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Research Update:

Austrian Erste Group Bank Rating Lowered To 'BBB+'; Outlook Negative

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Rating Score Snapshot

Related Criteria And Research

Ratings List

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Austrian Erste Group Bank Rating Lowered To 'BBB+'; Outlook Negative

Overview

- We believe the prospect of extraordinary government support for Austrian banks, such as Erste Group Bank AG, is now uncertain in view of the country's well advanced and effective resolution regime.
- We also believe significant overcapacity in Austrian banks' domestic operations results in very low earnings and may threaten the stability of the Austrian banking system, leading to increased industry risks for Erste.
- We nevertheless consider Erste's earnings could improve after the 2014 clean-up of its portfolio and management plans to issue hybrid capital to strengthen the bank's profile over the next two years.
- We are lowering our long-term rating on Erste to 'BBB+' from 'A-' and removing it from CreditWatch with negative implications.
- The negative outlook on Erste reflects the risk that positive momentum in internal capital generation proves slower than we currently anticipate or that the bank does not accumulate a sufficient hybrid capital buffer.

Rating Action

As previously announced, on June 9, 2015, Standard & Poor's Ratings Services has lowered its long-term counterparty credit ratings on Austria-based Erste Group Bank AG (Erste) to 'BBB+' from 'A-' and affirmed the 'A-2' short-term rating. The outlook is negative. We also lowered the rating on subordinated capital instruments issued by Erste to 'BB+' from 'BBB-'.

At the same time, we affirmed the long- and short-term counterparty credit ratings on Erste's core subsidiary, Czech Republic-based Ceska Sporitelna A.S. (Ceska) at 'A-/A-2'. The outlook is negative.

All ratings were removed from CreditWatch with negative implications, where they were placed on Feb. 3, 2015.

Rationale

Our rating action on Erste reflects our opinion that industry risk for the Austrian banking system has increased. We consider that the significant overcapacity in banks' domestic operations results in very low bank earnings and may pose a threat to the stability of the Austrian banking system (for further details see "Ratings On Some Austrian Banks Lowered On Less Predictable State Support And Increasing Industry Risks," published June 9,

2015, on RatingsDirect).

We consider Erste vulnerable to this increased domestic risk and, as a result, the anchor and the stand-alone credit profile (SACP) for Erste have deteriorated to 'bbb' from 'bbb+'. The one-notch downgrade of Erste's subordinated debt to 'BB+' reflects the deterioration of the bank's SACP. We currently rate subordinated debt two notches below the bank's SACP.

We believe the risks associated with Erste's operations in Central and Eastern Europe (CEE) are easing with the economic stabilization in countries of operations in the region. Although Erste's foreign activities represent higher risk than its domestic operations, we consider these risks are adequately reflected in the current rating on the bank.

We believe the prospect of extraordinary government support for Austrian banks is now uncertain, following the full implementation of the EU Bank Recovery and Resolution Directive, including bail-in powers, in January 2015 (see "S&P Takes Various Rating Actions On Certain U.K. And German Banks Following Government Support And ALAC Review," June 9, 2015, for details). We have therefore reclassified Austria's tendency to support private sector commercial banks as "uncertain" under our criteria, and removed the two notches that we previously included for government support in the long-term counterparty credit ratings on banks we consider to have high systemic importance.

We have also removed the one-notch negative adjustment that we introduced into the ratings on these banks on Aug. 13, 2014, to reflect lower predictability of state support following the enactment of the legislation to bail in holders of Hypo Group Alpe Adria's subordinated debt, despite the State of Carinthia's grandfathered guarantee of this debt.

At the same time, we now include a one-notch upward adjustment into the ratings on Erste, as we anticipate positive momentum in the bank's earnings after the clean-up of its portfolio in 2014 and management's plans to issue hybrid capital to strengthen Erste's profile over the medium term.

Following our review of Erste's additional loss-absorbing capacity (ALAC), we currently do not add any uplift to the ratings for this reason. We nevertheless view the Austrian resolution regime as "effective" under our ALAC criteria because, among other factors, we believe it contains a well-defined bail-in process under which authorities would permit nonviable systemically important banks to continue critical functions as going concerns following a bail-in of eligible liabilities.

We include all of the consolidated Erste group's junior instruments in our ALAC assessment because, over our projection period, we believe they have capacity to absorb losses without triggering a default on Erste's senior obligations. On this basis, we calculate that the ALAC proportion of risk-weighted assets was slightly below the 5% threshold at year-end 2014.

We believe this ratio may increase above 5% if the management issues

additional eligible hybrids, as planned. However, we currently have no final certainty regarding the volume of hybrid issuance or about the future regulatory requirements on Erste to increase the buffer of instruments that we expect will be ALAC-eligible. Once there is clarity on this, we will reassess our forecast. We anticipate that this regulatory transition period, and so the ramp-up of the ALAC buffer, could take up to four years because we believe Austria is in an extended regulatory transition period in which banks will progressively build larger buffers of loss-absorbing capacity.

We furthermore consider that Erste's internal capital accumulation could improve following the clean-up of its portfolio in 2014, therefore helping improve its capital buffer over the next two years. If Erste's planned hybrid issues qualify for inclusion in our capital calculation, resulting in our risk-adjusted capital (RAC) ratio increasing above 7%, this will improve our view of the bank's capital and earnings position.

The affirmation of the ratings on Ceska reflects our opinion that the bank is likely to benefit from extraordinary government support from the Czech Republic. This provides a one-notch uplift to Ceska's SACP of 'bbb+', resulting in an 'A-' long-term issuer credit rating. We view Ceska as a core subsidiary of Erste under our criteria.

Outlook

The negative outlook on Erste reflects the risk that its internal capital generation proves to be slower than we currently anticipate, with a RAC ratio remaining below 7% over the next two years. It also reflects the risk that the bank might not accumulate a hybrid capital buffer to provide sufficient protection for senior unsecured creditors as reflected in an ALAC proportion of risk-weighted assets, as calculated by Standard & Poor's, above 5%. We may furthermore take a negative rating action if unexpected material risks arise from the bank's CEE operations, leading to a deterioration of the bank's asset quality.

We could revise the outlook on Erste to stable over the next two years if we concluded that its capitalization and its hybrid issuance buffer are improving simultaneously, potentially leading to a RAC ratio above 7% or ALAC above 5%. However, materialization of these developments simultaneously would likely require material external capital inflow.

The negative outlook on Ceska reflects our view that potential extraordinary government support for systemically important banks in the Czech Republic will likely decrease when the resolution framework is put in place.

Rating Score Snapshot

	To	From
Issuer Credit Rating	BBB+/Negative/A-2	A-/Watch Neg/A-2
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	Average and Adequate (0)	Average and Adequate (0)
Support	(0)	(+2)
ALAC Support	(0)	N/A
GRE Support	(0)	(0)
Group Support	(0)	(0)
Sovereign Support	(0)	(+2)
Additional Factors	(1)	(-1)

N/A--Not applicable.

Related Criteria And Research

Related criteria

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Group Rating Methodology, Nov. 19, 2013
- Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012

Related research

- Ratings On Some Austrian Banks Lowered On Less Predictable State Support And Increasing Industry Risks, June 9, 2015
- S&P Takes Various Rating Actions On Certain U.K. And German Banks

Following Government Support And ALAC Review, June 9, 2015

- Credit FAQ: How Standard & Poor's Applied Its Government Support And ALAC Criteria To U.K., German, Austrian, And Swiss Banks, June 9, 2015
- Watch Placements For Systemic Austrian, German, And U.K. Bank Operating Companies To Be Reviewed Around End May 2015, April 16, 2015
- S&P Takes Various Rating Actions On Certain U.K., German, Austrian, And Swiss Banks Following Government Support Review, Feb. 3, 2015
- The Rating Implications Of The Emerging Bank Resolution Frameworks In The U.K., Germany, Austria, And Switzerland, Feb. 3, 2015
- Austria, Germany, And The U.K. Are Set To Fast Track EU Bank Bail-In Rules, Sept. 29, 2014
- How The Regulatory Reform Process Could Reshape Banks' Business Models And Affect Issuer Ratings, Aug. 18, 2014
- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014
- The Rating Impact Of Resolution Regimes For European Banks, April 29, 2014

Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Erste Group Bank AG		
Counterparty Credit Rating	BBB+/Negative/A-2	A-/Watch Neg/A-2
Senior Unsecured	BBB+	A-/Watch Neg
Subordinated	BB+	BBB-/Watch Neg
Commercial Paper	A-2	A-2/Watch Neg
Ceska Sporitelna A.S.		
Counterparty Credit Rating	A-/Negative/A-2	A-/Watch Neg/A-2
Erste Finance (Delaware) LLC		
Commercial Paper*	A-2	A-2/Watch Neg

*Guarantor: Erste Group Bank AG.

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