

Research Update:

Outlooks On Austria-Based Erste Group Bank And Subsidiary Ceska Sporitelna Revised To Stable; Affirmed At 'A/A-1'

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Overview

- We now expect Erste Group Bank and core subsidiary Ceska Sporitelna to demonstrate better operating performance than we had previously expected.
- The banks' asset-quality concerns stemming from their higher-risk exposures to Central and Eastern Europe have reduced.
- We are revising our outlooks on Erste and Ceska Sporitelna to stable from negative, and affirming the 'A' long-term and 'A-1' short-term ratings on both banks.
- We continue to grant a one-notch uplift to Erste's stand-alone credit profile, reflecting our expectation of implicit government support due to Erste's high systemic importance for Austria.

Rating Action

On Nov. 24, 2010, Standard & Poor's Ratings Services revised the outlooks on Austria-based Erste Group Bank AG (Erste) and its core subsidiary, Czech Republic-based Ceska Sporitelna a.s., to stable from negative and affirmed the 'A' long-term and 'A-1' short-term counterparty credit ratings on both entities.

Rationale

The outlook revision reflects Erste's recent track record of better-than-expected operating performance before risk provisions, as well as reduced asset-quality concerns stemming from the bank's significant exposures to what we see as a higher-risk region, Central and Eastern Europe (CEE). Although we expect nonperforming loans (NPLs) to rise further, mainly in CEE, and resulting provisioning needs to remain elevated in 2011, we believe that risk costs will peak in 2010 and that Erste will be able to absorb loan-loss provisions even in a stressed scenario, thanks to the bank's satisfactory earnings capacity.

The counterparty credit ratings continue to include a one-notch uplift from Erste's stand-alone credit profile, reflecting our assessment of Erste as a highly systemically important institution to Austria, which would likely receive extraordinary government support if necessary. The ratings continue to be based on our view of Erste and the Austrian savings banks as a single economic group. They also reflect Erste's strong retail franchise in Austria and CEE, as well as its good cost-efficiency and sound funding position.

Erste's comparatively weak capitalization, asset quality-related pressure on financial performance in 2010-2012, and still moderate profitability in Austria constrain the ratings.

We consider that the economic recovery--particularly in weaker CEE countries such as Romania and Hungary--is still fragile. We consequently believe that the considerable proportion of loan exposures dominated in foreign currency and potential economic setbacks due to government austerity measures will require sizable risk costs and a higher coverage of NPLs by loan-loss reserves. NPLs increased to 7.6% of total loans on the Erste Group basis as of Sept. 30, 2010, from 6.6% at year-end 2009. The increase for the CEE for the same periods was to 10.6% from 7.8%. Nevertheless, in our base-case scenario, we expect NPLs to peak in 2012 at the latest, whereas loan-loss provisions should start falling already in 2011.

Stable to slightly rising revenues and further cost reductions, particularly in CEE, have resulted in a good cost-to-income ratio of 54% for the year to date, strengthening Erste's risk-bearing capacity from earnings. The potential for additional cost savings is likely to be mostly exhausted, while what we expect will be subdued business growth will limit revenue increases in the short to medium term. We therefore expect rising operating profitability to mainly come from declining risk-provisioning requirements in coming years.

We consider Erste's funding and liquidity position to be comparatively comfortable, illustrated by the average total loan-to-deposit ratio of 127% with a high share of stable retail customer deposits. Long-term funding needs from capital markets are relatively low, while Erste holds a sufficient portfolio of high-quality securities for liquidity and short-term funding requirements.

Erste's equity increase and the injection of hybrid participation capital in 2009 testify to Erste's good financial flexibility to strengthen capital under more difficult capital market conditions. Nevertheless, we still regard Erste's capitalization to be moderate. Erste's risk-adjusted-capital ratio of 5.1% (5.9% after a net diversification adjustment) remains significantly below the average of major international banks, but should gradually rise as a result of retained earnings. In our calculation, we consider hybrid capital only to a limited extent--about €350 million--in our definition of total adjusted capital (TAC). We exclude participation capital instruments from TAC (in total €1.76 billion, of which €1.22 billion is provided by the Austrian government) because their step-up features and the regulatory grandfathering until Jan. 1, 2018, provide a strong incentive to redeem them. Nevertheless, we consider the instruments in our capital analysis because we believe that these hybrids provide an additional buffer to cover unexpected losses on a going-concern basis through coupon suspension and principal write-downs.

Outlook

The stable outlook reflects our expectation that Erste will be able to cope with the ongoing challenging environment in the group's key markets and that preprovisioning profitability will well exceed the cost of risks in 2010-2012, allowing the support of business growth and improvement of capitalization through retained earnings.

We would consider negative rating actions if, in contrast to our expectation, Erste's satisfactory financial profile were to deteriorate materially under economic stress conditions as a result of higher loan-loss provisions--exceeding our projected range of €3.1 billion-€3.8 billion over 2011-2012--or lower operating profitability. Pressure on the stand-alone credit profile could be mitigated by potential further extraordinary government support, however, because we believe that support--within the limits of the state aid framework set by the European Commission--would be forthcoming to avert systemic risk in the Austrian banking system. We would also view it negatively if Erste failed to strengthen capitalization as a buffer against material adverse events in coming years.

A positive rating action is unlikely in the near to medium term, barring a material and sustainable stabilization of economically conditions both in Austria and CEE, improved capital strength, and higher contributions from Austrian operations.

Related Criteria And Research

- Credit Stress Testing For Financial Institutions, April 29, 2009
- FI Criteria: Bank Rating Analysis Methodology Profile, March 18, 2004
- FI Criteria: Assumptions: Implications Of The December 2009 Basel III Proposals For Our Bank Hybrid Criteria, Feb. 9, 2010
- FI Criteria: Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments, Feb. 9, 2010

Ratings List

CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Erste Group Bank AG		
Counterparty Credit Rating	A/Stable/A-1	A/Negative/A-1
Certificate Of Deposit	A/A-1	A/A-1
Ceska Sporitelna a.s.		
Counterparty Credit Rating	A/Stable/A-1	A/Negative/A-1
Certificate Of Deposit	A/A-1	A/A-1

Ratings Affirmed

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Erste Group Bank AG	
Senior Unsecured (12 issues)	A
Subordinated (1 issue)	A-
Commercial Paper (1 issue)	A-1
Erste Finance (Delaware) LLC	
Commercial Paper (1 issue)	A-1

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