



Moody's Investors Service

Credit Opinion: **Espirito Santo Financial Group S.A.**

Global Credit Research - 20 Jan 2010

Luxembourg

Ratings

| Category | Moody's Rating |
|---|----------------|
| Outlook | Stable |
| Issuer Rating | A3 |
| Senior Unsecured -Dom Curr | A3 |
| Subordinate -Dom Curr | Baa1 |
| Commercial Paper -Dom Curr | P-2 |
| Banco Espirito Santo S.A., London Branch | |
| Outlook | Stable |
| Bank Deposits -Dom Curr | A1/P-1 |
| Senior Unsecured MTN | A1 |
| Subordinate MTN | A2 |
| Jr Subordinate MTN | *A2 |
| Commercial Paper | P-1 |
| Other Short Term | P-1 |
| Banco Espirito Santo, S.A. | |
| Outlook | Stable |
| Bank Deposits | A1/P-1 |
| Bank Financial Strength | C- |
| Senior Unsecured -Dom Curr | A1 |
| Subordinate -Dom Curr | A2 |
| Jr Subordinate MTN -Dom Curr | *A2 |
| Commercial Paper -Dom Curr | P-1 |
| Other Short Term -Dom Curr | P-1 |

* Placed under review for possible downgrade on November 18, 2009

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Key Indicators

Espirito Santo Financial Group S.A.

| | [1]2008 | 2007 | 2006 | 2005 | 2004 | Avg. |
|------------------------------|---------|-------|-------|-------|-------|-------|
| Total assets (EUR billion) | 78.15 | 71.31 | 59.15 | 56.74 | 47.84 | 62.64 |
| Total capital (EUR billion) | 7.67 | 7.85 | 6.48 | 5.37 | 4.23 | 6.32 |
| Return on average assets | 0.54 | 1.00 | 1.54 | 0.52 | 0.33 | 0.78 |
| Recurring earnings power [2] | 0.90 | 1.13 | 1.30 | 1.16 | 0.88 | 1.07 |
| Net interest margin | 1.82 | 1.74 | 1.81 | 1.96 | 1.99 | 1.86 |
| Cost/income ratio (%) | 69.12 | 64.90 | 54.66 | 63.60 | 72.15 | 64.89 |
| Problem loans % gross loans | 1.58 | 1.40 | 1.50 | 1.63 | 1.94 | 1.61 |
| Tier 1 ratio (%) | 6.50 | 7.10 | 8.40 | 0.00 | 0.00 | 4.40 |

[1] As of December 31. [2] Preprovision income % average assets.

Opinion

SUMMARY RATING RATIONALE

Moody's assigns issuer and long term senior debt ratings of A3 to Espírito Santo Financial Group, S.A. (ESFG). We consider that ESFG's senior obligations are structurally subordinated relative to the direct obligations of Banco Espírito Santo (BES) - the Portuguese commercial bank controlled by ESFG, which accounts for the large majority of the group's assets and net income - and as result ESFG is rated A3, two notches below the A1 long-term senior debt and deposit ratings of BES.

Credit Strengths

- Leading market shares in the Portuguese banking and insurance markets, mainly through BES and Tranquilidade
- Willingness and proven commitment to support its subsidiaries, as witnessed by the recent capital increase of BES

Credit Challenges

- Deteriorating financial fundamentals of ESFG's two main assets (BES and insurance operations)
- Structural subordination of ESFG's creditors to the direct obligations of BES
- Systemic support may be limited given that ESFG is not based in Portugal and that during the financial crisis, holding companies have sometimes been excluded from government support

Rating Outlook

The outlook on ESFG's issuer and long term senior debt ratings is stable, while preferred securities are currently under review for possible downgrade.

What Could Change the Rating - Up

An upgrade of the ratings is very unlikely in the short-term, given the recent downgrade. However, upward pressure could result from a material strengthening of the group's activities and performance and, particularly, an upgrade of BES's deposit and debt ratings could lead to an upgrade of ESFG's ratings.

What Could Change the Rating - Down

A downgrade in BES's deposit and debt ratings would likely lead to a downgrade of ESFG's issuer rating.

Recent Results and Developments

On 16 September 2009 Moody's downgraded ESFG's issuer rating to A3 from A2, which concluded the review for possible downgrade of ESFG's issuer rating. Moody's also downgraded the short-term ratings of ESFG's ECP programme to Prime-2 from Prime-1 and the preferred securities to Baa2, currently under review for possible downgrade, from Baa1. These actions reflected the downgrade of BES to A1/P-1/C-, which is ESFG's main operating subsidiary and accounted for 90% of ESFG's operating income in H1 2009.

In the first nine months of 2009, ESFG reported an unaudited consolidated 20.3% year-on-year increase in net interest income to EUR 976.5 million, as a result of significant contributions from Portuguese and international banking operations. Fee and commission income was up by 12.3%, while insurance earned premiums net of reinsurance and claims incurred net of reinsurance decreased by 10.1% and 10.0%, respectively, on the back of increased competition in the Portuguese market. Total operating expenses increased by a modest 3.4%, while loan loss provisions were up by 56.8%. Reported net profit stood at EUR 101.3 million, up 53.9% year-on-year.

The cost-to-income ratio improved to 56.0% from 69.1% a year before. The reported NPL ratio at the end of September 2009, over 90 days, was 1.56% and the coverage ratio, over 90 days, was 186.4%. Core and Tier 1 capital ratios under the IRB Foundation were 7.1% and 8.2%, respectively.

On 15 September 2009, ESFG announced that it had increased its participation in Saxo Bank to around 5% through the exchange of a 25.0% stake in Banco Electrónico de Serviço Total.

DETAILED RATING CONSIDERATIONS

Detailed considerations for ESFG's currently assigned ratings are as follows:

ESFG's issuer and long-term senior debt ratings are A3. This rating incorporates the following: (i) Moody's view on the probability of systemic support for this holding company; and (ii) probability of support from BES, its main banking subsidiary (please refer to Moody's latest credit opinion for more details on BES). The structural subordination of ESFG's creditors and Moody's assessment that systemic support for ESFG is less certain is reflected in the two-notch differential between the issuer rating of ESFG and BES's long-term debt and deposit ratings.

Moody's believes that the very high probability of systemic support available to BES might not be extended to ESFG in case of need, given that, during the ongoing financial crisis, the Portuguese government has sometimes excluded holding companies from government support. Nonetheless, Moody's considers that support would likely be provided by BES.

ESFG is a Luxembourg-based company that owns the financial interests of the Espírito Santo family. In April 2009, ESFG subscribed to its full entitlement in BES's EUR 1.2 billion capital increase, maintaining its economic interest (both directly and indirectly) at 29% (with a voting interest of 42%). BES is the main financial asset of the Espírito Santo family. As a result, Moody's expects that BES would support ESFG in case of financial difficulties. The nature of BES as a regulated bank, however, constrains the extent to which funds could be upstreamed to ESFG.

ESFG's issuer rating also takes into account ESFG's other main businesses, which include

insurance (mainly through Companhia de Seguros Tranquilidade, but also through LOGO, T-Vida and AdvanceCare, in partnership with United Health Care), health care and asset management.

At the end of September 2009, banking operations represented 95.9% of total assets and 98.3% of net income, while insurance business accounted for 1.9% of total assets and 1.7% of net income. As of the same date, the contribution from Portuguese operations to the group's total assets and net income was 96.0% and 74.0%, respectively.

At year-end 2008, ESFG had a market share of the Portuguese banking market of 20.7%, with a particular strong position in corporate lending (24% market share). In terms of the insurance sector, ESFG had a market share of 13.2% at the end of September 2009, making it the third-biggest player in the market.

The group's insurance operations have experienced some volatility over the last few years, although market shares have remained good (albeit somewhat lower). As at end-September 2009, insurance income accounted for 4.5% of operating income (versus 2.18% as at end-December 2008), while net interest income represented 48.3% (versus 51.8%). As at end-September 2009, Tranquilidade's combined ratio stood at 104.4% from 107.2% a year before. The claims ratio (net of reinsurance) decreased to 60.5% (from 67.9% in September 2008).

Following cautious international expansion over the years, the group now has a growing presence abroad, mainly in Spain and Angola through BES, and in Brazil, France, Switzerland, the UAE and the Far East. However, Portugal remains the largest contributor to its consolidated net income. While the group's expansion strategy provides income diversification and cross-selling opportunities, we are cautious about the challenges that it may face in highly competitive and/or lower-rated countries, in particular the group's exposure to Spain and to less mature markets.

ESFG is supervised on a consolidated basis by the Bank of Portugal. On 30 April 2009, ESFG announced the Bank of Portugal's approval of its request for the use of the IRB method, with effect on 31 March 2009. The company's financials are adequate, with an improvement in its solvency ratios following BES's recent rights issue and a good stream of non-interest income. However, efficiency levels compare unfavourably with those of its peers and asset quality indicators are suffering an ongoing deterioration.

Foreign Currency Debt Rating

ESFG's foreign currency debt rating is A3 and unconstrained because Luxembourg, in common with other EU members, has a country ceiling of Aaa.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Ratings

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 Credit 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 government support for the bank in case a stress situation occurs 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.



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