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Research Update:

Austria-Based Erste Group Bank Downgraded To 'A-/A-2' On Lower Predictability Of State Support; Outlook Negative

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Overview

- Austria has recently enacted legislation to bail in holders of Hypo Group Alpe Adria's subordinated debt, despite Carinthia's grandfathered guarantee of this debt.
- In our view, the new law indicates reduced predictability of extraordinary government support for systemically important banks, and for banks' hybrid capital instruments and grandfathered debt, than we previously envisaged.
- We are therefore lowering our ratings on Erste Group Bank AG (Erste) and Ceska Sporitelna A.S. (Ceska) to 'A-/A-2' from 'A/A-1', and removing the ratings from CreditWatch negative. We are also lowering the rating on Slovenska Sporitelna A.S. to 'A-pi' from 'Api'.
- The negative outlooks on Erste and Ceska reflect our view that the likelihood of state support for Erste could diminish further, as well as bank- and industry-specific factors.

Rating Action

On Aug. 13, 2014, Standard & Poor's Ratings Services lowered its long- and short-term counterparty credit ratings on Austria-based Erste Group Bank AG (Erste) and its core subsidiary Czech Republic-based Ceska Sporitelna A.S. (Ceska) to 'A-/A-2' from 'A/A-1'. The outlooks are negative.

We removed these ratings from CreditWatch, where we had placed them with negative implications on June 10, 2014.

In addition, we lowered our unsolicited public information (pi) rating on Erste's Slovakia-based core subsidiary Slovenska Sporitelna A.S. (SLSP) to 'A-pi' from 'Api'.

Rationale

The downgrade follows the Austrian government's enactment of special legislation to bail in Hypo Group Alpe Adria's (HGAA's) subordinated debtholders, despite a grandfathered guarantee from the State of Carinthia for the debt. The legislation, passed in July, forms part of the law to transform HGAA into a wind-down unit from a bank, and it has been ratified by Austria's federal president. The Austrian government's decision to impose losses on

HGAA's subordinated debtholders, despite the grandfathered guarantee, and public statements from government officials, in our view, indicate that the authorities' stance toward supporting systemically important banks is wavering. We consider, therefore, that extraordinary government support for systemically important banks such as Erste is now less predictable than before.

Generally, however, we consider that, in the absence of a legal framework for bank resolution in Austria, extraordinary future government support could remain available. Consequently, we continue to classify the Austrian government as supportive of the banking sector.

We understand that, in the coming months, the Austrian constitutional court will examine whether the new legislation complies with national and European statutes. There will therefore be a period of uncertainty for market participants until the court makes its ruling.

To reflect the increased uncertainty about potential future extraordinary government support for highly systemically important banks in Austria, we have applied a one-notch negative adjustment to our long-term rating on Erste. This adjustment partly offsets the two notches of uplift for extraordinary government support in the ratings on Erste, resulting in the downgrades of Erste, Ceska, and SLSP.

We view Ceska and SLSP as "core" subsidiaries of Erste under our criteria, and therefore equalize our counterparty credit ratings on these banks with the long-term rating on Erste. Consequently our rating on SLSP is 'A-pi' even though we generally do not apply modifiers (+ or -) to pi ratings.

Outlook

The negative outlook on Erste mainly reflects our view that potential extraordinary government support for systemically important European banks will likely decrease as resolution frameworks are put in place over the next two years. If, as a result of such frameworks, we remove or reduce the notches of uplift for government support by year-end 2015, we would also review the one-notch negative adjustment we factor into the ratings on Erste.

The negative outlook also reflects the bank's exposure in Central and Eastern Europe (CEE). We expect that the improved economic environment in the eurozone (European Economic and Monetary Union) will contribute to the development of Erste's domestic earnings, and that Erste's capital base will continue to improve. However, we don't expect the risk-adjusted capital ratio to increase materially higher than 7% over the next two years, owing to subdued overall performance as a result of still-high cost of risk at the CEE operations.

The negative outlook also reflects our opinion that overcapacity in the Austrian banking sector, resulting in low earnings through aggressive pricing, increasingly poses a risk to the stability of the banking system. In addition,

if the government's comparably high levy on banks remains in place over the longer term, it will further diminish domestic banks' chances of improving their modest earnings.

We could revise the outlook to stable if we believed that industry-wide risks were diminishing and if increased bail-in risks under new bank recovery and the resolution framework would be offset by other rating factors, such as a stronger stand-alone credit profile (SACP) or measures that provide substantial additional flexibility to absorb losses while the bank remains a going concern. The outlook revision to stable would also require tangible signs that Erste's asset quality metrics were stabilizing, and that economic pressure was lifting in Erste's markets in CEE.

The outlook on Ceska mirrors that on its parent and reflects our view of its core status within the Erste group, as defined by our criteria.

Our ratings on SLSP do not have an outlook, as we generally don't assign outlooks to our pi ratings.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	A-/Negative/A-2	A/Watch Neg/A-1
SACP	bbb+	bbb+
Anchor	bbb+	bbb+
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Moderate (-1)	Moderate (-1)
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Above Average and Adequate (0)	Above Average and Adequate (0)
Support	+2	+2
GRE Support	0	0
Group Support	0	0
Sovereign Support	+2	+2
Additional Factors	-1	0

Related Criteria And Research

Related Criteria

- Group Rating Methodology, Nov. 19, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Various Rating Actions Taken On Six Austrian Banks On Legislation To Bail In State-Guaranteed Debt, Aug. 13, 2014
- Erste Group Bank AG, June 23, 2014
- Seven Austrian Banks Placed On CreditWatch Negative On Planned Bail-In Of State-Guaranteed Debt Of Hypo Group Alpe Adria, June 10, 2014
- Banking Industry Country Risk Assessment: Austria, June 3, 2014
- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014
- Credit FAQ: The Rating Impact Of Resolution Regimes For European Banks, April 29, 2014
- Supplementary Analysis: Austria (Republic of), April 25, 2014
- Austria Ratings Affirmed At 'AA+/A-1+' On Continuing Fiscal Consolidation And Resilient Economy; Outlook Stable, March 28, 2014

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Erste Group Bank AG Ceska Sporitelna A.S. Counterparty Credit Rating	A-/Negative/A-2	A/Watch Neg/A-1
Slovenska Sporitelna A.S. (Unsolicited Ratings) Counterparty Credit Rating	A-pi/--/--	Api/--/--
Erste Group Bank AG Senior Unsecured Commercial Paper	A- A-2	A/Watch Neg A-1/Watch Neg
Erste Finance (Delaware) LLC Commercial Paper*	A-2	A-1/Watch Neg

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Erste Group Bank AG Subordinated	BBB	BBB/Watch Neg

*Guaranteed by Erste Group Bank AG.

The rating on Slovenska Sporitelna A.S. is unsolicited.

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