

**Mexico
Special Report****Major Mexican Banks - Semi-Annual
Review and Outlook****Preparing to weather tougher times and increasing risks****Analysts**

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This report includes comments on the banking system data, as well as individual figures on the six largest banks rated by Fitch on the international scale, which together comprise the "peer group" under review (BBVA Bancomer, Banamex, Santander, HSBC, Banorte and Banco Inbursa).

Summary Opinion

After a few years of exceptionally strong earnings, Mexican banks are now facing the challenges arising from its rapid incursion into relatively new retail segments, a worsening economic environment and, to a lesser extent, the global liquidity crunch. The confluence of decelerating and seasoning loans, aggressive lending practices in 2005-2007 and a slowing economy is affecting asset quality. In view of the downturn in the global economic cycle, some further weakening in the commercial portfolios could also arise going forward. In addition to adverse external factors, banks are also challenged to weather an environment with relatively higher inflation and interest rates than expected.

Credit cards are the worst-performing line, given aggressive origination in 06-07. Fitch believes that household indebtedness, while increasing, remains modest at the aggregate level. Delinquency in retail portfolios has doubled despite strong growth, and well beyond in all consumer products. If the pace of deterioration remains while loans decelerate, delinquency ratios will continue under stress. Fitch notes that consumer portfolios in Mexico are the worst-performing among comparable Latin American peers in the recent past. Solid performance in the balance of the portfolio means overall asset quality has worsened at a slower pace. Hefty provisions and charge-offs have prevented further increases in PDLs and depletion of reserves, but have been a drag on banks' results.

While the trends in financial ratios among Mexican banks are mixed, recent performance has been characterized in general by deteriorating asset quality, climbing provisions and low and volatile trading results. However, strong margins, revenue diversification and contained operating costs have sustained adequate profitability. Despite ample provisions and trading losses, the system's ROA was an adequate 1.95% at June 2008. Other positive factors are the gradually tightening credit standards since early 2008; and a relatively strong risk-adjusted profitability in most sectors, which allow banks to absorb increasing credit losses. With the exception of asset quality and profitability, other factors have not materially worsened, since capital adequacy and liquidity remain robust.

Fitch believes that loan growth will remain at double-digit rates. However, the pick-up in banks' lending to the private sector could be jeopardized if the global outlook dims further, especially if the U.S. were to enter into a deeper and prolonged slowdown.

Rating Outlook and Major Risks

We expect that the performance of major Mexican banks will continue weakening to some extent, until asset quality problems are fully contained. However, we expect banks will maintain positive, although lower, profitability going forward. Fitch does not anticipate downward pressure on the major banks' ratings in the near future. Most IDRs are support-driven and are primarily exposed to issues at the parent level. Individual ratings for the

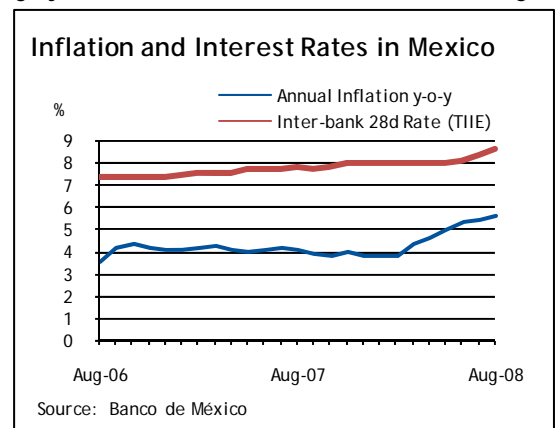
most part incorporate the likelihood of deterioration in downturn phases of the cycle. However, Fitch will continue to closely monitor asset quality and its effect on results, and does not rule out potential downgrades if the environment worsens substantially, or if any institution's performance should prove markedly worse than expected. Exposure to troubled global entities (Lehman Brothers, AIG) ranges from none to minimal.

Economic Environment and Sovereign Outlook

Mexico's ratings were affirmed in July 2008 at 'BBB+' and 'A-' (foreign and local currency IDRs) with a stable outlook. In Fitch's view, the Mexican economy is in a better position than in previous downturns to cope with a U.S. slowdown, due to its more entrenched domestic demand, healthy credit growth, some diversification of its trading partners and implementation of counter-cyclical policies. Beyond the current cyclical downturn, structural factors (weak infrastructure, low savings and investment, labor market rigidities, and limited competition in key sectors) continue constraining growth potential.

The economic outlook is becoming increasingly challenging for banks. In addition to adverse external factors (i.e. constrained liquidity and higher financing costs), which so far have had a limited impact on the banking system; intermediaries are also challenged

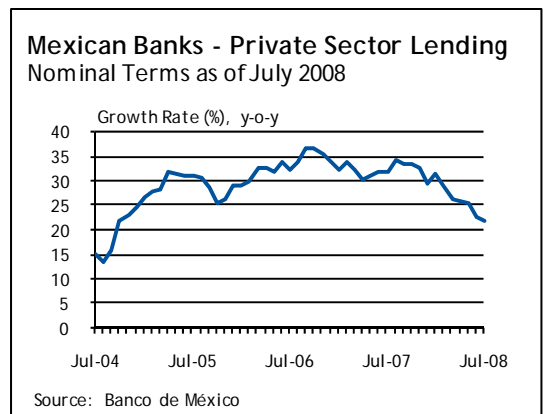
to weather higher inflation and interest rates. This fact, coupled with a decline in families' available income and higher unemployment, will likely continue to impact asset quality of the retail portfolio and, to a lesser extent, in commercial loans. Consumer expenditures in durable goods declined in the last two months of 2Q08 and a similar trend in non-durable goods could arise in 2H08. Also, while manufacturing production and employment remained strong until June 2008, these have likely downturned thereafter, given the growing impact of the US slowdown that will continue through the first part of 2009. Rising prices, particularly in food and energy, will continue to affect the credit quality of borrowers. This is especially true in the retail sector, given the increased levels of household indebtedness in recent years, although this remains relatively low (estimated at roughly 15% of GDP, based on Fitch's calculations that include non-bank retail lending).



Banking System's Trends and Operating Environment

While the trends in financial ratios among Mexican banks are mixed, recent performance has been characterized in general by deteriorating asset quality, climbing provisions and low and volatile trading results. However, adequate margins, further revenue diversification and well-contained operating costs have prevented weaker profitability measures, which still remain sound. Some of the main drivers are commented below.

Strong loan growth, but decelerating
After a number of years of loans increasing



by more than 25% p.a. in real terms, this has decelerated since February 2008 and was roughly 15% in real terms y-o-y by July 2008. As expected, consumer loans have decelerated at a faster pace, although y-o-y real growth remained at roughly 7% as of July 2008 (Fitch's estimate after adjusting for the transfer of Banamex's credit card portfolios into a newly-formed specialized company). Commercial lending remains as the primary driver of loan growth, at a 24% y-o-y rate at the same date, while mortgages increased at a robust 14%. The amount and relative contribution of lower-yielding government loans continues declining, which has prevented deterioration of margins and overall profitability.

Despite the challenging environment, Fitch believes that loan growth will likely remain at double-digit rates in real terms, underpinned by lending to the commercial and industrial sectors. However, the upward trend in banks' lending to the private sector could be jeopardized should the global economic outlook further exacerbates, especially if the U.S. economy were to enter into a deep and prolonged slowdown. While loan growth poses particular risks in the middle of an economic downturn, mitigating factors are the still modest loans/GDP ratio and the enhanced system-wide risk management frameworks.

Credit costs remain high and will continue increasing

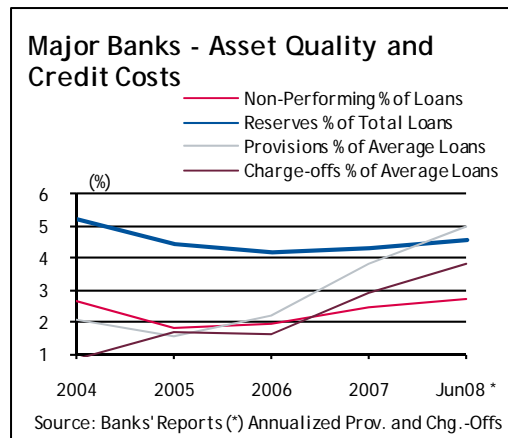
After some years of strong loan growth, these relatively new and riskier retail loans are seasoning and pressuring asset quality, as expected. Consumer loans are the worst-performing, as a large portion of these has been granted to individuals with little or no financial track-record. The higher personal indebtedness has also weighed, but Fitch believes that this is particularly high only within some low-to-medium income brackets of population, but it remains reasonable at the aggregated level; many of these individuals also have debt to non-bank financial entities that can understate indebtedness. Delinquency in retail portfolios has doubled in a period of strong growth, especially in consumer loans, where impairment ratios have more than doubled in all products (see table above). If the pace of deterioration remains while loans continue to decelerate, retail delinquency ratios will increase further. Fitch highlights that consumer portfolios in Mexico are the worst-performing among comparable Latin American banking systems in the recent past.

Delinquency in Retail Loans - Mexican Banks

(% PDLs within each category)

	2005	2006	2007	08-Jul
Consumer Loans	3.0	4.3	5.7	6.9
Credit Card	3.9	5.5	6.9	8.2
Personal	1.2	2.8	3.5	4.5
Durable Goods	2.4	2.7	4.3	5.9
Mortgage Loans	2.2	2.1	2.6	3.0
Residential	1.8	1.9	2.2	2.6
Low Income	4.0	2.9	4.6	5.6
TOTAL RETAIL	2.8	3.7	4.8	5.6

Source: Banco de Mexico



Despite rapid deterioration of retail portfolios, overall asset quality has worsened at a slower pace. However, sharp increases in provisions and charge-offs deserve close monitoring. To contain asset quality deterioration, provisions and charge-offs have climbed to high levels (4-5% of average loans in 1H08, at the system's and sample's level). Positively, provisions continue exceeding charge-offs, preventing depletion of reserves; banks have prioritized maintaining reserves over boosting

net income, clearly a sign of conservative credit management. Since Fitch expects that problem loans will continue rising going forward, especially in credit cards, there is still ample room for further deterioration on overall asset quality and profitability.

Major strengths against asset quality deterioration are the sound capitalization of large banks and the system; the gradually tightening credit standards since early 2008; and the still strong risk-adjusted profitability in most sectors, which allow banks to absorb higher credit losses. Fitch believes that these partially compensate the weakening asset quality, but if this balance no longer holds, downgrades on Individual ratings could arise.

Lower and more volatile trading results

As expected, financial volatility has pressured market-related results. The portfolios of Mexican banks are mostly concentrated in local government bonds. However, Mexican banks carry sizeable fixed-rate positions associated to asset-liability and margin-protection strategies, which are sensitive to interest rates changes. Given the clear upward trend in inflation and domestic interest rates, the impact of marking-to-market fixed-income positions is increasingly affecting the banks' operating and net profits. Moreover, some major banks recorded losses on a quarterly or semi-annually basis as of June 2008 -see 'Individual Results' below.



Positively, most Mexican banks are not particularly reliant on trading income. However, trading gains had provided the equivalent to 5-10% of net interest income in 2004-2006, which has rapidly declined to 1% in 2007 and the first six months of 2008 (see graph). Also positive is the widespread belief that inflation and interest rates are at or near the peak under the current scenario, which could drive smoother trading results going forward.

Most Mexican banks benefited in 1H08 from high realized and unrealized gains associated to the initial public offerings of VISA and the Mexican Stock Exchange (BMV), commonly recorded as trading gains. After adjusting for this non-recurring event, trading results would have been negative at the system and most banks had had further drops in earnings.

The overall financial profile remains sound

With the exception of asset quality, other factors have not materially worsened. At the system level, the equity/assets and Basel II ratios continue exceeding 13% and 15%, respectively. Liquidity is also strong, with cash accounting for 25% of total deposits (48% when securities are included). Rapid lending growth has not dramatically increased the loans/deposits ratio (95% at 1H08), while major banks continue being largely deposit-funded. As Fitch has stated previously, risks on the funding side might be somewhat higher in smaller and less diversified specialized banks. Risk aversion from institutional investors towards regulated banks has not increased sharply in the local market.

While provisions and market-related losses have impacted the banks' earnings, overall profitability remains sound, with the system's ROA at an adequate 1.95% as of June 2008. Based on a net interest margin (NIM) at 7% and net fees and commissions contributing a further 1.9% of average assets, the banking system comfortably absorbed operating costs of 4.8% of average assets and the sizeable and growing provisions, which climbed to an

above-normal level of 4.2% of average loans. The upward trend in interest rates is likely to benefit the largest banks, given their asset-liability pricing structure, but the effect could be the opposite in the case of smaller and less customer deposits-oriented banks.

Individual Results – Key Facts

BBVA Bancomer

After adjusting for non-recurring revenues, the bank's performance has remained strong and similar to 2007. Higher provisions have been offset by gains in margins (NIM in 1H08: 7.8%) and efficiency (cost/income: 39.9%) from its larger scale. The bank is widening the gap with its main peers, with net and operating ROA in excess of 3% and 4%, respectively. Provisions, although high and growing, are below its main competitors'. Delinquency and coverage ratios remain at the system's average. An aggressive dividend policy has resulted in below-average capital ratios, but we expect these should not further decline significantly. Parent support and its ability to sustain strong earnings throughout the business and credit cycle are mitigating factors against its relatively tight capital levels.

Banco Nacional de México ["Banamex"]

Banamex's profitability ratios are overstated at 1H08, in view of its shrinking asset base. Given its sizeable fixed-income trading portfolio, market-related results have negatively affected its 2007 and 1H08 earnings. However, the weak performance is largely driven by exceptionally high provisions in 1H08 (49% of net interest income and 8.7% [annualized] of average loans). While profitability is still reasonable despite hefty provisions, we expect it will remain well below the bank's historic standards until loan deterioration is properly contained, particularly the sizeable and worsening credit card portfolio. In Fitch's opinion, its weak asset quality is compensated by its strong franchise, liquidity and capitalization.

Banco Santander (México)

Recurring earnings maintain a positive trend aided by a shifting asset mix, since the previously ample public sector loans have shrunk rapidly and are being replaced by higher-yielding consumer, mortgage and SME loans, although from a small base. Margins and efficiency are now comparable to its peers'. However, sizeable market-related losses were recorded in 2007 and 1H08 under Mexican GAAP, since the vast majority of its hedging portfolio has to be accounted as "held for trading" on local standards (i.e. the unrealized mark-to-market gains/losses pass through the income statement). Asset quality continues outperforming its peers, but delinquency and coverage are weakening at a relatively rapid pace. Sound capital and ample liquidity are also sources of comfort.

HSBC México

HSBC has been struggling to contain asset quality deterioration, especially in credit cards, its worst performing portfolio. While the bank maintains strong margins and is gradually improving its weaker-than-average efficiency, climbing provisions continue harming its overall earnings. Provisions accounted for a hefty 6.5% of average loans and 51% of net interest income in 1H08. Despite sizeable charge-offs for 5.5% of average loans (1H08 annualized), delinquency continues rising rapidly, to 4.6% in June 2008 from 2.7% in 2006. With reserve coverage at 124% of PDLs, its performance will likely remain weak in the near future, as further provisions are expected. Coupled with its relatively tight capital position, these are among the major sources of pressures for HSBC's Individual rating, although parent support and centrally-managed equity are major mitigating factors.

Banco Mercantil del Norte ["Banorte"]

While provisions have also increased, Banorte has contained asset quality problems and its ratios compare well with its larger peers. At 1.4%, its NPL ratio is sound and stable, although its reserves are a modest 1.9% of total loans. However, Banorte's portfolio is

Mexican Banks with International Ratings

	Individual	Support	Foreign Currency		Local Currency		Outlook	National Scale	
			L/T IDR	S/T IDR	L/T IDR	S/T IDR		L/T	S/T
BBVA Bancomer	B/C	1	A	F1	A	F1	Stable	AAA(mex)	F1+(mex)
Banco Nacional de Mexico	B/C	1	A	F1	A	F1	Stable	AAA(mex)	F1+(mex)
Banco Santander	C	1	A	F1	A	F1	Stable	AAA(mex)	F1+(mex)
HSBC Mexico	C	1	A	F1	A+	F1	Stable	AAA(mex)	F1+(mex)
Banco Mercantil del Norte	C	2	BBB(*)	F2	BBB(*)	F2	Positive	AA+(mex)	F1+(mex)
Banco Inbursa	C	4	BBB	F2	BBB	F2	Stable	AA+(mex)	F1+(mex)
Banco del Bajío	C/D	5	BB+	B	BB+	B	Stable	A+(mex)	F1(mex)
Ixe Banco	C/D	5	BB	B	BB	B	Stable	A(mex)	F1(mex)
Banca Mifel	C/D	5	BB	B	BB	B	Stable	A-(mex)	F2(mex)
ING Bank (Mexico)	C/D	2	BBB+	F2	BBB+	F2	Stable	AAA(mex)	F1+(mex)
Nacional Financiera	—	2	BBB+	F2	A-	F2	Stable	AAA(mex)	F1+(mex)
Bancomext	—	2	BBB+	F2	A-	F2	Stable	AAA(mex)	F1+(mex)
Banobras	—	2	BBB+	F2	A-	F2	Stable	AAA(mex)	F1+(mex)

L/T - Long term. S/T - Short term. IDR - Issuer Default Rating. (*) indicates the L/T rating for which the Positive outlook applies (FC, LC and/or national-scale).

more concentrated on middle market and SME loans, which could be more affected if the economic slowdown dims. It is also challenged to continue improving its funding base, which is still more concentrated on relatively more expensive funds. Banorte is more reliant than its peers on Tier II capital, but its core and eligible capital are increasing. Its IDRs have a positive outlook, given its slightly improving capitalization and performance, and relatively lower appetite for retail credit risk. Should the local environment continue to worsen, however, it becomes more likely this will revert to stable.

Banco Inbursa

Unlike its larger peers, Inbursa’s performance has improved under the current conditions, given its sizeable portfolio of trading positions that provide mark-to-market gains when interest rates increase, as has been the case in recent months. Therefore, its operating and net ROA in 2007 and 1H08 broadly exceeded its performance in previous years. However, this performance is underpinned by hefty market-related gains (20% of total operating revenues in 1H08), which have been widely volatile in the past. A strong capital cushion, ample liquidity and a nimble operating cost base are mitigating factors against the bank’s major risks, namely its sizeable market risk appetite, large concentrations in its corporate portfolio and its recent incursion into riskier retail loans.

Outlook

As Fitch had projected, profitability has been declining from the historically high and unsustainable levels it had reached recently, according to the regular phases of the business and credit cycles. Deteriorating assets and a slowdown in loan growth have accelerated this trend. In general, we expect that the performance of major Mexican banks will continue weakening to some extent, until asset quality problems are fully contained. However, we do not expect the performance to be dramatically adverse, rather low, although still positive, profitability measures will likely be recorded in the foreseeable future. Strong margins, adequate revenue diversification, well-contained operating costs and sound franchises are among the major banks’ most valuable assets to weather the tough conditions of the current operating environment.

In addition to asset quality issues derived from aggressive loan growth in recent years, other risks deserve close monitoring, namely the negative trend of the customer’s

disposable income driven by rising inflation and declining employment, as well as the impact on the commercial and corporate clients from a deeper economic downturn globally. Rising interest rates and the continued environment of scarce liquidity and high risk aversion of investors are also important challenges for financial entities.

Fitch does not anticipate downward pressure on the major banks' ratings in the near future. Most IDRs are support-driven and are primarily exposed to declining willingness to support or rating downgrades at the parent-company level. Individual ratings for the most part already incorporate the likelihood of deterioration in downturn phases of the cycle. However, Fitch will continue to closely monitor asset quality and its effect on results, and does not rule out potential downgrades if the environment worsens substantially, or if any institution's performance should prove markedly worse than expected.

Mexican Banks - Financial Statements and Key Ratios

	Total Assets (MXPbn)			Loans (MXPbn)			Equity (MXPbn)		
	Jun 08	2007	2006	Jun 08	2007	2006	Jun 08	2006	2005
BBVA Bancomer	748.6	707.4	602.8	485.9	462.9	371.6	72.9	78.9	70.6
Banamex	545.4	594.9	539.3	271.5	274.1	224.2	108.2	102.5	93.0
Banco Santander	440.9	398.9	401.9	244.6	218.6	208.6	69.9	61.6	50.5
HSBC Mexico	374.1	344.4	284.0	195.0	200.1	161.7	30.5	31.8	24.6
Banco Mercantil del Norte	312.5	274.9	225.8	214.1	188.3	138.7	34.7	30.9	24.3
Banco Inbursa	179.2	118.3	81.0	115.3	84.9	64.8	28.1	26.8	24.2
Combined Peer Group (*)	2,601	2,439	2,135	1,526	1,429	1,170	344	333	287
Mexican Banking System	3,238	2,954	2,564	1,799	1,698	1,383	426	408	347

	Net Income (MXPbn)			NIM (%)			Cost / Income (%)		
	1H08	2007	2006	1H08	2007	2006	1H08	2007	2006
BBVA Bancomer	11.6	19.8	18.1	7.82	7.74	7.57	39.92	43.76	42.20
Banamex	3.6	19.2	21.2	8.53	7.39	6.93	47.79	49.46	49.51
Banco Santander	3.4	7.8	9.2	7.11	6.50	5.09	43.25	46.74	44.95
HSBC Mexico	2.2	4.7	4.4	6.96	6.89	6.25	57.32	60.33	62.42
Banco Mercantil del Norte	3.5	6.3	5.2	6.81	6.74	6.95	54.01	57.64	56.09
Banco Inbursa	1.4	2.1	0.1	3.73	4.00	3.81	27.73	37.94	63.79
Combined Peer Group (*)	26	60	58	7.38	7.05	6.55	46.02	49.42	49.19
Mexican Banking System	30	70	67	6.97	7.51	7.08	53.19	50.61	49.72

	Return on Assets (%)			Liq. Asts / D&MMF (%)			Equity / Assets (%)		
	1H08	2007	2006	Jun 08	2007	2006	Jun 08	2007	2006
BBVA Bancomer	3.19	3.02	3.15	29.92	33.91	38.69	9.73	11.15	11.71
Banamex	1.28	3.39	4.20	48.58	57.15	56.97	19.83	17.23	17.25
Banco Santander	1.62	1.94	2.39	42.52	47.90	46.18	15.85	15.45	12.55
HSBC Mexico	1.23	1.48	1.65	37.53	35.13	30.66	8.14	9.25	8.65
Banco Mercantil del Norte	2.36	2.51	2.59	21.43	25.13	35.17	11.11	11.24	10.74
Banco Inbursa	1.83	2.12	0.13	18.79	39.63	28.91	15.67	22.69	29.93
Combined Peer Group (*)	2.04	2.62	2.89	24.23	34.99	34.79	13.23	13.64	13.45
Mexican Banking System	1.95	2.52	2.77	25.24	26.64	27.42	13.16	13.80	13.55

	PDL / Loans (%)			Reserves / Loans (%)			Provis. / Avg. Loans (%)		
	Jun 08	2007	2006	Jun 08	2007	2006	1H08	2007	2006
BBVA Bancomer	2.50	2.31	2.19	3.73	3.62	4.27	3.25	3.03	1.99
Banamex	3.59	2.85	2.34	6.24	4.99	4.18	8.74	5.96	3.09
Banco Santander	2.12	1.81	1.12	2.98	2.62	2.04	5.35	3.59	1.52
HSBC Mexico	4.64	4.01	2.67	5.76	5.29	4.19	6.47	5.24	2.84
Banco Mercantil del Norte	1.43	1.46	1.41	1.94	1.97	2.48	2.21	1.58	1.22
Banco Inbursa	1.83	1.78	0.92	10.30	12.41	13.66	4.09	2.59	2.52
Combined Peer Group (*)	2.71	2.43	1.93	4.56	4.27	4.15	4.94	3.78	2.18
Mexican Banking System	2.45	2.54	2.03	4.14	4.29	4.16	4.22	3.86	2.23

(*) Sum of the six largest rated banks' statements. D&MMF - Deposits and Money Market Funds. NIM - Net Interest Margin. PDL - Past-Due Loans.

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