MOODY'S INVESTORS SERVICE

Credit Opinion: Erste Group Bank AG

Global Credit Research - 24 Mar 2015

Vienna, Austria

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*Baa2/P-2
Baseline Credit Assessment	ba1
Adjusted Baseline Credit Assessment	ba1
Senior Unsecured	**Baa2
Senior Subordinate -Dom Curr	Ba2
Jr Subordinate -Dom Curr	Caa1 (hyb)
Commercial Paper -Dom Curr	P-2
Other Short Term -Dom Curr	(P)P-2
Ceska Sporitelna, a.s.	
Outlook	Stable
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Erste Bank Hungary Zrt.	
Outlook	Negative(m)
Bank Deposits	B3/NP
Baseline Credit Assessment	caa2
Adjusted Baseline Credit Assessment	b3
Erste Bank, New York	
Outlook	Rating(s) Under Review
Bank Deposits	**Baa2/--

* Rating(s) within this class was/were placed on review on March 17, 2015
** Placed under review for possible upgrade on March 17, 2015

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Key Indicators

Erste Group Bank AG (Consolidated Financials)[1]

	[2]**9-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (EUR million)	**196,973.2**	**192,384.1**	**202,267.0**	**209,875.3**	**205,639.0**	[4]**-1.1**
Total Assets (USD million)	**248,826.1**	**265,094.2**	**266,667.1**	**272,448.6**	**275,873.7**	[4]**-2.5**

Tangible Common Equity (EUR million)	**8,017.8**	**8,793.2**	**8,053.6**	**7,045.7**	**7,016.4**	[4]**3.4**
Tangible Common Equity (USD million)	**10,128.5**	**12,116.6**	**10,617.8**	**9,146.3**	**9,412.8**	[4]**1.8**
Problem Loans / Gross Loans (%)	**8.9**	**9.6**	**9.2**	**8.5**	**7.6**	[5]**8.7**
Tangible Common Equity / Risk Weighted Assets (%)	**7.9**	**9.0**	**7.6**	**6.2**	**5.9**	[6]**7.9**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**71.9**	**74.1**	**77.1**	**80.9**	**76.5**	[5]**76.1**
Net Interest Margin (%)	**2.3**	**2.4**	**2.5**	**2.7**	**2.7**	[5]**2.5**
PPI / Average RWA (%)	**2.6**	**2.7**	**2.8**	**2.8**	**2.9**	[6]**2.6**
Net Income / Tangible Assets (%)	**-0.5**	**0.3**	**0.4**	**0.2**	**0.6**	[5]**0.2**
Cost / Income Ratio (%)	**60.5**	**61.1**	**58.5**	**56.3**	**53.4**	[5]**58.0**
Market Funds / Tangible Banking Assets (%)	**24.7**	**22.3**	**24.3**	**28.8**	**27.6**	[5]**25.5**
Liquid Banking Assets / Tangible Banking Assets (%)	**28.7**	**23.3**	**23.3**	**20.9**	**20.7**	[5]**23.4**
Gross Loans / Total Deposits (%)	**95.3**	**91.5**	**91.1**	**94.5**	**96.5**	[5]**93.8**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 17 March, we placed on review for upgrade the Baa2 long-term debt and deposit ratings of Erste Group Bank AG (Erste). Erste's ba1 baseline credit assessment (BCA) was unaffected by the action and continues to reflect its fundamental credit profile under our new methodology for rating banks globally. The Prime-2 short term ratings as well as the bank's hybrid ratings are also not affected.

The review for upgrade on the bank's Baa2 long-term ratings was prompted by the substitution of two notches of systemic support by two notches of uplift from the loss given failure (LGF) analysis and potentially one notch of systemic support. The likely outcome of the review is an affirmation at the current rating levels as we may decide to exclude any systemic support for domestically significant financial institutions (D-SIFIs) in Austria. We are considering to exclude government support from Erste's ratings, reflecting recent developments in the Austrian banking market such as the early adoption of the European Bank Resolution and Recovery Directive (BRRD) and its recent application to Heta Asset Resolution AG (Carinthian-State-guaranteed senior unsecured debt rated Ca, negative).

Erste's stand-alone ba1 BCA continues to reflect Erste's overall satisfactory financial fundamentals, its leading retail and corporate franchises throughout Austria and the more mature economies in Central and Eastern Europe (CEE), and its solid deposit funding base. However, the BCA is constrained by the bank's (1) high volume of problem loans (despite adequate coverage ratios of over 60%), which might negatively affect the bank's capital generation capacity; (2) concentration risk as a result of sizeable exposures to Hungary and Romania, thereby limiting Erste's geographical diversification; and (3) moderate capitalisation compared to its credit risk profile.

ERSTE'S BCA IS CALIBRATED AGAINST ITS MACRO PROFILE OF STRONG

The bank's BCA is calibrated to reflect its Strong Macro Profile, which results from the focus of its business activities in Austria (51% of its exposure) and CEE. While we determine the macro profile for Austria to be "Very Strong-", some of the countries in CEE in which Erste operates show significantly weaker macro profiles (Hungary, Croatia, Romania).

Rating Drivers

- CEE subsidiaries remain the group's driver of profitability and high credit costs

- Weak earnings trend, hence significantly reduced internal capital generation

- Elevated level of problem loans constrains Erste's standalone credit profile

- Improved capital position

- Deposit-rich balance sheet, with moderate reliance on wholesale funding

Rating Outlook

The review for upgrade on Erste's long-term debt and deposit ratings reflects the substitution of two notches of systemic support by two notches of uplift from the loss given failure (LGF) analysis and potentially one notch of systemic support.

The negative outlook on Erste's subordinated debt reflects pressure on Erste's stand-alone credit profile arising from (1) our assessment of additional uncertainties arising from the recent deterioration of operating conditions in Russia and potential negative implications on some of the bank's operations in CEE; and (2) our assessment regarding the bank's ability to provide a buffer for negative developments in its pressured profitability in order to avoid losses for subordinated creditors, as indicated by the recent announcement to skip or defer coupon payments on the bank's subordinated capital instruments. Erste's hybrid debt is rated on an expected loss basis and carries a stable outlook.

What Could Change the Rating - Down

Downward pressure could be exerted on Erste's ba1 standalone BCA following (1) further additional credit charges, in particular related to the bank's operations in CEE; (2) further weakening in earnings that result in lower internal capital generation; and (3) weakened capitalisation levels.

Downward pressure could be exerted on Erste's long-term ratings as a result of (1) a lowering of its standalone ba1 BCA; or (2) a re-assessment of our systemic support assumptions.

What Could Change the Rating - Up

Upward pressure on Erste's ba1 standalone BCA would be prompted by (1) a significant and sustained reduction in the volume of NPLs; (2) a material increase of its capitalisation; and (3) sustained improvement in the bank's operating performance and its capital generation capacity.

If Erste were to resume payments on its supplementary capital and hybrid capital instruments on a sustained basis, upward pressure would develop on these ratings to the extent that ratings would return to normal notching.

DETAILED RATING CONSIDERATIONS

The detailed rating considerations still reflect financials as of September 2014 and will be updated in due course.

CEE SUBSIDIARIES REMAIN THE GROUP'S DRIVER OF PROFITABILITY AND HIGH CREDIT COSTS

Erste's credit profile is driven by its operations in Austria (accounting for almost 44% of its exposure) and its activities in CEE. Both activities have distinct characteristics: The bank's domestic operations contribute stable but lower-margin business, with Erste accounting for 19% of retail deposits in Austria as of year-end 2013.

Erste also has leading market shares in most of its six core markets in CEE. Its CEE operations account for two-thirds of the group's pre-provision income (first nine months of 2014). Erste's operations in CEE are geographically more concentrated than some of its major peers because operations in the Czech Republic and Slovakia increasingly contribute the bulk of the group's CEE earnings; in the first nine months of 2014, these two countries accounted for 36% of the group's pre-provision income. In addition, the bank's activities in Hungary, Romania and Croatia - with combined total loans of EUR21.3 billion as of end-September 2014 (representing 17% of total gross loans) - face specific challenges and, therefore, have continued to reduce group-wide risk-adjusted profitability. We expect the bank's cost of risk to stabilise in the coming quarters at lower and more sustainable levels, which however may become challenged by the impact of the deterioration of operating conditions in Russia on Erste's exposures in CEE.

In recent years, Erste's cost of risk accounted for more than 35% its net interest income. For 2014, we expect Erste's cost of risk to be more than 50% of its net interest income as the bank increased its full year expectation for loan loss provisions to EUR2.4 billion, from its previous forecast of EUR1.7 billion, as a result of increased provisions in Hungary and Romania. In addition, Erste continued to write-down its intangible assets related to CEE during H1 2014. The main drivers for the net loss of EUR1.5 billion in the first nine months of 2014 were loan-loss provisions of EUR2.0 billion which includes an estimate of EUR361 million additional provisioning needs for consumer loans in Hungary. In addition, Erste accounted for EUR471 million write-downs of the customer relationships, and the brand in Romania, as well as goodwill impairments amounting to EUR421 million (comprising EUR319 million in Romania and EUR61 million in Croatia, as well as EUR40 million of Steiermärkische Sparkasse which holds a significant stake in Erste Bank Croatia).

ELEVATED LEVEL OF PROBLEM LOANS CONSTRAINS ERSTE'S STANDALONE CREDIT PROFILE

The Asset Risk score of ba3 adequately reflects the bank's elevated problem ratio which has started to fall, mainly due the sale of NPL portfolios in CEE. NPLs as of September 2014 amounted to EUR11.4 billion, down from EUR12.3 billion at year-end 2013. As a result, over this period the bank's NPL ratio (NPLs as percentage of total loans) dropped to 8.9% from 9.6%. The decline was mainly the result of EUR562 million of NPL sales since the beginning of the year, EUR341 million of which Erste completed in the third quarter. Moreover, the formation of new NPLs slowed down with a net reduction of EUR312 million, despite additional NPLs of EUR122 million related to Erste's non-core operations in Southeastern Europe and the Commonwealth of Independent States region.

We expect the bank's credit profile to remain constrained by the high stock of NPLs - mainly related to the bank's operations in CEE - as we expect the bank to remain vulnerable to a slowdown in economic activity in Eastern Europe. Key drivers of Erste's high NPL ratios are three of the bank's five core markets in CEE: Romania (NPL ratio 26.5% as of September 2014), Hungary (26.3%) and Croatia (18.7%). At the same time, Erste reports good asset quality and comfortable coverage in the Czech Republic (NPL ratio: 4.7%, coverage: 79%) and Slovakia (NPL ratio: 5.1%, coverage: 85%), accounting for more than 50% of the bank's gross loans in CEE.

While still at very high levels, the volume of NPLs for Hungary and Romania has started to decrease. For Romania, Erste reported a decline in NPLs to EUR2.5 billion as at September 2014, down from EUR3.3 billion as at September 2013, mainly on the back of the sale portfolios of NPLs (about EUR276 million of NPLs sold in Q3 2014). Further NPL sales should help the bank to substantially decrease its stock of NPLs in Romania over time. For Hungary, over the same period the volume of NPLs decreased to EUR1.3 billion from EUR1.5 billion.

Despite some recent stabilisation and success in active reduction of the volume of NPLs, we consider the weak credit quality of significant parts of its CEE exposure to pose a considerable tail risk, particularly if the latest trend in group NPLs proves short-lived, which could be the case in an overall economic slowdown in Europe.

IMPROVED CAPITAL POSITION

We assign a Capital score of ba1, three notches above the historic ratio, to reflect the resilience of the bank in a stress case which has also been affirmed by the recent stress test of ECB as part of the Comprehensive Assessment.

We consider Erste's capital position to be sufficiently adequate to absorb losses in a downside scenario, (1) given a reported Common Equity Tier 1 (CET1) of 10.8% as of 30 September 2014 and guidance of a fully phased-in CET1 comfortably above 10% as per year-end 2014; and (2) also taking into account Erste's improved coverage ratio. A combination of a capital increase and a reduction in risk-weighted assets enabled Erste to repay its entire participation capital in 2013, thereby improving its capital quality without negatively affecting its capital ratio. Erste's disposal of non-core assets and changes to its business mix towards a larger portion of mortgage loans enabled the bank to decrease the risk-weighted assets to EUR101 billion as of end-September 2014 from EUR120 billion as of December 2010. Because of limited adjustments implied by the transitioning to the full implementation of Basel III, we consider the bank's capital position to be in line with similarly rated peers.

Erste passed the ECB's comprehensive assessment with a CET1 of 10.1% in the ECB's "baseline" scenario and 7.6% in its "adverse" stress scenario. As a result of the asset quality review, the ECB adjusted Erste's CET1 ratio down to 10.0%, compared with the 11.2% ratio reported by the bank at the beginning of 2014 and which is one of the most significant adjustments among the 130 banks assessed by the ECB. Erste has addressed the additional provisioning needs outlined by the ECB (EUR1.4 billion under ECB rules) and significantly increased the provisioning related to its operations in Hungary and Romania.

WEAK EARNINGS TREND, HENCE SIGNIFICANTLY REDUCED INTERNAL CAPITAL GENERATION

Erste's earnings strength has weakened in recent years while the bank's capital generation capacity remains constrained by high risk charges and one-off payments. Given the low interest environment, we consider that Erste's earnings generation capacity has diminished as reflected by lower net interest income. After a significant decrease in the bank's operating result since 2010 (to EUR3.3 billion in 2013, from EUR3.8 billion in 2010), we note that it stabilised at EUR2.3 billion during the nine months to September 2014 compared to the same period in

2013 as the bank was able to compensate for the pressure on interest income mainly by lower expenses.

Erste still expects a weaker operating result for full year 2014, mainly driven by weaker operating results in Hungary and Romania. Operations in both countries continue to experience poor asset quality related to substantial legacy portfolios, and, in the case of Hungary, continued government intervention related to the bank's substantial foreign-currency mortgage book. For 2014, we expect the bank to accelerate its NPL reduction in Romania. Following new legislation in June 2014, the Hungarian government has passed legislation in November on how interest rates on foreign-currency retail loans will be converted into local currency. While the conversion still benefits borrowers as the Swiss franc base rate is replaced by the Hungarian forint rate, there will be no further additional haircut on conversion rates. As the conversion is performed on a loan-by-loan basis, effects depend on the period when the loans were granted, and will only be fully visible once Hungarian banks start reporting according to the new rules in H1 2015.

For 2014, Erste expects loan loss provisions of EUR2.4 billion, mainly as a result of increased provisions in Hungary and Romania. Erste now expects to record a full year net loss of EUR1.4-1.6 billion, also as a result of a write-down on intangibles in Romania and deferred tax assets of up to EUR1.0 billion that does not impact regulatory capital. Erste expects a normalisation of the cost of risk in Romania at 100-150 bps for 2015 and in Hungary at 150-200 bps by 2016. However, given the significant deterioration of the operating environment in Russia, we are concerned over the potential adverse effect on the credit metrics of some of the bank's main operations in CEE. At the same time, we note that Erste's direct exposure to Russia is limited.

As a result of the above increase in loan loss charge coverage, we adjust our Profitability Score to ba3, from caa1. Given the stabilisation of the bank's asset quality metrics, we expect bottom-line profitability to increase over time.

DEPOSIT-RICH BALANCE SHEET WITH MODERATE RELIANCE ON WHOLESALE FUNDING

The Liquidity score of baa2 adequately reflects Erste's balanced funding profile, also given a significant reduction in wholesale funding dependence (down 40% from 2008).

Erste's funding structure continues to be a relative strength, with a loan-to-deposit structure at the end of September 2014 of 100%. The bank continues to benefit from its access to a broad and diversified base of customer deposits of EUR120 billion - accounting for 61% of total liabilities. Around 57% of the bank's deposits are generated from its domestic operations, while roughly 65% of its CEE-related deposits (EUR34 billion out of EUR51 billion) are generated from the Czech Republic and Slovakia.

Erste benefits from a comfortable liquidity profile. As at end-September 2014, Erste's short-term funding needs were EUR20 billion compared to a portfolio of unencumbered assets (post haircut) of EUR41.5 billion. The bank's liquidity portfolio is mainly invested in ECB- and other central bank-eligible assets. The bank's outstanding securities amounted to EUR29 billion and accounted for 15% of total liabilities, of which covered bonds represented EUR10 billion. We estimate Erste's annual long-term refinancing needs to be around EUR3 billion for the next three years, which we believe is manageable compared to the bank's balance sheet size.

In March 2012, Austria's banking regulators recommended that the country's three major banks limit their new lending in Eastern European subsidiaries to 110% of local deposits, plus funding in local capital markets and funding from supranational institutions. In our view, the promotion of a more locally based funding model mitigates potential risks resulting from potential funding imbalances in local markets. Accounting for local customer loans and deposits only, Erste's Czech subsidiary benefits from EUR5.6 billion excess deposits (Slovakia: EUR1.3 billion) as of September 2014. In Romania, Hungary and Croatia loans exceeded deposits by EUR1.0 billion, EUR1.2 billion and EUR1.7 billion, respectively.

Notching Considerations

We assign a global local currency (GLC) debt and deposit rating of Baa2 to Erste, on review for upgrade. In accordance with our revised methodology, the rating is supported by Erste's ba1 BCA as well as two notches of LGF uplift and may continue to benefit from one notch of systemic support.

LOSS GIVEN FAILURE

Erste is subject to the EU Bank Resolution and Recovery Directive, which we consider to be an Operational Resolution Regime. In accordance with our methodology, we therefore apply our advanced LGF analysis, considering the risks faced by the different debt and deposit classes across the liability structure should the bank enter resolution. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25%

probability to deposits being preferred to senior unsecured debt. These ratios are in line with our standard assumptions.

Our LGF analysis indicates a very low loss-given-failure for senior unsecured debt and deposits, leading us to position Erste's Preliminary Rating Assessment (PRA) two notches above the Adjusted BCA.

For junior debt classes, our initial LGF analysis indicates a high loss-given-failure, given the limited volume of debt and limited protection from more subordinated instruments and residual equity. We also incorporate additional notching for junior subordinated and hybrid debt instruments reflecting the coupon features. The resulting PRAs are set out below.

ADDITIONAL NOTCHING FOR SUBORDINATED AND HYBRID INSTRUMENTS

Erste's subordinated debt is assigned a Ba2 local-currency debt rating. The rating is one notch below the bank's ba1 adjusted BCA and carries a negative outlook.

The ratings of Erste's supplementary capital and hybrid capital instruments reflect the bank's announcement on 9 December 2014 to pay no coupons on these instruments in 2015. The ratings are positioned at the lower of normal notching or on an expected loss basis once the coupons stop paying. The rating levels depend on the terms and conditions of these securities and their respective coupon levels.

(1) We continue to rate Erste's cumulative junior subordinated debt maturing in 2019 (ISIN:XS0303559115, Moody's Debt ID: 820418491) at B1(hyb) (three notches below the ba1 adjusted BCA) as bondholders benefit from Erste's obligation to pay the 2015 coupons once the bank has sufficient annual profits to resume payments. The ratings reflect the junior subordinated claim in liquidation and cumulative deferral features tied to the breach of a net loss trigger. The outlook is negative, in line with the outlook on Erste's subordinated debt.

(2) We rate three junior subordinated debt securities at B2(hyb) (ISIN:AT000B000450, Moody's Debt ID: 809640880; ISIN:AT000B000518, Moody's Debt ID: 809783821; ISIN:AT000B001078, Moody's Debt ID: 820411086). To the extent that there are not sufficient profits (prior to movements in reserves) under Austrian GAAP, coupon payments must not be paid out in that year. Whether coupons are then deferred or skipped is subject to management discretion according to our assessment of the bond documentation and as reflected in the rating levels at four notches below the adjusted BCA. We expect Erste to recoup payments in 2016. The outlook on these ratings is stable.

The following ratings are based on our expected loss approach and carry a stable outlook as we do not expect any further impairment at the current rating levels.

(3) The ratings of Erste's non-cumulative preferred securities reflect the expected recovery rate given the announced loss of coupon payments in 2015: Caa1(hyb) (ISIN XS0268694808, Moody's Debt ID: 809807559; XS0215338152, Moody's Debt ID: 808192280) and B2(hyb) (ISIN XS0188305741, Moody's Debt ID: 807484307) from B1(hyb). These securities have a deeply subordinated claim in liquidation and non-cumulative coupon skip mechanism tied to the breach of a balance sheet loss trigger.

(4) Two junior subordinated debt securities (ISIN:AT000B000062, Moody's Debt ID: 809202341; and ISIN:XS0143383148, Moody's Debt ID: 10323181) have non-cumulative coupons and are rated at Caa1(hyb) (AT000B000062) and B2(hyb) (XS0143383148).

(5) For Erste's junior subordinated debt maturing in 2015 (ISIN:AT000B000708, Moody's Debt ID: 815144235) we do not expect bondholders to recoup the lost coupons at maturity and hence rate the debt at Caa1(hyb).

All subordinated and hybrid ratings are notched off the adjusted BCA of ba1 and include one notch of LGF notching given the high loss-given-failure for these instruments.

GOVERNMENT SUPPORT

The implementation of the BRRD has caused us to reconsider the potential for government support to benefit certain creditors. Austrian banks operate in an environment of materially weakened prospects for financial assistance from the government. We now expect a low or moderate probability of government support for deposits for Erste as a domestic systemically important financial institution (D-SIFI). We are considering to exclude government support from Erste's ratings, reflecting recent developments in the Austrian banking market such as the early adoption of the European Bank Resolution and Recovery Directive (BRRD) and its recent application to Heta Asset Resolution AG.

Rating Factors

Erste Group Bank AG

Macro Factors	
Weighted Macro Profile	**Strong**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	9.0%	ba3	↑	ba3		
Capital						
TCE / RWA	7.9%	b1	↑	ba1	Stress capital resilience	
Profitability						
Net Income / Tangible Assets	-0.5%	caa1	↑ ↑	ba3	Loan loss charge coverage	
Combined Solvency Score		b1		ba2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	22.3%	baa2	←→	baa2		
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	23.3%	baa2	←→	baa2		
Combined Liquidity Score		baa2		baa2		

Financial Profile	**ba1**

Qualitative Adjustments	Adjustment
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

Sovereign or Affiliate constraint	Aaa
Scorecard Calculated BCA range	**baa3 - ba2**
Assigned BCA	**ba1**
Affiliate Support	**0**

notching	

Adjusted BCA	**ba1**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	--	--	--	--	Baa2 RUR Possible Upgrade	Baa2 RUR Possible Upgrade
Senior unsecured bank debt	--	--	--	--	Baa2 RUR Possible Upgrade	Baa2 RUR Possible Upgrade
Dated subordinated bank debt	-1	0	ba2	0	Ba2	
Junior subordinated bank debt	-1	-2	b1	0	B1(hyb)	

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