FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Erste at 'A'; Outlook Negative

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Fitch Ratings - Frankfurt am Main - 01 Dec 2020: Fitch Ratings has affirmed Erste Group Bank AG's (Erste) Long-Term Issuer Default Rating (IDR) at 'A' with a Negative Outlook and Viability Rating (VR) at 'a'. The Long-Term IDR, VR, Derivative Counterparty Rating (DCR) and long-term debt ratings have been removed from Rating Watch Negative (RWN). A full list of rating actions is at the end of this rating action commentary.

The affirmation reflects Fitch's view that there is sufficient rating headroom to absorb pressure on asset quality and profitability from the coronavirus outbreak, mainly due to the bank's solid capitalisation. The Negative Outlook reflects downside risks to the ratings if profitability and asset quality deteriorate more permanently without credible prospects being restored.

KEY RATING DRIVERS

IDRS, VR, DCR AND SENIOR UNSECURED DEBT RATINGS

Erste's IDRs, VR and preferred ratings reflect the bank's sound financial profile and resilience, strong execution of its consistent strategy and tightened risk appetite. They also reflect its diversified business model, focused on retail and corporate banking, underpinned by leading franchises in its main core markets of Austria, Czech Republic, Slovakia and Romania.

Asset quality is supported by the dominance of the group's fairly low-risk Austrian lending and stable Czech operations. Exposure to other countries in central and eastern Europe (CEE) gives rise to potential volatility in earnings and asset quality, but we believe risk controls and credit standards are robust.

The impact of the pandemic on Erste's asset quality has so far been mostly visible through a doubling of its Stage 2 loans ratio to 16.7% at end-3Q20 from 8.3% at end-2019. However, Erste's Stage 3 loans ratio remained broadly stable at 2.4% at end-3Q20. Similar to 2Q20 and 3Q20, we expect any asset deterioration in 4Q20 to be cushioned by the various fiscal measures and loan moratoria in place in Erste's countries of operation.

We expect a material increase in Stage 3 loans in 2021 as support measures gradually fade out, and given the group's relatively high exposure to the SME and corporate sectors (about 48% of gross loans at end-3Q20). However, under our baseline scenario, we expect the Stage 3 loan ratio to remain below 5% and revert towards 3% in the medium term.

We believe that Erste's operating profit/risk-weighted assets (RWA) peaked at 2.2% in 2018, driven by record low loan impairment charges (LICs). Operating profit/RWA declined to 1.2% in 9M20 due to frontloading of LICs, and we expect it to remain close to this level in 2021. At the same time, we believe Erste's pre-impairment profit will continue to benefit from the sound operating margins and long-term growth potential available in its markets of operation, with only moderate variability over the cycle. Erste has also some room to improve cost efficiency, particularly in Austria, and we believe that management's cost/income ratio target of 55% for 2024 is challenging but achievable.

Erste's common equity Tier 1 (CET1) ratio of 14.2% at end-3Q20 and target of 13.5% solidly exceed its regulatory requirements and are broadly commensurate with its risk profile. Profit contribution from its geographically diversified CEE subsidiaries should support the group's capital ratios through the cycle, by enabling operating profit margins that will remain materially higher than in Austria.

The 'F1' Short-Term IDR is the baseline option mapping to a Long-Term IDR of 'A'. This reflects Fitch's assessment of funding and liquidity, which is scored at 'a'. Funding and liquidity are a rating strength. Customer deposits, mostly from retail clients, are the main source of funding and are in excess of customer loans. Erste accesses the debt capital markets through a wide range of products. Wholesale funding maturities are reasonably well spread, and the ample liquidity buffer adequately mitigates refinancing risk.

Erste's resolution strategy is multiple-point-of-entry (MPE), with one resolution group for each of its six EU core markets. We believe that this limits intragroup contagion risk, which is already largely mitigated by the group's policy that prescribes that CEE subsidiaries must be largely self-funded. However, the MPE strategy does not change our assumptions for intragroup support, as we still expect Erste to support its foreign subsidiaries via pre-emptive measures, such as capital injections, guarantees or liquidity lines, should such measures become necessary. We expect the group's parent and CEE subsidiaries to increase their senior non-preferred (SNP) debt issuance to meet their resolution buffer requirements by 2024.

Erste's SNP debt is rated one notch below its Long-Term IDR to reflect the risk of below-average recoveries in a resolution. This is because we expect Erste to use senior preferred (SP) debt to meet its resolution buffer requirements, and we do not expect SNP and more junior debt to sustainably exceed 10% of the Austrian resolution group's RWA.

Erste Finance (Delaware) LLC's commercial paper programme's 'F1' rating is equalised with Erste's Short-Term IDR, based on our view that Erste will honour its obligations under its guarantee of the programme.

Fitch has also assigned SP and SNP ratings to Erste's Multi Issuer EMTN Programme, in line with Erste's respective debt ratings.

SUPPORT RATING AND SUPPORT RATING FLOOR

Erste's Support Rating and Support Rating Floor (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 and the Single Resolution Mechanism, which provide a resolution framework that is likely to require senior creditors participating in losses, if necessary, instead, or ahead, of a bank receiving sovereign support.

SUBORDINATED DEBT

The subordinated Tier 2 debt is rated two notches below the VR for loss severity. The notching reflects our expectation that the bank will not maintain buffers of Tier 2 and AT1 debt exceeding 10% of the Austrian resolution group's RWA.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

IDRS, VR, DCR and SENIOR UNSECURED DEBT RATINGS

The Negative Outlook on Erste's Long-Term IDRs signals that an upgrade of its ratings is unlikely in the short term. The Outlook could be revised to Stable if the pressure on asset quality and profitability is in line with our base case scenario. In the longer term, even if the group withstands rating pressure arising from the coronavirus crisis, an upgrade would require an improvement of asset quality metrics and earnings generation above pre-crisis levels, together with higher capital ratios.

The DCR and the long-term SP and SNP debt ratings could also be upgraded by one notch if we expect Erste to meet its MREL requirements with SNP and more junior instruments only or if we expect Erste's SNP and more junior debt buffers to sustainably exceed 10% of the Austrian resolution group's RWA.

Erste's Short-Term IDR and short-term SP debt rating, as well as Erste Finance (Delaware) Short-Term unsecured debt rating, would be upgraded if Erste's Funding and Liquidity score was revised up to 'aa-' or above.

SUBORDINATED DEBT RATING

An upgrade of the subordinated securities would require an upgrade of Erste's VR. We could also upgrade the Tier 2 notes if we deem the buffer of Tier 1 and Tier 2 debt are likely to increase to and sustainably exceed 10% of the Austrian resolution group's RWA.

SUPPORT RATING AND SRF

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 regulatory environment, in our view.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

IDRS, VR, DCR and SENIOR UNSECURED DEBT RATINGS

We could downgrade the ratings if asset quality and operating profitability deteriorate substantially and durably, most likely due to severe damage to the SME and corporate loan portfolios. In particular, an impaired loan ratio durably above 5% or operating profitability/RWA materially and durably below 2% would lead to a downgrade. We would also downgrade the ratings if Erste's CET1 ratio falls materially below its current target or if the share of unreserved Stage 3 loans rises materially. This could arise if the fallout from the coronavirus crisis is more severe than in Fitch's baseline scenario.

Erste's Short-Term IDR and short-term SP debt rating, as well as Erste Finance (Delaware) Short-Term unsecured debt rating, would be downgraded if both Erste's Long-Term IDR and its Funding and Liquidity score were downgraded by one or more notches.

SUBORDINATED DEBT RATING

A downgrade of the subordinated securities would require a downgrade of Erste's VR.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Erste Group Bank AG	LT IDR	A Rating Outlook Negative	Affirmed	A Rating Watch Negative
	ST IDR	F1	Affirmed	F1
	Viability	a	Affirmed	a Rating Watch Negative
	Support	5	Affirmed	5
	Support Floor	NF	Affirmed	NF
	DCR	A(dcr)	Affirmed	A(dcr) Rating Watch

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Erste Finance (Delaware) LLC	EU Issued
Erste Group Bank AG	EU Issued

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