Credit Opinion: Banco Paulista S.A.

Banco Paulista S.A.

Sao Paulo, Brazil

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	B1/NP
NSR Bank Deposits -Dom Curr	Baa2.br/BR-3
Bank Financial Strength	E+

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Key Indicators

Banco Paulista S.A.

	[1]Mar-08	Dec-07	Jun-07	Dec-06	Jun-06	Avg.
Total Assets (US$B)	0.56	0.52	0.33	0.23	0.26	[2]47.46
Share Equity (US$M)	68	63	37	26	23	[2]70.93
Pre-Provision Profit/Tt.Avg. Assets	7.10	12.62	8.69	4.16	2.56	5.84
ROAA	3.13	9.09	5.03	2.44	1.82	4.02
NIM	23.54	30.10	27.71	11.92	7.97	16.70
Oper Expenses/Gross Op. Revenues	23.22	22.96	25.81	51.07	61.07	48.07
NPL/Gross Loans & Lease	--	5.84	4.94	0.05	2.10	2.75
BIS Ratio	0.00	0.00	13.33	0.00	14.65	10.24

[1] As of March 31. [2] Compound annual growth rate.

Opinion

SUMMARY RATING RATIONALE

Moody's assigns an E+ bank financial strength rating to Banco Paulista S.A. (Paulista). This rating reflects the challenges related to Paulista's developing banking franchise as its management focuses on the consumer finance segment, particularly on vehicle financing. The rating additionally incorporates the bank's limited financial flexibility. This latter constraint is now becoming more evident, as indicated by the modest recurring profitability, poorly diversified funding sources, and tight capital structure -- all factors that may cut off growth prospects.

In the past two years, Paulista's shifts from commercial lending to payroll lending, and then to vehicle financing, have sacrificed asset quality, at least when indicators are measured against the bank's prior history of few delinquencies. In addition, Paulista's thin capital prompted management to lever its origination capability by securitizing loans in the local capital markets.

Moody's emphasizes that Paulista's business-diversification efforts are positive from a credit perspective because it has a well-recognized operation that furnishes financial and clearing services to Brazilian brokerage houses. The bank's traditional foreign exchange business contributes to steady its fee-based earnings, which are supported by a prudent risk and compliance framework.

Nevertheless, we believe that it is also critical that management's expansion program ensures the following: a) recurrent earnings; and b) profitability and asset quality metrics that can support sustainability. Improved corporate governance would also go far in contributing to future growth amid such sustainability.

The B1 global local-currency deposit rating incorporates Banco Paulista's Baseline Credit Assessment of B1, as well as Moody's conviction that no systemic support would be available in case of stress because of the bank's limited market share in terms of deposits.

Credit Strengths

- Well-recognized brand in the financial clearing, trust/fiduciary, and FX services

- Stable fee-income business

- Increasing focus on retail banking may contribute to strengthening franchise

- Management's agile decision-making process gains from the bank's small structure, which can be easily redesigned according to market opportunities

- Improved profitability from the healthy net interest margins of new products and asset sales

- Prudent and experienced management team led by the main shareholder

Credit Challenges

- Small player in a crowded and highly competitive segment

- Margins at risk

- Sustainability of profitability and efficiency indicators

- Rapid growth in used-vehicle financing segment and adequacy of credit risk management is relatively unseasoned

- Lack of funding diversification and prevalence of short-term deposits to finance a long-tenor credit portfolio

- Relatively weak capital levels

- Poor corporate governance practices and transparency

Rating Outlook

All ratings have stable outlooks.

What Could Change the Rating - Up

In the medium term, the bank's rating level could rise if management is able to uphold profitability ratios and asset quality in the midst of intense competition for consumer lending and pressured net interest margins. Continued success in diversifying funding would also benefit the ratings because this advantage would support Paulista's capacity to retain loans. Conservative liquidity management, as the loan book lengthens, also sends positive rating signals.

What Could Change the Rating - Down

The currently fierce competition in consumer lending could fail to ease. If management chooses to adopt aggressive lending practices - specifically, those that could adversely affect profitability and asset quality indicators -- ratings could undergo pressure in such conditions. With operations so tightly focused on the medium-term vehicle financing segment, funding disruption and increasing costs may hurt the ratings.

Recent Results and Developments

Paulista posted R$58.6million of consolidated net income in 2007, which was boosted by extraordinary gains on the sale of shares of BM&F and BOVESPA that were recognized through its equity participation at its broker Socopa. Also contributing was the fast growth in auto financing, which doubled credit income in the period, though leverage by credit sales.

In March 2008, Paulista reported total assets of R$ 968million, a jump of 70.4% over the same period in 2007. 1Q08 net income declined 24.3% when compared with 1Q07's, reaching R$7.3million. This was relatively influenced by the recent hike in funding costs and by the negative effects produced by the maneuver to reacquire credits previously sold under a recourse agreement, which were not performing or were prepaid. However, Paulista's bottom-line results continue to be largely driven by the strong growth of its auto-finance portfolio, which more than doubled on a year-on-year basis, and was up by 30.7% YTD. The bank presented annualized return on average assets (ROAA) of 3.9% and return on average equity (ROAE) of 31.6%, both measures well above historical levels.

Asset quality remained relatively flat at 8% in 2007 and 2006.

Regulatory capital ratios were at the border line in the 1Q08, staying at 11.7%, or down from 16% at year-end, indicating the effects of fast credit growth. Liquidity and capital ratios remained under pressure.

DETAILED RATING CONSIDERATIONS

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

Bank Financial Strength Rating

Moody's assigns a E+ (E plus) BFSR, or four notches below the C- aggregate score produced by our scorecard. This rating incorporates Banco Paulista's small franchise and the challenges behind the post-2005 shift in business focus. In addition, the positive performance posted since last year has become more exposed to both inflation and to intensifying competition in the domestic banking market, especially for high-yielding consumer lending to low-income individuals. Moreover, adaptation of the bank's long-standing SME banking culture and building the structure to grow its consumer banking platform are both likely to require substantial time. Nevertheless, Paulista's well-established FX operation and reputable financial services should continue to contribute healthy fees, which make up a significant portion of the revenue stream.

The bank's financials improved significantly following the implementation of a consumer banking platform, particularly in terms of profitability levels that have been boosting capitalization. However, we note that the sustainability of such financials remains untested. Asset quality raises a key concern, in a highly competitive environment where management might be tempted to loosen credit standards to defend market share.

The rating also encompasses the bank's vulnerable funding structure, which has been reliant on loan securitization as well as on an expensive deposit base. The stability of the bank's deposit base in the past crisis depended on the recognition of its shareholders and some reliance on related-parties deposits.

Good performance and capital ratios lifted the financial fundamentals score. The high scores on Regulatory Environment also boosted the ratings.

Qualitative Rating Factors (70% weighting)

Factor 1: Franchise Value

Trend: Neutral

Banco Paulista was originally established in 1990, following the conversion of a traditional broker house - Socopa Corretora Paulista - into a commercial bank, focused on SME lending. The bank's E score for franchise value is attributable to its small-niche profile centered on commercial and consumer lending. Paulista has less than 0.05% of the total industry deposits as of December 2007. The bank operates in a highly competitive consumer segment that has been fueled by positive macro conditions, and management has been attempting to diversify the product base over the last few years. It has been doing this by taking advantage of Paulista's flexible business model to seize market opportunities.

Over the last three years, credit activities have been expanded to consumer-lending products, essentially through a strong origination of used car financing (15 years usage), and payroll-deductible loans. This portfolio accounted for 70% of the bank's credit book in March 2008, rapidly rising from 31% in 2005. Paulista is not a major player in payroll-loans business, only originating R$5million per month. Moreover, payroll lending is a high-cost product supported by an expensive commission structure and has only limited growth potential. Consequently, the bank sells roughly 60% of its monthly production to third-party banks.

As with other niche players operating in the same segment, Paulista's business model addresses the scale limitations on the consumer-lending distribution through agreements with pre-owned vehicle stores and the bank accesses its clients through bank correspondents that also originate payroll loans to retirees and public servants.

Since 2004, Paulista additionally operates with a middle market-lending platform targeting medium and small companies with annual revenues from R$20million to R$350million, primarily providing these entities with short-term financing supported by self-liquidating assets. This portfolio currently composes 29% of Paulista's credit book, and it comprises by 350 active companies with exposures covered 80% by collateral.

In addition, the bank is recognized for its traditional clearing and FX services offered to banks and brokers in the local market. This has proven to be a stable source of fee income that makes up roughly 40% of its net revenue generation, which is strong compared with other small players' in Brazil.

Factor 2: Risk Positioning

Trend: Neutral

The risk positioning score of E is influenced by the limited governance structure. Paulista is a privately-held institution owned by two financier entrepreneurs. Although the bank is managed by a team of market professionals that have a long history at the institution, we note that its brand image still relies on the acknowledged capacity of the main shareholder, who is actively involved in the day-to-day business, Mr. Alvaro Augusto Vidigal . As a result, the overall corporate governance and risk positioning scores are capped at the E level, despite the bank's relatively conservative risk management capacity and restricted market risk appetite.

Risk management practices are in line with other peers' of similar size, centering on efforts to control credit risk and monitor the liquidity profile of its collateral portfolio. Paulista's risk management systems are evolving, in line with the bank's increased efforts to upgrade its infrastructure and modernize in recent years to support its entrance into the consumer-lending segment.

The bank's financial statements (as with all commercial Brazilian banks) are prepared under local GAAP and provide some level of detail. However, they still lack important disclosures, such as risk-weighted assets, and information about market-risk measurements. The bank releases condensed results on a quarterly basis containing limited information about asset quality, capital requirements, business lines, and earnings generation.

In terms of credit risk concentration, Paulista scores C for its adequate industry-wise granularity with no major industry concentrations, and the fragmented nature of its consumer credit portfolio. The latter that has a low concentration by borrower: the 20 largest credit exposures accounted for 64% of pre-provision income (PPP) or 47% of the bank's Tier 1 equity in 2007, while exposure to government securities accounted for 100% of PPP and 73% of Tier 1 equity. On the other hand, we believe that there is an embedded risk of a concentrated exposure into vehicle financing business because this sector is highly sensitive to inflation and unemployment rates.

With the focus on consumer lending, and more specifically on medium-term vehicle financing, liquidity management becomes key for Paulista's growth sustainability. The bank has a concentrated funding structure on short-term deposits, averaging nine months, with increased reliance on shareholders' resources over the last years - 43.7% in 2007 and 23% in 2006.

As alternative, with a good portfolio quality, Paulista has been opportunistically using securitization through investment funds or credit assignment to third parties. That said, the bank has adequate liquid assets and other maturing loans to meet its obligations in a timely manner over a 12-month period without resorting to the capital markets or sustaining a significant reduction in its business activities. In addition, we note that Paulista's liquidity position is satisfactory, maintaining minimum cash liquidity, between 80% to 120% equity base equivalent, although its liquidity risk information systems need further upgrading to provide timely and sufficiently detailed information about the true liquidity position across the whole bank.

In terms of market risk appetite, Paulista's treasury activity is centered on managing liquidity, so the bank is mainly exposed to interest rate risk through its fixed rate assets while it is faced with very limited equity and foreign currency risks. Moody's expects Paulista's management to continue improving its risk management systems and infrastructure, which will allow the bank to monitor its risk positioning increasingly well.

Factor 3: Regulatory Environment

Moody's will comment on the Brazilian regulatory environment in a separate report.

Factor 4: Operating Environment

Trend: Improving

The Brazilian operating environment receives a D on the scorecard. The D derives from a score of E for economic stability (measured as nominal GDP volatility over the 20-year period) and a D for integrity and corruption. (The integrity and corruption index is based on data from the World Bank, which ranks approximately 200 countries worldwide.) The legal system's score of C reflects the average length of time required for the execution of guarantees in Brazil in the absence of reliable references for mortgage foreclosure.

Quantitative Rating Factors (30% weighting)

Factor 5: Profitability

Trend: Weakening

Good profitability indicators posted over the last two years have been boosted by the recent move to high-yield operations, and leveraged by active credit sales, with upfront revenues from credit assignment accounting for 28% of total credit income in 2007. Paulista posted a favorable performance on trading activities, which also helped to bolster bottom line results and these accounted for 24% of total operating earnings in the period. The traditional broker-dealer operations add steady fee income to the revenue stream, apart from extraordinary gains from the sale of shares held on the future and stock exchanges, both IPOed at the end of 2007.

Although 2007 profitability may not repeat in the coming quarters because we see stiff competition squeezing consumer lending margins, Paulista's focus on high-spread consumer finance products should continue to benefit the bank's bottom line results when compared with the bank's historical levels. In addition, we note that management has been seeking more balanced performance by increasing loan retention.

Factor 6: Liquidity

Trend: Neutral

Paulista scores a C+ for liquidity management, reflecting the bank's comfortable position with regard to liquid assets that would be available to pay market funds in case of any unexpected market downturn. However, our assessment of liquidity management still indicates a need to increase diversity and improve funding recurrence; we also emphasize the challenge of managing the longer-tenor profile of assets as the consumer-lending business grows, pressured by competition. Historically, Paulista's funding has a sizeable participation of deposits from shareholders, which, on the other hand, proven to be an important source of funds in times of stress.

Since 2006, the bank's origination capacity of consumer credit products has been supported by the attractable and marketable vehicle financing and payroll-deductible operations, securitized on a timely basis to third-parties under no formal agreement, or through investment funds structured (FIDCs). Over the last six months, Paulista has been securitizing 90% of its car finance origination flow, and 10% of payroll loans. In May 2007, Paulista issued an auto-finance FIDC current with net asset value of R$126million with subordination of 15.5% and 4% of excess spread. Another auto-finance FIDC in the amount of R$100million is in phase of settlement.

Factor 7: Capital Adequacy

Trend: Weakening

Capital ratios have been recently pressured by the fast credit growth as well as extraordinary gains on the sale of shares of BOVESPA and BM&F, thereby boosting profits from its subsidiary (Socopa), which accounted for more than 20% of net income before taxes. We see further pressure coming from the implementation of stricter accounting rules for credit sales to be implemented on January 2009, and the capital allocation to cover operational risk according to Basel II requirements from July 2007 on. Note that by applying the upcoming weighting, the bank's BIS ratio as of March 2008 gets very close to minimum requirements.

The bank's robust earnings generation in 2007 replenished its capital base, raising the BIS ratio to 16%, well above minimum requirements, but it is still well below its historical figures. Nevertheless, Paulista's 1Q08 BIS ratio bottom-lined 11.7%, well below the year-end ratio, which management explained as a time issue with the launch of the investment fund of vehicle loans. At the settlement of its new FIDC, expected for the end of June, BIS ratio should go back to 15%, the bank's projected ratio for year-end 2008.

Over the past years, shareholders have been forthcoming with small capital injections and a reduced dividend payout, which have ensured Paulista's capital adequacy in line with business opportunities.

Factor 8: Efficiency

Trend: Weakening

The cost base is high, but it improved over the last two years by greater profitability on the back of the Paulista's entrance in high-yield consumer lending activities and the good performance of its securities trading portfolio, although this is a volatile earning component. However, we believe that success in the new business is likely to require additional investment in controls, infrastructure, and personal development. Therefore, in light of the negligible track record of Paulista in this segment, we can not sustain the statement of a permanent improvement in efficiency levels based on 2007 metrics boosted by extraordinary items.

Factor 9: Asset Quality

Trend: Weakening

Recent asset quality deterioration is the effect of the rapid expansion into consumer banking activity, primarily into aged vehicle finance segment, which on the other hand embeds a high-spread product. As the portfolio averages 50 months, it has a relatively unseasoned nature, raising questions about the credit quality. Apart from a high-yield activity, and despite the portfolio's loss rate of 6%, this is primarily supported by lien on vehicle and payroll deductibility, which thus improves the recovery rate (currently at 55%).

Close monitoring will still be required, however; stiff competition adds potential pressure for aggressive credit practices to sustain business volumes in the face of tightening spreads.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's global local currency rating of B1 for Banco Paulista is supported by the commitment of its shareholders to the institution's operations. Moody's assigns no probability of systemic support to the bank's deposit ratings in local currency because of Paulista's very small footprint in the industry.

National Scale Rating

Paulista is rated Baa2.br/BR-3 by Moody's on Brazil's National Scale. The rating reflects its brand image and recognized management built since inception, but also carries the current volatility of performance and uncertain outlook for success in the new business.

Foreign Currency Deposit Rating

Moody's assigns a B1 foreign currency deposit rating to Banco Paulista. The rating is constrained by the foreign currency deposit ceiling for Brazil.

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. Bank Financial Strength Ratings 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 Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings 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 Bank Financial Strength Rating 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, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and 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 GLC 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 LCDC.

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. An 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 a high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be reminded 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 obligations 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 Paulista S.A.

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (70%)						**D+**	
Factor: Franchise Value						**E**	**Neutral**
Market Share and Sustainability					**x**		
Geographical Diversification					**x**		
Earnings Stability					**x**		
Earnings Diversification [2]							
Factor: Risk Positioning						**E**	**Neutral**
Corporate Governance [2]					**x**		
- Ownership and Organizational Complexity				x			
- Key Man Risk					x		
- Insider and Related-Party Risks					x		
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			**x**				
- Borrower Concentration			x				
- Industry Concentration			x				
Liquidity Management				**x**			
Market Risk Appetite			**x**				
Factor: Operating Environment						**D**	**Improving**
Economic Stability					**x**		

Integrity and Corruption				x			
Legal System			x				
Financial Factors (30%)						**B-**	
Factor: Profitability						**C**	**Weakening**
PPP % Avg RWA			2.00%				
Net Income % Avg RWA			1.00%				
Factor: Liquidity						**C+**	**Neutral**
(Mkt funds-Liquid Assets) % Total Assets	-10.19%						
Liquidity Management				x			
Factor: Capital Adequacy						**A**	**Weakening**
Tier 1 ratio (%)	17.24%						
Tangible Common Equity % RWA	17.24%						
Factor: Efficiency						**C**	**Weakening**
Cost/income ratio			57.73%				
Factor: Asset Quality						**B**	**Weakening**
Problem Loans % Gross Loans			2.23%				
Problem Loans % (Equity + LLR)	5.99%						
Lowest Combined Score (9%)						**C**	
Economic Insolvency Override						**Neutral**	
Aggregate Score						**C-**	
Assigned BFSR						**E+**	

[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