

Credit Opinion: Banco Modal S.A.

Banco Modal S.A.

Rio de Janeiro, Brazil

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Ba3/NP
NSR Bank Deposits -Dom Curr	A3.br/BR-2
Bank Financial Strength	D-

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Key Indicators

Banco Modal S.A.

	[1][2]Dec-08	Jun-08	Dec-07	Jun-07	Dec-06	[3]Avg.
Total Assets (US\$B)	0.34	0.66	0.40	0.32	0.17	[4]39.37
Share Equity (US\$M)	82	111	81	60	54	[4]23.49
Pre-Provision Profit/Tt.Avg. Assets	10.05	14.41	10.84	2.21	11.42	9.79
ROAA	6.01	8.76	6.36	0.30	7.00	5.69
NIM	13.39	18.52	14.42	5.23	16.22	13.56
Oper Expenses/Gross Op. Revenues	32.27	26.11	38.60	89.15	35.61	44.35
NPL/Gross Loans & Lease	--	--	--	--	--	--
BIS Ratio	25.02	22.12	23.68	30.25	26.79	25.57

[1] As of December 31. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate.

Opinion

SUMMARY RATING RATIONALE

Moody's assigns a bank financial strength rating (BFSR) of D- to Banco Modal S.A. (Modal), which translates into a baseline credit assessment of Ba3. The D- BFSR is supported by Modal's focused operation in the wholesale segment by offering structured credit products; the bank also furnishes tailor-made investment-banking services to medium and upper mid-sized corporate clients.

Over the past two years, Modal has often reported adequate profitability indicators; nevertheless, bottom line results have shown significant fluctuation over time. The volatility in Modal's profitability ratios derives from the still significant trading revenues in the bank's earnings mix and, as a result, such oscillation constrains the BFSR.

The D- BFSR maps into a Ba3 baseline credit assessment. Moody's assumes no systemic support for Modal to repay its domestic obligations in the event of a crisis, given the bank's small participation in the Brazilian deposit market. The rating agency also disregards any support from a parent company or economic group because Modal is a multiple bank controlled by its three founders. Therefore, in the absence of any type of support, Modal's global local-currency rating is placed at the Ba3 level as well.

Credit Strengths

- Focus on investment banking and on commercial lending to medium and upper mid-sized firms that operate in specific industry segments.
- Adequate capital indicators that result from successive profit reinvestment, coupled with a conservative lending leverage policy.
- Lean operating structure allows a low cost base.
- Adequate asset quality indicators for a specialized mid-sized bank with an investment banking profile.
- Controlling partners with experience in investment banking and close involvement in Modal's daily operations.

Credit Challenges

- Predominance of non-recurrent earnings from trading operations adds volatility to profitability ratios.
- Funding base has low granularity in terms of depositors and small diversification; it is mostly concentrated in wholesale time deposits.
- High competition in the segment of commercial lending to mid-sized companies.
- Prospect of low revenue generation in investment banking activities in view of difficult conditions in capital markets and slowdown in the economy.

Rating Outlook

All ratings have stable outlook.

What Could Change the Rating - Up

Modal's BFSR might benefit from an increase of recurrent revenues in the banks' earnings mix, such as those from commercial lending operations, which could mitigate the volatility of Modal's profitability indicators. Furthermore, the rating could also be positively affected by a more diversified funding structure, with increased participation of institutional investors and fund managers.

What Could Change the Rating - Down

Potential negative effects on Modal's BFSR could include deterioration of margins as a result of a more intense competitive scenario for commercial lending. Prolonged reduced activity in both investment banking and debt capital markets could hurt revenue generation as well. Moreover, the rating could be undermined by a more expensive funding structure derived from tightened liquidity.

Recent Results and Developments

Modal's net income increased by 71%, on a year-over-year basis, to R\$59.7 million in December 2008. The growth in the bank's bottom-line result was mostly driven by a 135% spike in income from securities operations, which includes a 158% surge in income from derivatives. Nonetheless, the business segments of investment banking and asset management also contributed to the bank's performance, being responsible for 9.2% and 8.4%, respectively, of total earnings in the period. Overall, Modal's profitability indicators showed improvement relative to the previous year, with a ROAA of 6% and a ROAE of 36%.

As of December 2008, approximately 56.5% of the bank's earnings derived from trading operations, which shows that Modal's profitability is still mostly based on nonrecurring revenues. Nevertheless, management highlights that part of the income from derivatives relates to commercial operations with corporate clients; therefore, it is not included in Modal's proprietary trading position and should be viewed as recurring revenue.

The bank reported R\$790 million in total assets as of December 2008, which represented an 11.5% growth compared to the previous year. Despite the increase in assets reported in 2008 it should be noted that Modal's balance sheet reduced significantly in size during the last quarter of the year, as total assets reached R\$1.7 billion in September.

Capital levels remained comfortable as shareholders increased common capital through the reinvestment of interest on capital and converted statutory reserves. In December 2008, the bank's BIS ratio stood at 25%, well above the regulatory minimum of 11%.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Modal's currently assigned ratings are as follows.

Bank Financial Strength Rating

Moody's assigns a D- BFSR to Modal. The rating is supported by Modal's franchise as a niche bank focused on commercial lending to middle- and upper-mid-sized companies and on investment banking services. Modal has developed robust commercial relations with companies from industry segments of oil and gas, telecommunication and mining; moreover, it has catered to companies that are not the primary target of the investment banking units of large domestic and foreign banks, providing these companies with services such as merges and acquisitions, structured products and capital markets. The bank has also developed expertise in the securitization of credit receivables - loans that are packed in the form of asset-backed securities and then sold to credit-receivable funds (FIDCs) administered by the bank's asset management unit.

On the other hand, the rating is constrained by a funding structure that has little granularity by depositors and limited diversification, because it mostly comprises wholesale time deposits, Tier 2 subordinated debt, and resources originated from the sale of credit operations to FIDCs. In a scenario of tightened liquidity, a potential increase in funding costs might cause severe impact on profits, especially when taking into consideration the bank's volatile earnings. The rating is also challenged by Modal's effort to increase its market-share in the mid-sized lending segment, especially in a period of high competition.

Moody's scorecard generates a BFSR of C- for Modal; which is three notches higher than the bank's assigned BFSR. The difference in notching is explained by transition risks that are not captured by the scorecard. Two such risks are the intense competition in the segment of commercial lending for mid-sized firms and activities in investment banking, not only from domestic rivals but also from the foreign banks that have aggressively increased their participations in those areas.

Moreover, the scorecard also does not capture fluctuations in Modal's profitability and efficiency indicators, which might reduce profit generation in a more competitive and volatile environment. However, it should be noted that Modal has reported end-of-year efficiency ratios that are low compared to those of other medium-sized banks - 32.3% in December 2008.

Qualitative Rating Factors (70% weighting)

Factor 1: Franchise Value

Trend: Neutral

Modal has an overall score of E+ for franchise value, which reflects the bank's small size and geographically concentrated operation. The bank's earnings stability is affected by the relevant participation of revenues from trading activities in the earnings mix, which increases the volatility of profitability indicators over time. As of December 2008, revenues from trading operations represented roughly 56.5% of total earnings.

As of December 2008, Modal was ranked as the 64th largest bank by total assets according to Brazil's Central Bank. Although the bank has clients located in different regions of the country, most of its operations are concentrated on the southeast region. The majority of Modal's corporate clients are located in São Paulo and Rio de Janeiro, both regions with a significant participation in Brazil's GDP. Modal has its headquarters in Rio de Janeiro and an office in São Paulo, which it opened in 2001.

Management's efforts to enhance the generation of recurrent revenues include the activities of the bank's asset management unit, which contributes to bottom-line results through revenues from administration and performance fees (8.4% of total earnings in 2008). Modal's asset management reported a robust expansion in 2008, as the total amount of funds under administration grew 126% to R\$805.2 million in December 2008. As of April 2009, funds under administration reached R\$1.3 billion, an increase from R\$200 million when the unit was created.

Factor 2: Risk Positioning

Trend: Neutral

Banco Modal has a limited structure of corporate governance; which results in an E score for the bank. Modal operates as a partnership with 17 shareholders who are actively responsible for daily operations, each one with an important task within the institution. The bank was founded by three former executives of Banco Garantia (acquired by Credit Suisse in 1998), who also hold controlling stakes. Modal's image as an agile institution specialized in investment banking is closely intertwined with the experience and risk intelligence of its three founders.

The score is capped by the lack of an independent board, a characteristic peculiar to mid-sized wholesale banks in Brazil. Nevertheless, management has in place committees that oversee operational and administrative

procedures (operational committee); implement and monitor systems and procedures related to compliance (compliance committee); structure and approve new products (products committee); establish operational limits and monitor risks (risk committee); analyze credit operations and stipulate guarantees (credit committee); and determine investment and human resources policies and evaluate the performance of all areas (executive committee).

Management has been improving the analysis of clients' credit risk as well as enhancing systems and procedures used to monitor guarantees. Moody's views potential improvement in Modal's risk positioning score as a result of the adoption of more robust processes that may improve growth sustainability. Regarding financial reporting transparency, Moody's notes that Modal's reports have the minimum level of disclosure required by regulators - a common characteristic among mid-sized banks in Brazil.

Factor 3: Regulatory Environment

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

Factor 4: Operating Environment

Trend: Neutral

Moody's grades the Brazilian operating environment at a D. The D derives from a score of E for economic stability (measured as nominal GDP volatility over the 20 year-period 1985-2005) and 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 indicates 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

Modal's profitability indicators remained stable compared to the previous year; return on assets stood at 6% and core earnings at 10%, compared to 6.4% and 10.1%, respectively, in 2007. While the bank reported an increase of 24% in income from credit operations, the bottom-line result was still mainly driven by income from derivative operations. As a matter of fact, Modal's profitability received a boost in mid-2008 because of trading activities, both from the bank's own proprietary position and from client's positions, which are associated to commercial operations with corporate clients. However, management has also focused on asset management and investment banking operations to strengthen the generation of revenues derived from fees.

Modal's net interest margins declined 100 basis points to 13.4%. The strong competition in the loans to mid-sized companies segment and the increase in funding costs resulting from the tightening liquidity in 4Q08 had a negative impact on margins. The ongoing restrictive monetary policy adopted by the government has the potential to add further pressure on the bank's margins, as the decline in the benchmark interest rate may bring revenues from trading operations down.

In 2008, the three-year average ratio of pre-provision profits to average risk-weighted assets stood at 9.4, while net income to average risk-weighted assets was 5.6%. These metrics yield an A score in profitability for Modal.

As a refinement of our analysis, we adjust risk weighted assets by assigning a 100% weight to government securities instead of 0% (as required by Brazilian regulators); which reduces profitability indicators. However, the score for profitability remains as an A.

Factor 6: Liquidity

Trend: Neutral

On a y-o-y basis, Modal's total deposits declined 45% to R\$152 million. The drop in deposit certificates occurred in the second half of 2008, with higher intensity after September, when tightened credit availability in the local market and the closure of international capital markets strained companies' liquidity needs. All in all, time deposits fell by 56% during the year; nevertheless, the negative trend was partially offset by a 130.5% increase in interbank deposits to R\$85 million.

In order to mitigate liquidity risk, management adopts a conservative strategy of keeping on balance sheet an amount equivalent to at least 25% of time deposits from clients in the form of cash and liquid assets. During the last quarter of 2008, when the local market was struck by a strong liquidity tightening, management was able to keep that ratio above 60%. In December 2008, the ratio peaked at almost 120%. According to management, Modal did not have to rely on credit sales to large banks and to the deposit insurance fund as a means to access

additional liquidity during the stress period.

The bank's funding base also contains a US\$30 million Tier 2 subordinated debt issued in March 2006. Modal has an overall liquidity score of C+.

Factor 7: Capital Adequacy

Trend: Neutral

Modal has a comfortable capital position, as demonstrated by a three-year average Tier 1 ratio of 17.9% in December 2008, resulting in an A score for the bank. Modal's capital position has been frequently strengthened through the reinvestment of interest on capital and the conversion of statutory reserves into capital. During the first half of 2008, Modal's capital was increased by R\$43.7 million as a result of that strategy. Modal's BIS ratio was 25% in December 2008, well above the regulatory minimum of 11%.

The score for capital adequacy remains as an A, even after adjusting for risk-weighted assets at a 100% weight for government securities.

Factor 8: Efficiency

Trend: Neutral

Modal's efficiency ratios are also affected by fluctuations in the bank's volatile earnings; however, as noted by management, the development of the asset management unit has generated fees that have contributed for the coverage of operational expenses.

The bank's modest operating structure and its small workforce (approximately 150 employees in December 2008) contribute to keep operating costs low. Yet, efficiency is influenced by non-recurrent revenues in the same way as profitability is: the ratio was at 32.3% in December 2008, as opposed to 26% in mid-2008, when income from derivatives spiked.

For the time being, the slowdown in economic activity makes it difficult to develop complementary business lines, such as middle corporate and international finance, both areas management in 1H08 pointed to as alternatives for diversifying earnings generation.

Factor 9: Asset Quality

Trend: Neutral

The bank's loan portfolio declined by 41.5% to R\$177 million on a y-o-y basis. The reduction in lending activity occurred in tandem with the liquidity tightening in local markets following the international financial turmoil in September. Overall, banks were forced to decrease loan origination and to focus on preserving cash instruments on balance sheet.

Despite the decrease in volume, Modal's credit portfolio continued focused primarily on commercial lending to middle-sized companies. As a result of the high level of collateral associated to that type of loans, Modal's credit portfolio shows an intrinsically low risk. The ratio of loans overdue more than 90 days to total loans was 1% in December 2008, or virtually at the same level as in December 2007.

Further improvement by management on mechanisms and systems to assign and control guarantees could keep delinquency at a low level. Conversely, negative pressure on ratios could arise from an increase in delinquency due to the slowdown in economic activity, which could constrain borrowers' ability to repay loans in the market. The score for asset quality is B+.

Global Local Currency Deposit Rating (Joint Default Analysis)

Modal's Ba3 global local-currency rating is explained by the bank's very modest participation in the Brazilian deposits market. Therefore, Moody's assesses no probability of support from the government to Modal, should a systemic crisis occur. The bank's global local-currency rating maps directly from its Ba3 baseline credit assessment.

National Scale Rating

The National Scale Rating for Modal is A3.br/BR-2. The rating derives from the bank's creditworthiness in its niche market and is derived from its global local-currency rating.

Foreign Currency Deposit Rating

Moody's assigns a Ba3 foreign currency deposit rating for Modal. Following Moody's methodology, the rating maps directly from the bank's global local-currency deposit rating.

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 Modal 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	Neutral
Economic Stability					x		
Integrity and Corruption				x			
Legal System			x				
Financial Factors (30%)						B	
Factor: Profitability						A	Weakening
PPP % Avg RWA - Basel II	9.40%						
Net Income % Avg RWA - Basel II	5.64%						
Factor: Liquidity						C+	Neutral
(Mkt funds-Liquid Assets) % Total Assets	-37.78%						
Liquidity Management				x			
Factor: Capital Adequacy						A	Neutral
Tier 1 ratio (%) - Basel II	17.91%						
Tangible Common Equity / RWA - Basel II	17.91%						
Factor: Efficiency						A	Neutral
Cost/income ratio	35.49%						
Factor: Asset Quality						B+	Neutral

Problem Loans % Gross Loans		1.50%					
Problem Loans % (Equity + LLR)	1.98%						
Lowest Combined Score (9%)						C+	
Economic Insolvency Override						Neutral	
Aggregate Score						C-	
Assigned BFSR						D-	

[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

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