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CREDIT OPINION
15 July 2021

Update

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RATINGS

PKO Bank Hipoteczny S.A.

Domicile	Poland
Long Term CRR	A2
Long-term issuer rating	A3
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Melina Skouridou, CFA +357.2569.3021
Vice President - Senior Analyst
melina.skouridou@moodys.com

Maria Asensio +34.91.768.8249
Associate Analyst
maria.asensio@moodys.com

Maria Jose Mori +34.91.768.8227
VP-Sr Credit Officer
mariajose.mori@moodys.com

Alexander Hendricks, CFA +49.69.70730.779
Associate Managing Director
alexander.hendricks@moodys.com

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PKO Bank Hipoteczny S.A.

Update following rating action and publication of new Banks Methodology

Summary

On 13 July, we upgraded PKO Bank Hipoteczny S.A.´s (PKO BH) long-term issuer rating to A3 with a stable outlook. We also upgraded the bank´s Counterparty Risk Ratings (CRRs) to A2/P-1, and its Counterparty Risk Assessment (CRA) to A2(cr)/P-1(cr).

PKO BH's ratings and assessments are aligned with those of its parent, Powszechna Kasa Oszczednosci Bank Polski S.A. (PKO BP, A2/A3 stable, BCA baa2)[1] reflecting our view that there is a low probability that PKO BP would de-prioritize meeting the debt obligations of PKO BH relative to meeting its own obligations in circumstances of financial stress for the parent or group entities.

Our assessment is driven by PKO BP's full ownership; PKO BH's high strategic importance as the group's covered bond issuing vehicle, which is required per the Polish legal framework for mortgage covered bonds; PKO BH's small size and absence of an independent franchise, which leads to a high degree of financial links and operational integration within the group. PKO BP has committed itself to maintaining the capital and liquidity of its subsidiary at satisfactory levels, meeting all regulatory requirements.

Credit strengths

» High strategic fit and operational integration within the group

» PKO BP's commitment to support PKO BH's capitalisation and liquidity

Credit challenges

» Limited standalone franchise

Outlook

The outlook on PKO BH's issuer rating is stable, in line with the stable outlook on PKO BP's long-term deposit and senior debt ratings.

Factors that could lead to an upgrade

PKO BH's issuer rating CRA and CRRs could be upgraded following an upgrade of the respective ratings of its parent bank.

Factors that could lead to a downgrade

A downgrade of PKO BP's rating would result in a similar action on the ratings and assessment of PKO BH. We could also downgrade PKO BH's rating in case the relationship between the subsidiary and its parent changes to an extent that would significantly reduce the level of integration between the two, leading to a withdrawal of the parent's commitment to support the mortgage bank's liquidity and capital buffers.

Key indicators

Exhibit 1

PKO Bank Hipoteczny S.A. (Unconsolidated Financials) [1]

	12-20[2]	12-19[2]	12-18[2]	12-17[2]	12-16[2]	CAGR/Avg.[3]
Total Assets (PLN Billion)	27.3	27.3	22.1	16.9	8.6	33.5[4]
Total Assets (USD Million)	7,329.7	7,196.0	5,883.6	4,864.3	2,062.7	37.3[4]
Tangible Common Equity (PLN Billion)	1.9	1.9	1.4	1.2	0.8	25.1[4]
Tangible Common Equity (USD Million)	521.3	491.0	377.9	358.3	190.2	28.7[4]
Problem Loans / Gross Loans (%)	0.1	0.1	0.0	0.0	0.0	0.0[5]
Tangible Common Equity / Risk Weighted Assets (%)	18.4	16.6	15.2	15.6	17.2	16.6[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	1.3	0.9	0.6	0.2	0.0	0.6[5]
Net Interest Margin (%)	1.2	1.3	1.3	1.2	1.4	1.3[5]
PPI / Average RWA (%)	1.5	1.4	1.5	1.2	0.8	1.3[6]
Net Income / Tangible Assets (%)	0.3	0.3	0.4	0.3	0.2	0.3[5]
Cost / Income Ratio (%)	50.6	51.7	46.5	49.8	66.9	53.1[5]
Market Funds / Tangible Banking Assets (%)	67.9	62.6	63.5	66.4	72.0	66.5[5]
Liquid Banking Assets / Tangible Banking Assets (%)	4.5	4.6	3.8	4.9	3.6	4.3[5]
Gross Loans / Due to Customers (%)	376158.6	529453.3	484027.1	764532.7	532579.7	537350.3[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully loaded or transitional phase-in; IFRS. [3] May include rounding differences because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. [5] Simple average of periods for the latest accounting regime. [6] Simple average of Basel III periods.

Sources: Moody's Investors Service and company filings

Profile

PKO Bank Hipoteczny S.A. (PKO BH) is the mortgage banking subsidiary of PKO BP, the largest commercial bank in Poland (A2 stable). PKO BH specialises in granting residential mortgage loans to individuals and acquiring receivables with respect to residential mortgage loans granted by PKO BP, which are primarily financed by the proceeds of the mortgage-covered bond issuances. As of 31 December 2020, the bank sold its mortgage loans through PKO BP's distribution network of around 1,004 branches, and 492 agents and intermediaries.

PKO BH is the largest mortgage bank in Poland in terms of total assets, which totalled PLN26.9 billion (€6 billion) as of March 2021. As of March 2021, PKO BH had a market share of 66% in the Polish covered bond market.

In addition to being subject to similar licensing procedures, regulatory supervision and monitoring as commercial banks, mortgage banks in Poland have to comply with additional regulations targeting this specific type of institution.

Recent developments

We maintain a stable outlook for the Polish banking system. The outlook reflects our expectation that Poland's GDP will recover to pre-pandemic levels in 2021, supporting growth in banks' corporate lending and in their fee and commission income. The sector's existing provisions will absorb a modest increase in nonperforming loans (NPLs). The banks will likely make a collective loss if they offer voluntary conversions of Swiss franc denominated mortgages into zlotys at unfavourable exchange rates, as proposed in December 2020 by the head of Poland's financial regulator.[2]

Since March 2020, the Polish government has concluded a series of proactive measures to support Polish businesses and employment, and help Polish banks weather the negative economic effects of the pandemic. The authorities' total support package to mitigate the effects of the coronavirus pandemic-induced economic shock amounts to PLN320 billion-PLN330 billion, or 14% of GDP, and comes on top of an already supportive fiscal policy in relation to household disposable income. Following the second wave of the pandemic, the government has made available additional funds.

Several measures have been taken by the authorities to support Polish banks, including a relaxation of capital measures, the cancellation of the 3% systemic risk buffer, a recommended ban on dividends in effect since March 2020, which will be reassessed in the second half of 2021, and actions to ensure banks' access to liquidity from Narodowy Bank Polski (NBP), the central bank. The central bank has also lowered interest rates to the historic low level of 0.10%, and started a debt purchase programme to support low yields.

Detailed credit considerations

High strategic fit and operational integration within the group

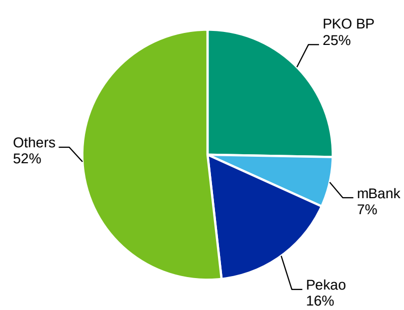
PKO BH was established and started its operations in April 2015 with the aim to provide the PKO BP group with access to covered bonds, which — under Polish regulations — can only be issued through mortgage banks. The group benefits from the mortgage bank in the form of reduced maturity mismatch between assets and liabilities as a result of the issuance of covered bonds, diversified sources of funding and lower cost of wholesale funding.

PKO BH originates mortgages using the parent bank's credit policies and the group's distribution network and IT infrastructure. Post-sale services are provided by PKO BP based on an outsourcing agreement. In addition, PKO BH only accepts the transfer of local-currency mortgages from PKO BP. As a result, PKO BH does not have exposure to foreign-currency mortgages, which carry high legal and social risks, and is not affected by the higher risk weight assigned to foreign-currency mortgages.

PKO BH is a strategic part of the PKO BP group and a visible part of its business. PKO BH's operations are highly integrated within the group, and it uses the same logo and branding as the PKO BP group. However, although the mortgage bank uses the group's infrastructure and IT resources, and relies on the group for post-sale services, it operates under an independent board and the credit decision process of the mortgage bank is independent from that of PKO BP. In addition to being subject to similar licencing procedures, regulatory supervision and monitoring as commercial banks, mortgage banks in Poland have to comply with regulations targeting these specific types of institutions.

Exhibit 2

PKO BP has a significant share of domestic-currency residential mortgages in Poland
As of the end of December 2020



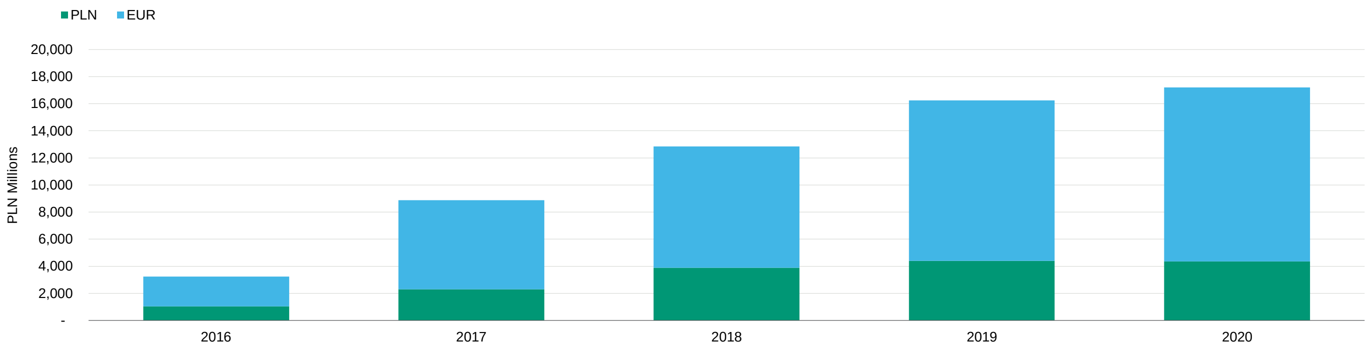
Sources: Banks' reports and NBP

PKO BH is the largest issuer of covered bonds in Poland. PKO BH has, to date, successfully placed multiple covered bond issuances, both on the domestic and international debt markets (see Exhibit 3). In 2020, the mortgage bank did not do any issuances because of the group's strong liquidity and its ample access to lower-cost deposits. In 2019, PKO BH carried out five issues of covered bonds, including the first two green covered bond issues in Poland (domestic bond issues of PLN250 million each). As of March 2021, PKO

BH had covered bonds outstanding with a nominal value of around PLN17.3 billion, slightly up from the value as of December 2020 because of the foreign-exchange rate difference.

We expect PKO BH to grow its balance sheet at a contained rate in 2021 and mainly focus its covered bond issuances on green bonds.

Exhibit 3
PKO BH's covered bond outstanding by period
By original issuance currency



Sources: Moody's Investors Service and company reports

PKO BP's commitment to support its subsidiary

PKO BP has made a public commitment to maintain the capital and liquidity ratios of its subsidiary at satisfactory levels and within the limits required by the relevant banking regulation. In case of a breach of the regulatory requirements, the Polish Financial Supervision Authority (PFSA) has the necessary powers under the Banking Act to require PKO BP to recapitalise or provide liquidity to its subsidiary. In case of refusal, the PFSA can intervene by limiting voting rights and dividend payments. However, PKO BH does not benefit from an explicit, full and irrevocable guarantee against its liabilities from its parent bank, and, as a result, we adjust the mortgage bank's issuer rating downward by one notch from PKO BP's senior debt rating.

PKO BH's total capital ratio was 18.9% as of March 2021, up from 18.7% as of the end of December 2020 and significantly higher than the 16.6% as of year-end 2019, and its leverage ratio was 7.5% as of March 2021. PKO BH must also comply with the minimum liquidity ratio defined by the PFSA and with the liquidity coverage ratio defined by the EU's Capital Requirements Regulation. In addition, the bank is no longer exempted from paying bank tax because the size of its assets has grown above the threshold specified in the bank tax law.

ESG considerations

In line with our general view of the banking sector, PKO BH has a low exposure to environmental risks. See our environmental risks heat map for further information.

Overall, we expect banks to face moderate social risks. This includes considerations in relation to the rapid and widening spread of the pandemic because of the substantial implications for public health and safety, and the deteriorating global economic outlook, which are creating a severe and extensive credit shock across many sectors, regions and market. See our social risks heat map for further information.

For Polish banks, we have identified rising legal risks related to foreign-currency mortgages as a key social risk. At this stage, there is high uncertainty surrounding how the borrower-friendly judgement of the European Court of Justice will affect Polish banks. However, the sector is exposed to the risk of significant potential losses and reputational damage because of the growing number of lawsuits that the banks face from their customers who claim their contracts contained abusive terms. PKO BH has no exposure to foreign-currency mortgages although its parent bank, PKO BP, has a moderate exposure. In April 2021, PKO BP's shareholders approved the rollout of voluntary conversions of all Swiss franc mortgages as proposed in December 2020 by the head of the PFSA, which resulted in PKO BP reporting a loss for 2020.

Corporate governance is highly relevant for PKO BH, as it is to all entities in the banking industry. Corporate governance weaknesses can lead to a deterioration in a bank's credit quality, whereas governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven. For PKO BH, we do not have any particular governance concern. Nonetheless, corporate governance remains a key credit consideration and requires ongoing monitoring.

Support and structural considerations

Counterparty Risk Ratings (CRRs)

PKO BH's CRRs are A2/P-1

PKO BH's CRRs are aligned with PKO BP's A2/P-1 CRRs. In our view it is unlikely that PKO BP would prioritise its own obligations over those of PKO BH in circumstances where the parent itself is facing material difficulties. We also take into account the parent bank's public commitment to support its mortgage bank subsidiary.

Counterparty Risk (CR) Assessment

Because the CR Assessment captures the probability of default on certain senior operational obligations, rather than expected loss, we focus purely on subordination and take no account of the volume of the instrument class

PKO BH´s CR Assessments are A2(cr)/P-1(cr)

PKO BH's CR Assessment is aligned with PKO BP's A2(cr)/P-1(cr) CR Assessment, based on our view that PKO BP would unlikely prioritise its own obligations over those of PKO BH in circumstances where the parent itself is facing material difficulties.

Ratings

Exhibit 4

Category	Moody's Rating
PKO BANK HIPOTECZNY S.A.	
Outlook	Stable
Counterparty Risk Rating	A2/P-1
Counterparty Risk Assessment	A2(cr)/P-1(cr)
Issuer Rating	A3
ST Issuer Rating	P-2
PARENT: POWSZECHNA KASA OSZCZEDNOSCI BANK POLSKI S.A.	
Outlook	Stable
Counterparty Risk Rating	A2/P-1
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A2(cr)/P-1(cr)
Senior Unsecured	A3
Other Short Term	(P)P-2

Source: Moody's Investors Service

Endnotes

1 The ratings shown in this report refer to the bank's deposit ratings, senior unsecured debt ratings and Baseline Credit Assessment.

2 Polish banks face legal action from some customers who took out Swiss franc-denominated mortgages to benefit from Switzerland's lower interest rates but have faced higher repayments since 2015, when the Swiss franc rose strongly against the zloty. While binding legal outcomes have been few and varied they have resulted in losses for the banks. Thus, banks are provisioning against their entire stock of Swiss franc mortgages, based on the court´s decision although this is not our base case.

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