FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Erste Group's Outlook to Stable; Affirms at 'A'

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Fitch Ratings - Frankfurt am Main - 27 Oct 2021: Fitch Ratings has revised Erste Group Bank AG's (Erste) Outlook to Stable from Negative and affirmed the bank's ratings, including the Long-Term Issuer Default Rating (IDR) at 'A' and Viability Rating (VR) at 'a'. A full list of rating actions is detailed below.

The revision of the Outlook reflects Fitch's updated economic assumptions for the bank's main operating countries, reflecting sufficient rating headroom to absorb residual pandemic-related risks. Fitch expects strong forecast economic recovery in Erste's core region will support the group's asset quality and operating profitability, which we expect to remain close to their four-year average in 2021-2022.

KEY RATING DRIVERS

IDRS, VR, DERIVATIVE COUNTERPARTY RATING AND SENIOR UNSECURED DEBT RATINGS

The IDRs, VR and senior preferred ratings of Erste reflect a leading franchise in retail and SME banking in Austria, Czech Republic, Slovakia and Romania and strong execution of its consistent strategy. At the same time, the group's material operations in less developed and more volatile countries in central and eastern Europe (CEE) translate into a slightly weaker operating environment compared with that of peers that solely focus on Austria. As a result, Erste needs to report better financial metrics than purely Austrian-focused peers to achieve a given rating level.

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 CEE gives rise to potential volatility in loan impairment charges (LICs), but we believe risk controls and credit standards in CEE are tighter than local peers' in the respective countries.

The impact of the pandemic on Erste's asset quality has so far been mostly visible through a sharp increase of Stage 2 loans and coverage since end-2020, but Erste's Stage 3 loans ratio remained broadly stable at 2.5% at end-1H21. We believe that the risk of asset quality weakening has subsided, and we expect only a moderate deterioration in the bank's corporate and SME loan book (43% of gross loans at end-1H21) in 2022, following the end of government-support measures.

After a sharp decline in net income due to prudent frontloading of pandemic-related provisions in 2020, Erste posted exceptionally high profits in 1H21 as a result of low LICs combined with strong business growth. We project its operating profits/risk-weighted assets (RWAs) to return to pre-pandemic levels in 2021, as the release of pandemic-related collective provisions should substantially mitigate the inflow of LICs in 2H21.

In the long term, we believe that Erste's revenue will continue to benefit from sound operating margins and growth potential available in the group's markets, with only modest variability over the cycle. Targeted growth in revenues from the asset management-and-security business will also add to revenue diversification, mitigating net interest margin pressure from increasing competition in CEE and low interest rates in the eurozone. Despite inflationary pressures, Erste has some room to improve its cost efficiency, particularly in Austria, and we believe that management's cost/income ratio target of 55% for 2024 is achievable.

Erste's fully loaded common equity Tier 1 (CET1) ratio of 14.2% at end-1H21 and 13.5% target are broadly commensurate with the group's risk profile. Capitalisation also benefits from strong retained earnings, low unreserved Stage 3 loans, moderate concentrations and good capital-markets access through its listing. Erste's leverage ratio of 6.3% is higher than large European peers', driven by the CEE operations' higher RWA density.

The Short-Term IDR of 'F1' is the baseline option mapping to a Long-Term IDR of 'A', and reflects the group's robust funding & liquidity, which we score at 'a'. Customer deposits, mostly from retail clients, are the main source of funding and are in excess of customer loans. Erste accesses debt-capital markets through a wide range of products. Wholesale-funding maturities are reasonably well-spread, and an 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 core EU markets. We believe that this limits intra-group contagion risk, which is already largely mitigated by the group's policy that CEE subsidiaries must be largely self-funded. However, the MPE strategy does not change our assumptions for intra-group support, as we still expect Erste to support its foreign subsidiaries via pre-emptive measures, such as capital injections, guarantees or liquidity lines, in case of need.

Issuance activities in CEE to comply with the minimum requirements for own funds and eligible liabilities (MREL) of the various resolution groups have progressed substantially, with senior non-preferred debt (SNP) placements in Czech Republic, Romania and Slovakia and first international senior preferred (SP) placements in Croatia. The less developed capital markets in some of these countries have not been a constraint so far, as demand is sustained by supra-nationals and European investors (a large portion of the issuance was in euros) in search of yields. Total MREL-driven issuance needs in CEE over the next three years will be around EUR5 billion.

Erste's SNP debt is rated one notch below the Long-Term IDR (and SP debt is rated in line with the Long-Term IDR) to reflect the risk of the SNP debt's below-average recoveries in a resolution. This is because we expect Erste to use 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 RWAs.

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.

SUPPORT RATING AND SUPPORT RATING FLOOR

Erste's Support Rating (SR) 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 to reflect subordinated debt's higher loss severity in a resolution scenario. The notching reflects our expectation that the bank will not maintain buffers of Tier 2 and additional Tier 1 (AT1) debt exceeding 10% of the Austrian resolution group's RWAs.

RATING SENSITIVITIES

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

Rating upside for Erste is limited in the medium term. An upgrade of its VR, DCR, Long-Term IDR and debt ratings would require an improvement of its operating environment in CEE, stronger asset-quality metrics and earnings generation above pre-pandemic levels, together with higher capital ratios.

The DCR and the long-term SP and SNP debt ratings could also be upgraded by one notch above the Long-Term IDR if we expect Erste's SNP and more junior debt buffers to sustainably exceed 10% of the Austrian resolution group's RWAs.

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 is upgraded to 'aa-' or above.

An upgrade of the SR and upward revision of the 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 prevailing regulatory environment, in our view.

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

We could downgrade the ratings if asset quality and operating profitability deteriorate substantially and on a sustained basis, most likely due to severe damage to the SME-and-corporate loan portfolios. In particular, an impaired loan ratio above 5% or operating profitability/RWAs materially below 2% on a sustained basis would lead to a downgrade. We would also downgrade the ratings if the CET1 ratio falls below its 13.5% target on a sustained basis.

Erste's Short-Term IDR and short-term SP debt rating, as well as Erste Finance (Delaware)'s short-term unsecured debt rating, would be downgraded if both Erste's Long-Term IDR and funding and liquidity score are downgraded.

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 Stable	Affirmed	A Rating Outlook Negative
	ST IDR	F1	Affirmed	F1
	Viability	a	Affirmed	a
	Support	5	Affirmed	5
	Support Floor	NF	Affirmed	NF
	DCR	A(dcr)	Affirmed	A(dcr)
• Senior preferred	LT	A	Affirmed	A

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, UK Endorsed
Erste Group Bank AG	EU Issued, UK Endorsed

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