Credit Opinion: Banco Espanol de Credito, S.A. (Banesto)

Banco Español de Credito, S.A.

Madrid, Spain

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Aa2/P-1
Bank Financial Strength	B-
Covered Bonds -Dom Curr	*Aa1
Senior Secured MTN -Dom Curr	Aaa
Senior Unsecured	Aa2
Subordinate MTN -Dom Curr	Aa3
Jr Subordinate -Dom Curr	Aa3
Preferred Stock -Dom Curr	A1
Parent: Banco Santander S.A. (Spain)	
Outlook	Stable
Bank Deposits	Aa1/P-1
Bank Financial Strength	B
Issuer Rating	Aa1
Covered Bonds -Dom Curr	Aaa
Senior Unsecured -Dom Curr	Aa1
Subordinate -Dom Curr	Aa2
Banesto Issuances Ltd.	
Outlook	Stable
Bkd Sr Unsec MTN	Aa2

* Placed under review for possible upgrade on April 16, 2007

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Key Indicators

Banco Espanol de Credito, S.A. (Banesto)

	[1]**2007**	**2006**	**2005**	**2004**	**2003**	**Avg.**
Total assets (EUR billion)	**111.95**	**105.35**	**88.04**	**69.58**	**57.93**	[2]**17.41**
Total capital (EUR billion)	**6.81**	**6.61**	**6.30**	**6.04**	**3.96**	[2]**15.10**
Return on average assets	**0.72**	**1.60**	**0.83**	**0.82**	**0.83**	**0.96**
Recurring earnings power [3]	**1.24**	**1.11**	**1.51**	**1.60**	**1.31**	**1.36**
Net interest margin	**1.42**	**1.32**	**1.52**	**1.73**	**2.10**	**1.62**
Cost/income ratio (%)	**44.87**	**49.81**	**46.68**	**49.33**	**54.80**	**49.10**
Problem loans % gross loans	**0.53**	**0.47**	**0.55**	**0.68**	**0.81**	**0.61**
Tier 1 ratio (%)	**6.98**	**7.43**	**7.06**	**7.16**	**7.46**	**7.22**

[1] As of December 31. [2] Compound annual growth rate. [3] Preprovision income % average assets.

Opinion

SUMMARY RATING RATIONALE

Moody's assigns a bank financial strength rating (BFSR) of B- to Banco Español de Crédito, S.A. (Banesto) which translates to a Baseline Credit Assessment of A1. The rating derives from Banesto's solid nationwide franchise, sound risk positioning, albeit with high borrower concentrations, and strong financial metrics, particularly cost efficiency and asset quality indicators.

Banesto's long-term global local currency (GLC) deposit rating at Aa2 is based on very high systemic support and on the high probability of support from its parent, Banco Santander, S.A. (Baseline Credit Assessment at Aa3 and GLC deposit rating at Aa1). These two forms of parental support result in a two-notch uplift from the A1 Baseline Credit Assessment. Banesto's debt rating is Aa2.

Credit Strengths

- Role as a strategic asset for its parent bank, Santander

- Sustained strong business growth across targeted business lines is translating into market share gains

- Strong focus on cost control continues to translate into efficiency gains

- Overall, low risk profile underpinned by domestic retail focus and conservative credit culture

- Focus on customer-driven activity translates into limited market risks

Credit Challenges

- To continue gaining market share and to deliver earnings growth in the currently more challenging operating environment

- To further develop cross-selling opportunities

- Inherent risk of large single-name concentrations

- To manage increased pressure on liquidity for the system as a whole

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

A sustained improvement in risk-weighted profitability to the 2.4%-3.5% range and stronger capital adequacy indicators (Tier-1 at 8-10% and core capital as a percentage of RWA solidly above 6% , without any accompanying deterioration in the bank's risk profile, asset quality and efficiency levels, could lead to positive pressure on the BFSR. In addition, a reduction in borrower concentrations - with top 20 group exposures not higher than 100% of Tier-1 or 350% of pre-provision income - would be required to generate positive rating pressure. An upgrade of Santander's debt rating could lead to an upgrade of Banesto's debt ratings. The likelihood of occurrence is currently very low given the stable outlook on Santander's ratings.

What Could Change the Rating - Down

Measured as a percentage of total loans and Tier-1 capital levels, Banesto's exposure to the real estate and construction sectors - two sectors that are going through a sharper than expected correction - are in line with the median of B- rated peers. Its risk absorption capacity, although sound, deviates by approximately 20% from the median. A larger deviation could result into downward pressure on ratings. In addition, failure to continue delivering recurring earnings growth and to maintain control over operating costs and sound asset quality indicators could lead to negative pressure on the bank's BFSR. A downgrade of Santander's debt ratings and/or signs of lower expected support from its parent bank could lead to a downgrade of Banesto's debt ratings. The likelihood of occurrence is currently very low given the stable outlook on Santander's ratings.

Recent Results and Company Events

Banesto posted net profits of EUR 218 million in March 2008, up by 16% compared with the same period last year. Pre-provision income increased by 15% year-on-year to EUR 362 million with a limited contribution - 7% of operating income - from market-related activities. Similar to its peers, asset quality indicators are weakening (problem loans as a percentage of total loans at 0.59% from 0.42% in the same period last year) and were 266.53% provided for (390.08% in March 2007). The bank's Tier-1 ratio stood at 7% and its core capital was 6.3%.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Banesto's ratings are as follows:

Bank Financial Strength Rating

Moody's assigns a bank financial strength rating (BFSR) of B- to Banco Español de Crédito, S.A. (Banesto), which translates to a Baseline Credit Assessment of A1. The rating is based on Banesto's sustained improvement in its creditworthiness - namely ongoing cost efficiency gains, improved revenue-generation capacity and sound risk profile, although with large borrower concentration - and strengthened domestic franchise. Under Banco Santander's ownership, Banesto's financial fundamentals have consistently improved on the back of strict implementation of strategic guidelines. As a result, the bank displays strong commercial dynamism resulting in market share gains while extensively streamlining its cost base.

Banesto displays relatively high credit risk concentration on the largest borrower, and exposure to the construction and real-estate sector is in line with similarly rated domestic peers. Earnings predictability is high, aided by its retail focus. The gap between the bank's 9.5% share (around 4% including savings banks and co-ops) of domestic business volumes (loans, deposits and funds under management) and its 12% share (6% including savings banks and co-ops) of total branches in Spain reflects the fact that, despite recent gains, there is ample scope for the bank's retail activities to grow further. In this respect, we believe that one of Banesto's key challenges is to continue delivering recurring earnings growth, an uphill task, in our view, in light of the current credit environment. Aside from borrower concentration, other key elements constraining Banesto's BFSR are its below-average scores on profitability and capital adequacy levels when compared to similarly rated Western European peers.

As a point of reference, the assigned BFSR is in line with the B- outcome of Moody's financial strength scorecard.

Qualitative Rating Factors (50%)

Factor 1: Franchise Value

Trend: Stable

Banesto is Spain's fourth-largest bank with total assets of EUR 112 billion at the end of March 2008 and a market share around 4% in loans and deposits (including both commercial banks and savings banks) which, despite consistent increases over recent years, remains below its 6% share of total branches in the Spanish banking system. The bank operates through an extensive network of 1,946 branches offering services to about 2.3 million customers throughout Spain and enjoys a leading franchise in rural areas. Excluding savings banks, Banesto holds an average 9% market share of the banking business in Spain, comprising 9.45% in lending, 9.27% of customer funds and 7.4% in funds under management at the end of February 2008. Earnings stability is high, underpinned by its retail banking operation, which is the bank's most important segment.

Breakdown of earnings by business lines at the end of March 2008 is as follows:

- 32% individuals (excluding mortgages)

- 19% small companies

- 13% medium-sized corporates

- 12% individual mortgages

- 7% large corporates

- 5% real estate developers

- 12% others

These characteristics are appropriately captured by a B score on franchise value.

Banesto has been gradually strengthening its franchise value, on the back of robust, above-market-average growth and resultant market share increases in targeted product and customer areas with a strong focus on recurrent earnings. Notwithstanding the above, we do not foresee any major changes that could warrant a higher score in the near future. The bank's focus continues to be on cross-selling to its existing customer base - where there is still ample room for growth - as well as enhancing its product offering, and further expansion into areas where its market share needs improvement.

Factor 2: Risk Positioning

Trend: Neutral

We notice that the perimeter of the mandate for Santander's Board Risk Committee and the central risk management function include the Santander Group, with the exception of Banesto. In this regard, Moody's would welcome a more integrated risk management approach between the latter and the Santander Group as a whole. Notwithstanding the above, Banesto enjoys a strong risk governance structure, high-quality risk infrastructure and risk management systems. We note there is a good risk culture throughout the organisation, and clear separation of risk and business functions. We note, however, that one of Banesto's weaknesses compared to international peers is its exposure to some large risks, both on- and off-balance sheet, with a significant exposure to the 20 largest exposures. Although the bank has reduced these exposures when compared to tier-1 capital ratios, they still remain high as a percentage of pre-provision income. Industry concentration is not a source of concern.

Banesto's treasury activities have been reoriented towards a more customer-driven profile by leveraging the bank's large customer base and distribution capability, with the goal of increasing recurring revenues. We note that Banesto is exposed to market risk as not all of its treasury activities are back-to-back. Pure trading activity is very limited. Banesto has chosen a policy of actively managing interest rate risk on its balance sheet by running an open position in its public debt investment portfolio that covers about 40-50% of its balance sheet interest rate risk. Overall, the sensitivity of both the trading and non-trading books to major changes in key financial variables (including interest rates, FX, equity prices, credit spreads) as a percentage of Tier-1 capital is low, as reflected in the score of A for this sub factor.

In common with its peers, Banesto's deposit growth has not kept pace with the rapid growth of its loan portfolio in recent years. The bank's average loan-to-average customer deposit ratio has been persistently rising over the past few years reaching 194% at year-end 2007, leading to a greater reliance on market funds. Nonetheless, the bank enjoys a positive net position in the interbank market. Apart from securitisations and the issuance of mortgage-covered bonds (cédulas hipotecarias) to fund mortgage lending, growth has mostly been funded by medium- to long-term market funds, leading to a better match between assets and liabilities. However, Banesto has a relatively high concentration of debt maturing in the short-term, arising from commercial paper placed with domestic clients. This instrument, which is a tax-efficient alternative to time deposits, has so far proven to be a stable source of funding during the current liquidity crunch. In addition, Banesto has also senior debt maturing in the following quarters. In order to offset these short-term pressures on liquidity, Banesto has increased the amount of eligible ECB assets fully covering up coming maturites in the following quarters. Banesto has also established prudent contingency planning that incorporates the analysis of net funding requirements under both bank-specific and market-related crisis scenarios.

We believe all these characteristics are appropriately captured by a score of C in risk positioning.

Factor 3: Regulatory Environment

This factor does not address bank-specific issues; instead it evaluates whether regulatory bodies are independent and credible, have demonstrable enforcement powers and adhere to global standards of best practices for risk control. Refer to Moody's Banking System Outlook for Spain, last published in April 2008, for a detailed discussion of the Spanish regulatory environment.

Factor 4: Operating Environment

Trend: Neutral

This factor is common to all Spanish banks. Moody's assigns a score of B- for overall operating environment. Moody's outlook for the Spanish banking system is currently negative. The outlook indicates Moody's view of the direction of credit fundamentals for the industry over the next 12 to 18 months. This view will reflect the key fundamental drivers for credit quality in the industry/banking system, such as economic growth; trends in profitability and margins, leverage, and asset quality; competitive conditions; overall demand trends; legal and regulatory issues. Refer to Moody's Banking System Outlook for Spain, published April 2008, for a detailed discussion of the operating environment in Spain.

Quantitative Rating Factors (50%)

Factor 5: Profitability

Trend: Weakening

Banesto's net interest income (NII) grew by 14% in March 2008, compared to the same period last year, on the back of strong business growth, particularly in targeted products, and somewhat wider net interest margins (NIM). We do not expect, however, that NIMs will maintain a positive trend on the back of the current liquidity crunch which is increasing funding costs system-wide. Although up until now, Banesto has successfully passed on higher funding costs to the asset side of the balance sheet, we do not believe this will be sustainable if the current liquidity crunch persists. NIMs were unchanged compared to the previous quarter.

The contribution of non-interest income to operating income has remained unchanged at around 25% and reflects Banesto's strategic focus on cross-selling and the growing importance of the distribution of treasury products to SMEs, which at the end of March 2008 accounted for close to 93% of the bank's profits from financial operations. Fee and commission income was up by 3.9%. Banesto has made further progress in generating commissions from mutual funds, traditional banking operations and the distribution of insurance products. The bank continues to actively promote cross-selling, which should help to drive continued improvement in non-interest income. As discussed above, we believe that despite expected slower growth in RWAs higher funding costs will lead to weakening of profitability indicators, going forward. The three-year average for pre-provision income/ RWA stands at 2%, which translates into a score of C. The net income/RWA is also at C.

Factor 6: Liquidity

Trend: Weakening

In common with its domestic peers, Banesto has increased its reliance on wholesale funds over recent years. Moody's acknowledges that the bank's liquidity position is prudently managed, with alternative sources of liquidity in place such as covered bonds and securitisation programmes although these markets are now effectively closed. In addition, the increasing dependence on market funds is well diversified. Similar to its domestic peers, we note Banesto's increased recourse to short-term funds in the form of domestic "pagarés" (whilst being a relatively stable source of funding during the current crisis) weaken in our view the bank's liquidity position given its short-term nature and the fact that this stability has not been tested in the case of a "name crisis" scenario. We have assigned a weakening trend to this factor on the back of the current global credit crisis and the challenges being faced by Spanish banks, including Banesto, to access wholesale markets. Notwithstanding the above, and to better reflect the position of the bank, we have adjusted the market funds by excluding securitisation bonds and covered bonds as well as long-term debt, which results in a score of B-.

Factor 7: Capital Adequacy

Trend: Neutral

Banesto's capital ratios have been maintained at satisfactory levels despite its aggressive growth strategy although we note that the Tier-1 - at 7% at the end of March 2008 - is somewhat below that of similarly rated peers in Western Europe. Given the expected slowdown in activity and thus in RWAs, we do not expect the bank's capital adequacy ratios to materially deteriorate from existing levels. Moreover, we expect prudent capital discipline to be maintained going forward.

Factor 8: Efficiency

Trend: Improving

In spite of above-market-average growth across all business lines and the opening of branches - in July 2007, Banesto completed its branch expansion programme with the opening of 300 branches in 18 months - Banesto's cost-to-income ratio compares very favourably with its Western European peers and is in line with a score of B. Efficiency gains remain one of management's key strategic targets and the bank's cost-efficiency ratio has displayed sustained improvement over the past few years via strict cost control as well as by leveraging on its enhanced IT platform, thereby reducing the number of employees dedicated to back office functions - to 3.5% in 2007 from 8% in 2001. Although under Plan Menara, Banesto is committed to continue to achieve both operational and commercial efficiencies we do not expect these to be of significance as the bank predicts less modest revenue growth for the system as a whole than in previous years. Banesto has set aside EUR 256 million from the sale of Urbis for a new three-year extraordinary early-retirement plan.

Factor 9: Asset Quality

Trend: Weakening

Similar to its domestic peers, Banesto's asset quality indicators are gradually deteriorating although they remain at sound levels, placing the bank in a comfortable position to accommodate further asset quality deterioration. The bank's score of A for asset quality reflects its focus on retail activities, strict and prudent underwriting criteria, and strong monitoring systems. At the end of March 2008, problem loans reached 0.59% of total loans (0.42% in March 2007) and were close to 267% provided for (390% in March 2007).

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a global local/foreign currency (GLC) deposit rating of Aa2 to Banesto.

The GLC deposit rating is supported by Banesto's Baseline Credit Assessment of A1 and by the Aaa local currency deposit ceiling (LCDC) of Spain and the Aa3 Baseline Credit Assessment of its parent bank, Santander. As a result, the bank receives a two-notch uplift from its Baseline Credit Assessment, bringing the GLC rating to Aa2.

The probability of systemic support in the event of a stress situation is judged to be very high. This is based on Banesto's tier-2 status in the Spanish banking system and our view that likely systemic support would not be lower than for other regional players with dominant market position in their regions. Banesto has nationwide market shares of around 4%. Spain is characterised as a medium support country. In addition, Banesto's ratings benefit from a high probability of support for its parent bank Santander. Moody's believes that Banesto is a strategic asset for Santander, as it counter-balances the more volatile earnings derived from the group's sizeable exposure in Latin America.

Notching Considerations

In line with Moody's notching guidelines published in April 2007, Banesto's dated and undated subordinated debt is rated at Aa3, that is, one notch below the bank's senior debt rating. The bank's preferred shares are rated at A1, two notches below the bank's senior debt rating.

Foreign Currency Deposit Rating

Banesto's foreign currency deposit ratings are Aa2/Prime 1.

Foreign Currency Debt Rating

Banesto's foreign currency debt ratings are Aa2/Prime 1.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Risk Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Banco Español de Credito, S.A.

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (50%)						**B-**	
Factor: Franchise Value						**B**	**Improving**
Market Share and Sustainability		**x**					
Geographical Diversification		**x**					
Earnings Stability		**x**					
Earnings Diversification [2]							
Factor: Risk Positioning						**C**	**Neutral**
Corporate Governance [2]							
- Ownership and Organizational Complexity	--	--	--	--	**--**		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
Controls and Risk Management		**x**					
- Risk Management		x					
- Controls	x						
Financial Reporting Transparency		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information		x					
Credit Risk Concentration	**--**	**--**	**--**	**--**	**--**		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management		**x**					
Market Risk Appetite	**x**						
Factor: Operating Environment						**B-**	**Neutral**
Economic Stability		**x**					

Integrity and Corruption			x				
Legal System		x					
Financial Factors (50%)						**B-**	
Factor: Profitability						**C**	**Weakening**
PPP % Avg RWA			2.01%				
Net Income % Avg RWA			1.55%				
Factor: Liquidity						**C**	**Weakening**
(Mkt funds-Liquid Assets) % Total Assets					21.98%		
Liquidity Management		x					
Factor: Capital Adequacy						**B**	**Neutral**
Tier 1 ratio (%)			7.16%				
Tangible Common Equity % RWA	7.46%						
Factor: Efficiency						**B**	**Improving**
Cost/income ratio		47.12%					
Factor: Asset Quality						**A**	**Weakening**
Problem Loans % Gross Loans	0.52%						
Problem Loans % (Equity + LLR)	6.15%						
Lowest Combined Score (15%)						**C**	
Economic Insolvency Override						**Neutral**	
Aggregate Score						**B-**	
Assigned BFSR						**B-**	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information
[2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral