FitchRatings

Fitch Upgrades Erste Group Bank AG to 'A-'; Outlook Stable

Fitch Ratings-London-03 March 2017: Fitch Ratings has upgraded Erste Group Bank AG's (Erste) Long-Term Issuer Default Rating (IDR) and senior debt rating to 'A-' from 'BBB+' and Viability Rating (VR) to 'a-' from 'bbb+'. The Outlook on the Long-Term IDR is Stable.

Fitch has also assigned a Derivative Counterparty Rating (DCR) at 'A-(dcr)' to Erste as part of its roll-out of DCRs to significant derivative counterparties in western Europe and the US. DCRs are issuer ratings and express Fitch's view of banks' relative vulnerability to default under derivative contracts with third-party, non-government counterparties. A full list of rating actions is at the end of this rating action commentary.

The rating action reflects our view that Erste's risk profile has improved as a consequence of active balance sheet clean-up and improving operating conditions in central and eastern Europe (CEE). This has resulted in higher and more balanced earnings and strong internal capital generation over the last two years, which we expect will continue, albeit at a decelerating pace.

The rating action was taken in conjunction with Fitch's periodic review of major Austrian banks.

KEY RATING DRIVERS
IDRS, VR, DCR AND SENIOR DEBT
Erste's IDRs, VR and senior debt rating reflect Fitch's view that the bank's profitability has improved owing to more balanced profit contributions from CEE subsidiaries as well as cyclically and structurally lower loan impairment charges (LICs). The outlook for 2017 is benign, but cost inefficiencies at some Austrian savings banks, the need to boost IT investments, low base rates and more normalised LICs will likely dampen returns in the medium term.

The VR is supported by the sound franchises of Erste in its core markets, Austria, the Czech Republic, Slovakia and Romania, and by a diversified business model with a slight bias towards retail banking. Erste's geographic footprint leaves the group more vulnerable to the political environment in CEE than its domestic-focused Austrian peers. This has in the past resulted in high charges in the form of bank levies, reimbursements of bid/ask spreads and mandatory conversion of foreign currency loans. The cost of bank-adverse political actions decreased in 2016. This risk remains inherent in Erste's business model, in our view, but is less acute than in recent years.

Erste's asset quality has improved rapidly over the past two years owing to active clean-up, tightened underwriting and improving economic conditions in CEE. The consolidated NPL ratio fell to 4.9% at end-2016 from a peak of 9.6% at end-2013. The asset quality of individual markets is slowly converging, but disparity remains between the strong loan quality at Erste Bank Oesterreich and its savings banks subsidiaries and in the Czech Republic (NPL ratios below overall group level) and weaker markets such as Romania, Hungary and Croatia (NPL ratios around 9% - 12%). Impaired loan reserve coverage is adequate across all markets, and allowed Erste to progress with sales of NPL portfolios in 2016 without additional risk costs. We expect Erste to maintain its positive asset quality trajectory given its moderate risk appetite, sound underwriting standards and risk controls.

The improved earnings have supported internal capital generation, strengthening the bank's fully-loaded CET1 ratio to 12.8% at end-2016 from 10.6% two years earlier. Risk-adjusted capitalisation is now broadly in line with European universal bank peers. The high regulatory risk weights of CEE assets are reflected in the group's solid fully-loaded leverage ratio of 6.2%. We expect capitalisation to continue to benefit from adequate retained earnings and moderate growth ambitions.

Erste's Short-Term IDR of 'F1' is the higher of the two possibilities corresponding to the Long-Term IDR of 'A-'. This reflects our view that the group's liquidity is strong, benefitting strongly from its leading retail deposit franchises in Austria, the Czech Republic and Slovakia. Intragroup funding needs have declined substantially in recent years. At end-2016, Erste's liquidity buffer (unencumbered collateral and cash) was a high EUR51.2 billion, which is equivalent to around 3x short-term wholesale funding.

A DCR has been assigned to Erste because we deem its derivatives activities to be significant. The DCR is equalised with Erste's Long-Term IDRs because in Austria derivative counterparties have no definitive preferential status over other senior obligations in a resolution scenario.

SUPPORT RATING AND SUPPORT RATING FLOOR (SRF)
Erste's Support Rating and SRF reflect Fitch's view that senior creditors can no longer rely on full extraordinary state support. This is driven by the EU's Bank Recovery and Resolution Directive (BRRD), which has been in force with its bail-in tool in since 1 January 2015.

SUBORDINATED DEBT
Erste's legacy Tier 2 debt is rated one notch below the VR to reflect the instruments' below-average recovery prospects.

RATING SENSITIVITIES
IDRS, VR, DCR AND SENIOR DEBT
Erste's VR, IDRs and senior unsecured debt ratings would mostly likely come under pressure if earnings and asset quality deteriorate as a result of changes in market conditions or adverse political actions, if capital deteriorates as a result of insufficient earnings retention or losses, or if we have indications that the group's risk appetite is increasing in a way that exceeds the bank's ability to build up capital.

A further upgrade of Erste's VR, Long-Term IDR and senior unsecured debt ratings is unlikely in the medium term, and would be conditioned by a substantial reduction of risk appetite and NPLs, particularly in the more vulnerable Romanian and Croatian markets, beyond our expectations for the rating. We believe that this is unlikely given Erste's CEE-focused business model and foreseeable developments in its main markets.

Erste's Short-Term IDR could be downgraded to 'F2' if the Long-Term IDR is downgraded or the bank's liquidity position deteriorates.

The DCR is primarily sensitive to changes in Erste's Long-Term IDR. It could also be upgraded to one notch above the IDR if changes in legislation (for example as recently proposed by the European Commission) create legal preference for derivatives over certain other senior obligations and if, in Fitch's view, the volume of all legally subordinated and non-preferred senior obligations provides a substantial enough buffer to protect derivative counterparties from default in a resolution scenario. In such a scenario, however, building up a sufficient buffer could take several years.

SUPPORT RATING AND SRF
An upgrade of Erste's Support Ratings and an upward revision of its SRF would be contingent on a positive change in the sovereign's propensity to support the bank. This is highly unlikely in light of the new regulatory environment, in our view.

SUBORDINATED DEBT
The rating of the legacy Tier 2 notes is primarily sensitive to changes in the bank's VR.

The rating actions are as follows:

Long-Term IDR: upgraded to 'A-' from 'BBB+'; Outlook Stable
Short-Term IDR: upgraded to 'F1' from 'F2'
Viability Rating: upgraded to 'a-' from 'bbb+'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Derivative Counterparty Rating: assigned at 'A-(dcr)'
Senior unsecured notes: upgraded to 'A-'/'F1' from 'BBB+'/'F2'
Market-linked senior unsecured notes: upgraded to 'A-emr' from 'BBB+emr'
Legacy Tier 2 debt: upgraded to 'BBB+' from 'BBB'
Erste Finance (Delaware) LLC: USD10bn CP programme guaranteed by Erste: upgraded to 'F1' from 'F2'

Contact:
Primary Analyst
Krista Davies
Director
+44 20 3530 1579
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Ioana Sima
Associate Director
+44 20 3530 1736

Committee Chairperson
Christian Scarafia
Senior Director
+44 20 3530 1012

Media Relations: Elaine Bailey, London, Tel: +44 203 530 1153, Email: elaine.bailey@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Global Bank Rating Criteria (pub. 25 Nov 2016) (https://www.fitchratings.com/site/re/891051)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
(https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?
pr_id=1020009&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJzZXNzaW9uS2V5IjoiNUdIQ0NaT0NNNk9VRURBNjdSUFpZQ05FVUxHSFlGSlJUN0VBQjZYUCIsImV4cCI6MTQ4OTE0MTEzNiwidXNlcklkIjoyNDYwMTIzfQ.yt-1hLCS5yA3WdVaaIkwW8tliCd7YVkCRo6XwaqVvdc)
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