total construction and real estate exposure, as having less risky characteristics than other types of exposure in the portfolio and provides the Group with greater opportunity to sell these assets without further losses. On the other hand, if the market fragility and uncertainty continues for an extended period of time, DBRS views this portfolio as leaving the Group exposed to meaningful losses. The difficulties continue for this segment in Spain as property values decline, sales volumes remain low and financing is difficult. As the economic downturn has been prolonged, this segment increasingly becomes a source of additional credit costs and impairments.

At 2Q11, the NPL ratio for this loan segment was 16.5% with an additional 15.4% of loans on the substandard list. The substandard list includes loans that are still performing but have been flagged as at-risk for non-performing. DBRS views the Group as appropriately continuing to build reserve coverage, reaching 90.6% against construction and real estate NPLs and substandard loans (including collateral and guarantees) at 2Q11.

Exhibit 6



Source: DBRS, Company Reports

*Exposure to Foreclosed Real Estate Assets*

The Group's strong balance sheet has enabled it to contribute to restructurings and resolutions for troubled developers, but this has added to its direct ownership of real estate assets. Through purchases and repossessions, the Group has acquired significant real estate. Popular has net acquired real estate assets of EUR 3.7 billion at 2Q11, or 2.8% of total assets, with coverage of 35% at 2Q11. While the Group now has these assets marked at approximately 55%-60% below peak prices and coverage has been increased from 29% to 35% in 1H11, DBRS views these assets as an additional burden to the already sizable amount of NPLs on Popular's books of EUR 6.5 billion. The sum of NPLs plus net acquired real estate assets of EUR 10.24 billion, or 8.8% of total risks, adds further pressure to net earnings, in the DBRS view.

*Loan Loss Reserves*

The Group's reserves comprise two components: a specific reserve and a generic reserve. The Group maintains a specific reserve that is built up to address losses recognised as inherent in the portfolios of credit exposures across the Group. At the end of June 2011, the specific reserve was EUR 2.4 billion, up 12% in 1H11. This compares to an increase in NPLs of 8% over the same time period. Prior to and throughout the crisis, Popular

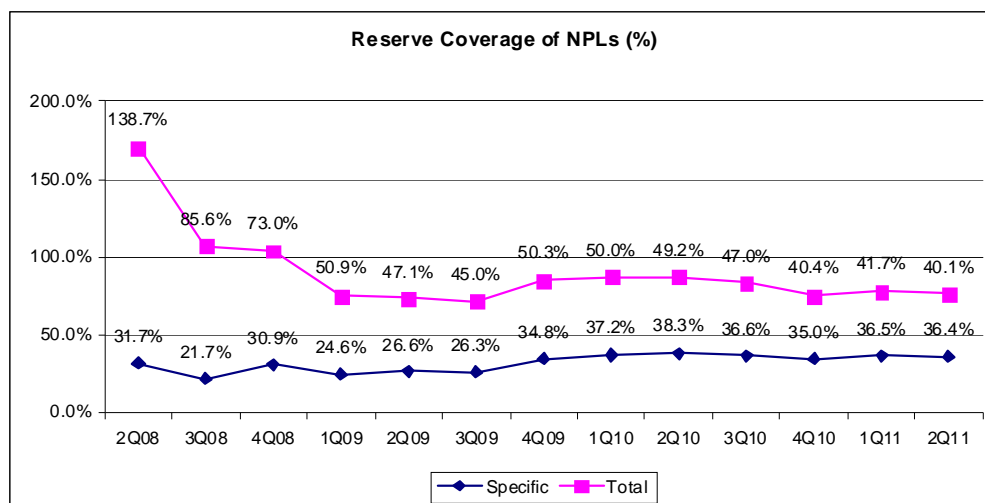


added to specific reserves to maintain coverage levels of approximately 25% to 30% (see Exhibit 7). In 2010, the Group boosted this level further, bringing specific coverage of NPLs to a minimum of 35% and has maintained this level of coverage throughout 2010 and 1H11. At 2Q11, Popular's specific reserve coverage ratio was 36.4%. This level incorporates both the Banco de España's requirements and the Group's perspective on collateral and severity of loss.

In its risk management processes, the Group determines its level of specific provisioning by estimating the potential for future losses, which includes provisions taken for potential losses on performing loans. At year-end 2007, at a time of relatively normal credit conditions, the Group had specific reserves of EUR 245 million, or 0.28% of EUR 88.7 billion gross loans, with an NPL/gross loan ratio of 0.92%. By 2Q11, the loan portfolio had grown to EUR 100.4 billion and specific reserves were increased to EUR 2.4 billion, or 2.36% of gross loans, to reflect the significant increase in the NPL/gross loan ratio to 6.27%. Adjusting for the growth in the loan portfolio and reserves for the performing portfolio, DBRS estimates that the Group's specific reserve coverage of elevated NPLs has declined throughout the crisis as Popular has utilised its generic reserves to add to specific reserves to address the deterioration in credit quality and the increase in impairments.

The generic reserves are counter-cyclical reserves established under Bank of Spain regulations to help Spanish banks absorb elevated losses during cyclical downturns. While not easily predicted, cyclical downturns can be reasonably expected to occur periodically. Popular built up sizeable contingent reserves for use; when credit deteriorated, the Group utilised these generic reserves as intended. The generic reserve amounted to EUR 245 million billion at 2Q11, down from EUR 329 million at the start of the year and down from over EUR 1 billion pre-crisis. As intended, Popular has used its generic reserves through this prolonged economic downturn, while also periodically generating one-off gains on sales or utilising other resources to replenish this reserve. While DBRS views Popular as having less resources to cope with a continued downturn for an extended period of time, the Group has so far proven its ability to cope with the deterioration in credit, while maintaining an appropriate level of reserves. Inclusive of specific and generic reserves, as well as collateral adjusted for haircuts, the Group's coverage ratio was just over 100% at 2Q11.

Exhibit 7



Source: DBRS, Company reports

### Capitalisation: Structure & Adequacy

Given the still weak credit and economic conditions in Spain and globally, DBRS views Popular as taking appropriate steps to bolster its capitalisation. Popular has boosted its capital ratios through its management of risk-weighted assets and retained earnings. Additionally, the Group increased capital in 4Q10 through share issuance to Crédit Mutuel, its partner in a new joint banking platform in Spain, and the distribution of core Tier 1 eligible convertible bonds to its retail investors. At 2Q11, Popular had tangible equity capital of EUR 7.9 billion, or 6.1% of tangible assets. Having already absorbed write-offs of EUR 3.2 billion and credit valuation adjustments of EUR 2.6 billion, DBRS views the Group as continuing to maintain a sizable cushion against a more adverse environment.



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Given the current market turmoil, however, the pressure on banks generally is to have even larger cushions over the minimum to be considered well-capitalised. At 2Q11, the Group's core capital ratio was 9.84%, up 41 bps from the end of 4Q10 and up 126 bps from 2Q10. Currently, the Bank of Spain is requiring a minimum 8% core capital ratio for publicly-listed Spanish financial institutions; Popular has a comfortable buffer above this minimum. The strength of the Group's capital was demonstrated by the European Banking Authority's (EBA) recent EU-wide stress test. Under the adverse scenario, including EBA-recognised mitigating measures as of 30 April 2011, Popular's estimated Core Tier 1 would be 5.3% at the end of 2012, exceeding the minimum 5% Core Tier 1 ratio established by the EBA to pass the test. DBRS notes that the EBA did not recognise certain mitigating measures that are recognised by the Spanish regulators, such as mandatory convertible bonds and generic and substandard provisions. Including existing loss absorption elements recognised by the Bank of Spain, the Group's core Tier 1 capital ratio would have been 7.4% under the adverse scenario and 9.3% under the baseline scenario. In anticipation of further deterioration in credit trends or regulatory reforms, DBRS would expect Banco Popular to continue to further increase its resources and add to its cushion over regulatory requirements.



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|   | <u>2011H1</u>     |                | <u>2010Y</u>      |                | <u>2009Y</u>      |                | <u>2008Y</u>      |                |
|---|-------------------|----------------|-------------------|----------------|-------------------|----------------|-------------------|----------------|
| <b>Banco Popular Español SA</b>                                     | <b>30/06/2011</b> |                | <b>31/12/2010</b> |                | <b>31/12/2009</b> |                | <b>31/12/2008</b> |                |
|   | EUR               |                | EUR               |                | EUR               |                | EUR               |                |
| <b>EUR Millions</b>   | IFRS              |                | IFRS              |                | IFRS              |                | IFRS              |                |
| <b>Balance Sheet</b>  |                   |                |                   |                |                   |                |                   |                |
| Cash and deposits with central banks                                | 893               | 0.68%          | 683               | 0.52%          | 3,749             | 2.90%          | 1,860             | 1.68%          |
| Lending to/deposits with credit institutions                        | 3,155             | 2.42%          | 6,055             | 4.65%          | 7,342             | 5.68%          | 4,905             | 4.44%          |
| Financial Securities*   | 19,128            | 14.67%         | 17,085            | 13.13%         | 14,234            | 11.01%         | 4,569             | 4.13%          |
| - Trading portfolio   | 1,108             | 0.85%          | 50                | 0.04%          | 520               | 0.40%          | 427               | 0.39%          |
| - At fair value   | 441               | 0.34%          | 465               | 0.36%          | 417               | 0.32%          | 337               | 0.31%          |
| - Available for sale  | 10,107            | 13.48%         | 11,176            | 8.59%          | 11,030            | 8.53%          | 3,760             | 3.41%          |
| - Held-to-maturity  | 7,472             | -              | 5,395             | 4.15%          | 2,267             | 1.75%          | 35                | 0.03%          |
| - Other   | 0                 | 0.00%          | 0                 | 0.00%          | 0                 | 0.00%          | 0                 | 0.00%          |
| Financial derivatives instruments                                   | 664               | 0.51%          | 2,220             | 1.71%          | 2,304             | 1.78%          | 1,899             | 1.72%          |
| - Fair Value Hedging Derivatives                                    | 664               | 0.51%          | 1,038             | 0.80%          | 1,470             | 1.14%          | 993               | 0.90%          |
| - Non Fair Value Treated Derivatives                                | NA                | -              | 1,181             | 0.91%          | 834               | 0.64%          | 907               | 0.82%          |
| Gross lending to customers  | 100,431           | 77.02%         | 98,389            | 75.60%         | 97,508            | 75.42%         | 93,717            | 84.91%         |
| - Loan loss provisions  | 2,273             | 1.74%          | 2,356             | 1.81%          | 2,551             | 1.97%          | 2,015             | 1.83%          |
| Insurance assets  | 3                 | 0.00%          | 4                 | 0.00%          | 3                 | 0.00%          | 6                 | 0.01%          |
| Investments in associates/subsidiaries                              | 576               | 0.44%          | 169               | 0.13%          | 56                | 0.04%          | 32                | 0.03%          |
| Fixed assets  | 1,632             | 1.25%          | 1,890             | 1.45%          | 1,807             | 1.40%          | 1,355             | 1.23%          |
| Goodwill and other intangible assets                                | 635               | 0.49%          | 657               | 0.50%          | 487               | 0.38%          | 547               | 0.50%          |
| Other assets  | 5,552             | 4.26%          | 5,345             | 4.11%          | 4,353             | 3.37%          | 3,511             | 3.18%          |
| <b>Total assets</b>   | <b>130,398</b>    | <b>100.00%</b> | <b>130,140</b>    | <b>100.00%</b> | <b>129,290</b>    | <b>100.00%</b> | <b>110,376</b>    | <b>100.00%</b> |
| Total assets (USD)  | 189,038           |                | 174,567           |                | 185,503           |                | 153,423           |                |
| Loans and deposits from credit institutions                         | 12,297            | 9.43%          | 12,650            | 9.72%          | 23,900            | 18.49%         | 14,264            | 12.92%         |
| Deposits with central counterparty entities                         | 16,739            | 12.84%         | 12,676            | 9.74%          | 839               | 0.65%          | n.a.              |                |
| Deposits from customers   | 65,899            | 50.54%         | 66,708            | 51.26%         | 58,719            | 45.42%         | 51,665            | 46.81%         |
| - Demand  | 21,347            | 16.37%         | 14,327            | 11.01%         | 14,628            | 11.31%         | 14,027            | 12.71%         |
| - Time and savings  | 38,621            | 29.62%         | 44,269            | 34.02%         | 37,753            | 29.20%         | 30,526            | 27.66%         |
| Issued debt securities  | 20,184            | 15.48%         | 21,851            | 16.79%         | 30,334            | 23.46%         | 30,208            | 27.37%         |
| Financial derivatives instruments                                   | 1,482             | 1.14%          | 1,911             | 1.47%          | 1,793             | 1.39%          | 2,109             | 1.91%          |
| - For hedging purposes  | 643               | 0.49%          | 764               | 0.59%          | 597               | 0.46%          | 414               | 0.38%          |
| - Other   | 839               | 0.64%          | 1,146             | 0.88%          | 1,196             | 0.92%          | 1,695             | 1.54%          |
| Insurance liabilities   | 597               | 0.46%          | 1,091             | 0.84%          | 1,073             | 0.83%          | 932               | 0.84%          |
| Other liabilities   | 2,286             | 1.75%          | 2,621             | 2.01%          | 2,364             | 1.83%          | 2,523             | 2.29%          |
| - Financial liabilities at fair value through P/L                   | 111               | 0.09%          | 128               | 0.10%          | 104               | 0.08%          | 135               | 0.12%          |
| Subordinated debt   | 2,358             | 1.81%          | 1,197             | 0.92%          | 602               | 0.47%          | 329               | 0.30%          |
| Hybrid Capital  | NA                | -              | 1,185             | 0.91%          | 1,218             | 0.94%          | 1,288             | 1.17%          |
| Equity  | 8,557             | 6.56%          | 8,252             | 6.34%          | 8,448             | 6.53%          | 7,058             | 6.39%          |
| <b>Total liabilities and equity funds</b>                           | <b>130,398</b>    | <b>100.00%</b> | <b>130,140</b>    | <b>100.00%</b> | <b>129,290</b>    | <b>100.00%</b> | <b>110,376</b>    | <b>100.00%</b> |
| <b>Income Statement</b>   |                   |                |                   |                |                   |                |                   |                |
| Interest income   | 2,204             |                | 4,163             |                | 5,059             |                | 6,289             |                |
| Interest expenses   | 1,159             |                | 1,711             |                | 2,237             |                | 3,754             |                |
| Net interest income   | 1,045             | 68.70%         | 2,452             | 69.12%         | 2,823             | 68.44%         | 2,535             | 68.55%         |
| Net fees and commissions  | 350               | 23.03%         | 747               | 21.04%         | 763               | 18.51%         | 865               | 23.37%         |
| Trading / FX Income   | NA                | -              | 70                | 1.98%          | 67                | 1.64%          | 16                | 0.45%          |
| Net realised results on investment securities (available for sale)  | NA                | -              | 85                | 2.40%          | 318               | 7.71%          | 50                | 1.34%          |
| Net results from other financial instruments at fair value          | NA                | -              | -2                | -0.06%         | 1                 | 0.01%          | -10               | -0.28%         |
| Net income from insurance operations                                | NA                | -              | 27                | 0.75%          | 20                | 0.48%          | 23                | 0.63%          |
| Results from associates/subsidiaries accounted by the equity method | 22                | 1.47%          | -2                | -0.04%         | 1                 | 0.02%          | 14                | 0.39%          |
| Other operating income (incl. dividends)                            | 103               | 6.80%          | 171               | 4.81%          | 132               | 3.19%          | 205               | 5.55%          |
| <b>Total operating income</b>                                       | <b>1,521</b>      | <b>100.00%</b> | <b>3,548</b>      | <b>100.00%</b> | <b>4,124</b>      | <b>100.00%</b> | <b>3,699</b>      | <b>100.00%</b> |
| Staff costs   | 387               | 58.36%         | 784               | 57.82%         | 792               | 58.71%         | 818               | 58.95%         |
| Other operating costs   | 223               | 33.68%         | 476               | 35.07%         | 453               | 33.58%         | 469               | 33.79%         |
| Depreciation/amortisation   | 53                | 7.96%          | 96                | 7.10%          | 104               | 7.71%          | 101               | 7.26%          |
| <b>Total operating expenses</b>                                     | <b>663</b>        | <b>100.00%</b> | <b>1,356</b>      | <b>100.00%</b> | <b>1,349</b>      | <b>100.00%</b> | <b>1,388</b>      | <b>100.00%</b> |
| <b>Pre-provision operating income</b>                               | <b>858</b>        |                | <b>2,192</b>      |                | <b>2,775</b>      |                | <b>2,311</b>      |                |
| Loan loss provisions**  | 597               |                | 1,275             |                | 1,752             |                | 998               |                |
| <b>Post-provision operating income</b>                              | <b>261</b>        |                | <b>916</b>        |                | <b>1,023</b>      |                | <b>1,313</b>      |                |
| Impairment on (in) tangible assets                                  | NA                |                | 43                |                | 143               |                | 15                |                |
| Net losses on (in) tangible assets                                  | NA                |                | 35                |                | 64                |                | 0                 |                |
| Other non-operating items***  | NA                |                | -6                |                | 258               |                | 164               |                |
| Pre-tax income  | 261               |                | 833               |                | 1,073             |                | 1,461             |                |
| (-)Taxes  | -46               |                | 228               |                | 293               |                | 390               |                |
| (-)Minority interest  | 1                 |                | 14                |                | 14                |                | 59                |                |
| <b>Net income</b>   | <b>305</b>        |                | <b>590</b>        |                | <b>766</b>        |                | <b>1,052</b>      |                |
| Net income (USD)  | 429               |                | 783               |                | 1,068             |                | 1,548             |                |

\*Includes derivatives when break down unavailable, \*\*LLP includes Impairments on financial assets,

\*\*\*Includes gains/losses related to certain asset disposals and gains/losses related to certain non-current assets held for sale



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|   | 2011H1     | 2010Y      | 2009Y      | 2008Y      |
|---|------------|------------|------------|------------|
| EUR Millions  | 30/06/2011 | 31/12/2010 | 31/12/2009 | 31/12/2008 |
| <b>Off-balance sheet and other items</b>                          |            |            |            |            |
| Asset under management  | 12,738     | 11,708     | 13,062     | 13,431     |
| Derivatives (notional amount)                                     | NA         | 65,339     | 73,055     | 69,346     |
| BIS Risk-weighted assets (RWA)                                    | 90,639     | 93,856     | 92,574     | 92,129     |
| No. of employees (end-period)                                     | 14,111     | 14,252     | 14,431     | 15,069     |
| <b>Earnings and Expenses</b>                                      |            |            |            |            |
| <b>Earnings</b>   |            |            |            |            |
| Net interest margin [1]   | 1.73%      | 2.04%      | 2.51%      | 2.45%      |
| Pre-provision earning capacity (total assets basis) [2]           | 1.35%      | 1.78%      | 2.41%      | 2.16%      |
| Pre-provision earning capacity (risk-weighted basis) [3]          | 1.88%      | 2.35%      | 3.04%      | 2.55%      |
| Pre-provision earning capacity by employee                        | 121,551    | 153,794    | 192,302    | 153,341    |
| Post-provision earning capacity (total assets basis)              | 0.00%      | 0.74%      | 0.89%      | 1.22%      |
| Post-provision earning capacity (risk-weighted basis)             | 0.00%      | 0.98%      | 1.12%      | 1.45%      |
| <b>Expenses</b>   |            |            |            |            |
| Efficiency ratio (operating expenses / operating income)          | 43.62%     | 38.22%     | 32.71%     | 37.53%     |
| All inclusive costs to revenues [4]                               | 43.62%     | 47.29%     | 36.94%     | 37.45%     |
| Operating expenses by employee                                    | 94,030     | 95,148     | 93,493     | 92,104     |
| Loan loss provision / pre-provision operating income              | 69.60%     | 58.19%     | 63.15%     | 43.20%     |
| Provision coverage by net interest income                         | 175.08%    | 192.27%    | 161.07%    | 253.99%    |
| <b>Profitability Returns</b>                                      |            |            |            |            |
| Pre-tax return on Tier 1 (excl. hybrids)                          | 5.83%      | 9.26%      | 13.34%     | 21.23%     |
| Return on equity  | 7.22%      | 7.19%      | 9.12%      | 15.55%     |
| Return on average total assets                                    | 0.48%      | 0.48%      | 0.67%      | 0.98%      |
| Return on average risk-weighted assets                            | 0.67%      | 0.63%      | 0.84%      | 1.16%      |
| Dividend payout ratio [5]   | 44.69%     | 34.29%     | 60.44%     | 58.32%     |
| Internal capital generation [6]                                   | 2.05%      | 5.36%      | 5.25%      | 8.19%      |
| <b>Growth</b>   |            |            |            |            |
| Loans   | 4.43%      | 1.13%      | 3.55%      | 5.35%      |
| Deposits  | 8.20%      | 33.29%     | 15.28%     | 21.24%     |
| Net interest income   | -18.12%    | -13.12%    | 11.33%     | 10.81%     |
| Fees and commissions  | 3.03%      | -2.22%     | -11.69%    | -2.07%     |
| Expenses  | 5.25%      | 0.51%      | -2.79%     | 9.30%      |
| Pre-provision earning capacity                                    | -24.94%    | -21.02%    | 20.10%     | 3.99%      |
| Loan-loss provisions  | -3.62%     | -27.22%    | 75.56%     | 230.21%    |
| Net income  | -13.86%    | -22.97%    | -27.18%    | -16.83%    |
| <b>Risks</b>  |            |            |            |            |
| RWA% total assets   | 69.51%     | 72.12%     | 71.60%     | 83.47%     |
| <b>Credit Risks</b>   |            |            |            |            |
| Impaired loans % gross loans                                      | 6.27%      | 5.92%      | 5.47%      | 3.04%      |
| Loss loan provisions % impaired loans                             | 36.11%     | 40.44%     | 47.83%     | 70.63%     |
| Impaired loans (net of LLPs) % pre-provision operating income [7] | 234.47%    | 158.31%    | 100.28%    | 36.26%     |
| Impaired loans (net of LLPs) % equity                             | 47.00%     | 49.10%     | 38.49%     | 14.52%     |
| <b>Liquidity and Funding</b>                                      |            |            |            |            |
| Customer deposits % total funding                                 | 56.10%     | 57.97%     | 51.33%     | 53.56%     |
| Total wholesale funding % total funding [8]                       | 43.90%     | 42.03%     | 48.67%     | 46.44%     |
| - Interbank % total funding                                       | 10.47%     | 10.99%     | 20.89%     | 14.79%     |
| - Debt securities % total funding                                 | 17.18%     | 18.99%     | 26.52%     | 31.31%     |
| - Subordinated debt % total funding                               | 2.01%      | 1.04%      | 0.53%      | 0.34%      |
| Short-term wholesale funding % total wholesale funding            | 35.30%     | 48.41%     | 65.42%     | 60.78%     |
| Liquid assets % total assets                                      | 17.77%     | 18.31%     | 19.59%     | 10.26%     |
| Net short-term wholesale funding reliance [9]                     | -10.15%    | -6.15%     | 10.15%     | 16.06%     |
| Adjusted net short-term wholesale funding reliance [10]           | -10.15%    | -32.61%    | -17.71%    | -15.77%    |
| Customer deposits % gross loans                                   | 82.28%     | 80.68%     | 61.08%     | 55.13%     |
| <b>Capital [11]</b>   |            |            |            |            |
| Tier 1  | 9.84%      | 9.63%      | 9.13%      | 8.12%      |
| Tier 1 excl. All Hybrids  | 9.84%      | 9.63%      | 9.13%      | 8.11%      |
| Core Tier 1 (As-reported)   | 9.84%      | 9.43%      | 8.57%      | 7.17%      |
| Total Capital   | 9.90%      | 9.66%      | 9.60%      | 9.10%      |

[1] (Net interest income + dividends) % average interest earning assets.

[2] Pre-provision operating income % average total assets.

[3] Pre-provision operating income % average total risk-weighted assets.

[4] (Operating & non-op. costs) % (op. & non-op. revenues)

[5] Paid dividend % net income.

[6] (Net income - dividends) % shareholders' equity at t-1.

[7] We take into account the stock of LLPs in this ratio.



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**Ratings**

| Issuer                         | Debt Rated                                       | Rating       | Trend    |
|--------------------------------|--|--------------|----------|
| Banco Popular Español S.A.     | Senior Unsecured Long-Term Debt & Deposit        | AA (low)     | --       |
| Banco Popular Español S.A.     | Subordinated Debt                                | A (high)     | --       |
| Banco Popular Español S.A.     | Short-Term Debt & Deposit                        | R-1 (middle) | --       |
| Banco Popular Español S.A.     | Senior Notes, Guaranteed by the Kingdom of Spain | AA           | Negative |
| BPE Financiaciones, S.A.       | Senior Unsecured Long-Term Debt                  | AA (low)     | --       |
| BPE Financiaciones, S.A.       | Subordinated Debt                                | A (high)     | --       |
| BPE Finance International Ltd. | Senior Unsecured Long-Term Debt                  | AA (low)     | --       |
| BPE Capital International      | Subordinated Debt                                | A (high)     | --       |
| Popular Capital Europe         | Subordinated Debt                                | A (high)     | --       |
| Popular Capital S.A.           | Preferred Shares                                 | BBB          | --       |

**Ratings History**

| Issuer                         | Debt Rated                                       | Current      | 2010       | 2009       | 2008       |
|--------------------------------|--|--------------|------------|------------|------------|
| Banco Popular Español S.A.     | Senior Unsecured Long-Term Debt & Deposit        | AA (low)     | AA         | AA         | AA (high)  |
| Banco Popular Español S.A.     | Subordinated Debt                                | A (high)     | AA (low)   | AA (low)   | AA         |
| Banco Popular Español S.A.     | Short-Term Debt & Deposit                        | R-1 (middle) | R-1 (high) | R-1 (high) | R-1 (high) |
| Banco Popular Español S.A.     | Senior Notes, Guaranteed by the Kingdom of Spain | AA           | AAA        | AAA        | NR         |
| BPE Financiaciones, S.A.       | Senior Unsecured Long-Term Debt                  | AA (low)     | AA         | AA         | AA (high)  |
| BPE Financiaciones, S.A.       | Subordinated Debt                                | A (high)     | AA (low)   | AA (low)   | AA         |
| BPE Finance International Ltd. | Senior Unsecured Long-Term Debt                  | AA (low)     | AA         | AA         | AA (high)  |
| BPE Capital International      | Subordinated Debt                                | A (high)     | AA (low)   | AA (low)   | AA         |
| Popular Capital Europe         | Subordinated Debt                                | A (high)     | AA (low)   | AA (low)   | AA         |
| Popular Capital S.A.           | Preferred Shares                                 | BBB          | A (low)    | A (low)    | AA (low)   |

Note:  
All figures are in EUR unless otherwise noted.

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