FITCH AFFIRMS ERSTE GROUP BANK AT 'A-'; OUTLOOK STABLE

Fitch Ratings-London-19 February 2018: Fitch Ratings has affirmed Erste Group Bank AG's (Erste) Long-Term Issuer Default Rating (IDR) at 'A-' with a Stable Outlook, and Viability Rating (VR) at 'a-'. The Short-Term IDR has been affirmed at 'F1'.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

IDRS, VR, DERIVATIVE COUNTERPARTY RATING (DCR) AND SENIOR DEBT

Erste's IDRs, VR and senior debt ratings reflect the bank's strong and diversified franchise in its core markets of Austria, the Czech Republic, Slovakia and Romania, and its diversified business model focusing on retail and corporate banking. Capitalisation, funding and liquidity are solid, and asset quality has strengthened considerably in recent years thanks to workout measures and strengthened underwriting, as well as improving economic conditions in Erste's CEE markets.

Erste's performance has improved since 2015, supported by more balanced profit contribution from CEE subsidiaries as well as cyclically and structurally lower loan impairment charges (LICs) and the non-recurrence of mostly regulatory one-off charges. We believe LICs are close to their cyclical lows but expect lower normalised levels compared with 2009-14 given strengthened underwriting in recent years. The bank's efforts to strengthen cost control and reduced banking and financial transaction taxes should also help support medium-term profitability, assuming Erste can maintain pricing discipline and avoid asset spread erosion.

Economic conditions are supportive of banks in most CEE countries where Erste operates although we consider the operating environment in these countries as weaker than the very stable Austrian market. Vulnerabilities remain in Erste's smaller markets Serbia and Croatia although the outlook in these countries is also improving. In the past, the political environment in CEE has resulted in high charges in the form of bank levies, reimbursements of bid/ask spreads and mandatory conversion of foreign currency loans, but the cost of bank-adverse political actions has decreased considerably since 2015.

The bank's strengthened asset quality results in a consolidated gross NPL ratio of 4.3% at end-3Q17, down 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 in markets such as Romania, Hungary and Croatia (NPL ratios around 7% - 13%). Impaired loan reserve coverage is adequate across all markets. We expect Erste to maintain its positive asset quality trajectory given its moderate risk appetite, sound underwriting standards and risk controls.

The bank's fully-loaded CET1 ratio improved to 12.4% at end-3Q17 from 10.6% at end-2014, helped by internal capital generation. 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 end-3Q17 regulatory leverage ratio of 6.3%. 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, benefiting strongly from its leading retail deposit franchises in Austria, the Czech Republic and Slovakia. Intragroup funding needs have declined substantially in recent years.

Fitch assigns Erste a DCR because we deem its derivatives activities to be significant. The DCR is equalised with Erste's Long-Term IDRs because derivative counterparties in Austria 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 come under pressure if earnings and asset quality deteriorate, which could happen as a result of changes in market or economic conditions, if capital deteriorates from insufficient earnings retention or losses, or if Erste's risk appetite increases materially.

Improved cost efficiency in the Austrian savings banks segment while maintaining price discipline could be positive for the bank's ratings because this would help limit the downside risk to Erste's capital generation, for which it largely relies on what we consider more volatile earnings from CEE. Any upgrade would require a continued solid economic outlook in Erste's core markets and sustained improvement in the outlook for the higher-risk markets it operates in.

Erste's Short-Term IDR could be downgraded to 'F2' if the Long-Term IDR is downgraded or if 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. However, in such a scenario building up a sufficient buffer could take several years.

SUPPORT RATING AND SUPPORT RATING FLOOR
An upgrade of Erste's Support Rating and 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 AND OTHER HYBRID SECURITIES
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: affirmed at 'A-'; Outlook Stable
Short-Term IDR: affirmed at 'F1'
Viability Rating: affirmed at 'a-'
Support Rating: affirmed at '5'

Support Rating Floor: affirmed at 'No Floor'
Derivative Counterparty Rating: affirmed at 'A-(dcr)'
Senior unsecured notes: affirmed at 'A-'/'F1'
Market-linked senior unsecured notes: affirmed at 'A-emr'
Legacy Tier 2 debt: affirmed at 'BBB+'
Erste Finance (Delaware) LLC USD10 billion CP programme guaranteed by Erste: affirmed at 'F1'

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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