Global Credit Research
Credit Opinion
19 JAN 2009

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+

Contacts

Analyst	Phone
Ceres Lisboa/Sao Paulo	55.11.3043.7300
Alexandre Albuquerque/New York	1.212.553.1653
M. Celina Vansetti/New York	

Key Indicators

Banco Paulista S.A.

	[1]**Jun-08**	**Dec-07**	**Jun-07**	**Dec-06**	**Jun-06**	**Avg.**
Total Assets (US$B)	**0.83**	**0.52**	**0.33**	**0.23**	**0.26**	[2]**79.77**
Share Equity (US$M)	**81**	**63**	**37**	**26**	**23**	[2]**86.39**
Pre-Provision Profit/Tt.Avg. Assets	**6.00**	**12.62**	**8.69**	**4.16**	**2.56**	**5.84**
ROAA	**3.29**	**9.09**	**5.03**	**2.44**	**1.82**	**4.02**
NIM	**19.18**	**30.10**	**27.71**	**11.92**	**7.97**	**16.70**
Oper Expenses/Gross Op. Revenues	**25.07**	**22.96**	**25.81**	**51.07**	**61.07**	**48.07**
NPL/Gross Loans & Lease	**5.56**	**5.84**	**4.94**	**0.05**	**2.10**	**2.75**
BIS Ratio	**11.00**	**0.00**	**13.33**	**0.00**	**14.65**	**10.24**

[1] As of June 30. [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.

The bank's business-diversification efforts are positive from a credit perspective because the bank 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.

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 the 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

- Capital levels at regulatory border line

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

- 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

- 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 as it would support Paulista's capacity to retain loans. Conservative liquidity management, as the loan book lengthens, would also send 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 negative pressure. With operations so tightly focused on the medium-term vehicle financing segment, funding disruption and increasing costs may hurt the ratings.

Recent Results

Paulista reported net income of R$17.6million in the 1S08, 27% above the same period in 2007, boosted by income from credit sales, which accounted for 37% of credit revenues in June. The bank yielded a return on average assets of 3.3% and a return on average equity of 29.5%. Margins slipped to levels 19.2% in June 2008, still high though, as a result of the fiercely competitive environment especially in consumer finance activities, which reduced spreads in payroll and auto loans. While strong growth that doubled the portfolio on a 12-month basis supported the bank's result, performance was at the same time hurt by a deterioration in the delinquency ratio, which rose to 5.3% from 4.9% in June 2007, and also a significant hike in funding costs. Both these issues that should persist in a scenario of decelerated growth and tough liquidity conditions.

In June 2008, Paulista presented tight capital levels at the borderline of regulatory requirements, which showed the effects of fast credit growth. Liquidity and capital ratios remained under pressure.

Recent Developments

The heightened market volatility during the month of October resulted in sharp depreciation of Brazilian currency, equities, and interest rates, together with much tighter liquidity conditions. Banco Paulista reported a manageable liquidity structure, suffering a deposit run off of about 15% from September until the end of December 2008. Management moved to preserve liquidity, as did by many other banks in the system, by limiting loan origination in the period and intensifying the credit sales. In line with its liquidity management policies, Paulista was able to maintain a cash base to total deposit ratio within 30%, same as in September 2008, according to management. In the last quarter, the bank sold roughly R$135million of credit receivables.

As of today, the bank had not released its third-quarter financial statements.

DETAILED RATING CONSIDERATIONS

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

Bank Financial Strength Rating

Moody's assigns an 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 shift in business mix since 2006. In addition, the positive performance posted since last year might not continue going forward because of the new credit market dynamics and funding conditions that have been squeezed since the beginning of 2008.

Over the last two years, 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 these improved financials remains untested. Asset quality raises a key concern in an economic slowdown environment where employment rates and income levels could move downwards and affect unseasoned long-term auto finance portfolios.

The rating also encompasses the bank's vulnerable funding structure, which has been reliant on loan securitization as well as on an expensive-professional 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 0.04% of the total industry deposits as of September 2008. The bank operates in a highly competitive consumer segment that has been fueled by positive macro conditions since 2004, 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.

The expansion of credit activities into consumer-lending products has been essentially through a strong origination of used car financing (15 years usage), and payroll-deductible loans. Retail lending products now account for more than 70% of the bank's credit book, rapidly rising from 31% in 2005. Paulista is not a major player in payroll-loans business though, given its small structure and late entrance into this mature segment. 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. The bank accesses its clients through bank correspondents who also originate payroll loans to retirees and public servants.

Since 2004, Paulista additionally has operated 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 350 active companies with exposures 80% covered by collateral.

In addition, the bank is recognized for the traditional clearing and FX services that it offers 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 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 in the 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 six months, with increased reliance on shareholders' resources over the last years - 43.7% in 2007 and 23% in 2006. Paulista's deposit base has been relatively stable over the liquidity crisis in 2004 and again through the current unstable conditions in comparison to those of similar small peers in the local market. It has had a deposit renewal rate of roughly 80% since September 2008; while most of its peers in the last 3 months have seen an intense deposit run-off and modest renewal rates.

With its 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, as it maintains minimum cash liquidity of 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. These parameters have been sustainable over the last three months following the heightened volatility.

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 its equity and foreign currency risks are very limited. 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 effectively.

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 and 37% in June 2008. Paulista posted a favorable performance on trading activities, which also helped to bolster bottom line results and these accounted for 25% 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.

Past profitability may not repeat in the coming years because we see stiff funding conditions squeezing credit market dynamics. We expect slow growth in 2009 ahead, as Paulista reduces its credit appetite in the face of such uncertainties. Potential deterioration in asset quality, as it portofolio seasons in times of economic deceleration, could possibly drain profitability ratios.

We also see some stress coming out of the new regulatory requirements on credit sales; these will be implemented starting in January 2009, as revenues from credit assignments may be accrued, not accounted upfront, as they have been until up to December 31, 2008.

Factor 6: Liquidity

Trend: Weakening

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 the implied vulnerability at Paulista's predominantly short-term wholesale deposit base. One of the bank's central challenges is related to the management of a longer-tenor asset profile, mostly encompassed by auto loans that average 42 months. Historically and tested over the last two liquidity disruptions - in 2004 and current -- Paulista's deposit base suffered less than those of similar small banks, which can, fundamentally, be explained by local investors' confidence at the renowned shareholder. In addition, there has been a sizeable participation of deposits from shareholders, which has proven to be an important source of funds in times of stress.

The recent deposit run off, roughly of 15%, has been addressed through intensified credit sales activities, most of them under the Deposit Guarantee Fund (FGC), as part of the stimulus package put in place by regulator in October to ease liquidity pressure, especially on mid-size bank's liquidity management. Another mitigant on Paulista's liquidity situation is the lack of external funding, which reduces pressure on its currently squeezed cash position.

In 2007, Paulista took advantage of the marketability of its consumer banking portfolio and issued an investment fund linked to auto-finance receivables, current with net asset value of R$126million and subordination of 15.5% with 4% of excess spread (Ba2/Aa2.br by Moody's). Another auto-finance FIDC in the amount of R$100million was issued in the 2H08 (Baa3/Aaa.br).

Factor 7: Capital Adequacy

Trend: Weakening

Capital is a point of concern for Banco Paulista's ratings. The bank has been operating under a very harsh capital base since 2007, reporting a BIS ratio in June and September 2008 at the minimum 11% requirement. We see further pressure on leverage coming from the implementation of the stricter accounting rules for credit sales, which are expected to be implemented on January 2009.

In addition, the robust earnings generation in 2007 that replenished the bank's capital bas is unlikely to be repeated, as performance should continue to be pressured by much lower loan growth, higher funding costs and a likely hike in nonperforming loans. Credit sales relieved part of this pressure over the last 3 months of 2008.

According to management, the tension around BIS ratio was due to delays in launching the investment fund encompassed by auto loans. At the settlement of its new FIDC -- previously expected for the end of June - the BIS ratio should have gone up back to 15%; which is the level that bank projects for year-end 2008.

Factor 8: Efficiency

Trend: Weakening

The cost base is high, but it improved over the last two years through greater profitability on the back of the Paulista's entrance into high-yield consumer lending activities and the good performance of its securities trading portfolio, although this is a volatile earning component.

In October and November, management has moved to adjust and reduce operational structure and staff, while reevaluating strategy and operations, as it an anticipates a difficult year. The bank has already reduced its working force in the car loan platform by 40% in the face of slow and shut down 4 branches, from a total of 11.

Factor 9: Asset Quality

Trend: Weakening

Asset quality deterioration in 2007 was an effect of the rapid expansion into consumer, primarily into the aged vehicle finance segment, which on the other hand is a high-spread product. As the portfolio averages 42 months, it has a relatively unseasoned nature, raising questions about its credit quality. Apart from being a high-yield activity, and despite the portfolio's loss rate of 6%, credit quality is primarily supported by liens on vehicles and payroll deductibility, which improves the recovery rate (currently close to 55%).

Close monitoring will still be required. We already expect some worsening in the asset quality level as the portfolio volume diminishes in the period.

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+**	**Weakening**
(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