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Erste Group Bank AG Outlook Revised To Stable On Improving Capitalization; 'BBB+/A-2' Ratings Affirmed

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Erste Group Bank AG's risk-adjusted capitalization has materially strengthened in financial year 2015 owing to earnings retention, in line with our expectation.

The proposed issuance of a benchmark Additional Tier 1 capital instrument--which we consider to have intermediate equity content--supports our assessment of Erste's capital and earnings as adequate. We are assigning the instrument a rating of 'BB'.

Given Erste's improving capital position, we are revising upward our stand-alone credit profile assessment on Erste to 'bbb+' from 'bbb' and removing the one-notch positive adjustment we had previously incorporated in its ratings.

We are affirming the 'BBB+/A-2' ratings on Erste and revising the outlook to stable.

The stable outlook reflects our view that Erste will hold a sufficient capital buffer against unexpected losses in its operations in Central and Eastern Europe and that its asset quality metrics have now stabilized.

FRANKFURT (S&P Global Ratings) May 17, 2016--S&P Global Ratings today revised to stable from negative its outlook on Erste Group Bank AG. We also affirmed our 'BBB+/A-2' long- and short-term ratings on Erste.

At the same time, we raised the issue ratings on Erste's subordinated debt instruments to 'BBB-' from 'BB+'; the ratings on these instruments are notched down from Erste's 'bbb+' stand-alone credit profile (SACP).

We are assigning a 'BB' long-term issue rating to the proposed perpetual Additional Tier 1 (AT1) capital notes to be issued by Erste. This rating is subject to our review of the notes' final documentation.

As we expected, Erste strengthened its risk-adjusted capitalization through sound profit retention in the financial year ending Dec. 31, 2015. Our risk-adjusted capital ratio (RAC) on Erste equaled 7.3% on Dec. 31, 2015, which is about 130 basis points (bps) above the level at year-end 2014. We project Erste's RAC ratio will increase to 7.5%-8.0% by year-end 2017 from stable earnings. We have therefore revised our assessment of Erste's capital and earnings to adequate from moderate.

Following a clean-up process in 2014, which was connected with high one-off costs, Erste's revenue generation from traditional retail and commercial banking, combined with its sound operating efficiency and materially lower costs of risk, resulted in net profit of €968 million in financial year 2015, after a net loss of €1.383 million in 2014.

In addition, Erste is considering issuing a benchmark perpetual AT1 instrument in 2016. We expect this hybrid issuance to have intermediate equity content and to be fully included in Erste's total adjusted capital (our measure of a bank's loss-absorbing capital) when it is issued. The AT1 issue is expected to raise the RAC ratio by about 30 bps in 2016.

We have also removed the positive adjustment we previously included in our rating analysis. This adjustment was based on our anticipation that a positive trend in the bank's earnings and management's plans to issue hybrid capital would improve either Erste's capital and earnings position or its additional loss-absorbing capacity (ALAC).

Accordingly, we are revising to 'bbb+' from 'bbb' our assessment of Erste's SACP. This reflects its unchanged 'bbb' anchor, based on the blended economic risks in its countries of operations, and the industry risk in Austria.

We continue to view Erste's business position as strong, owing to its solid franchise in both retail and corporate banking in Austria and its core markets in Central and Eastern Europe (CEE), underpinned by high market shares and revenue stability. It also incorporates Erste's adequate capital and earnings assessment. Its adequate risk position remains based on its primarily lower-risk retail and small-to-midsize enterprise lending profile and

stabilized asset quality metrics, which are underpinned by its reported nonperforming loan ratio of 6.7% as of March 31, 2016. We continue to assess Erste's funding as above-average and its liquidity as adequate, reflecting its customer-dominated stable funding profile, self-funded operations by the core CEE subsidiaries and its comfortable liquidity buffer.

We consider the prospect of extraordinary government support for the Austrian banking sector to be uncertain. Since June 2015, we have not incorporated any uplift above the bank's SACP for government support. We currently do not expect Erste's ALAC to meet the threshold of 5% in proportion to S&P Global Ratings risk-weighted assets in the next 12-24 months; therefore, we do not incorporate any additional uplift into the ratings. Moreover, we might apply a higher ALAC threshold to Erste because deploying ALAC within the group could be limited by capital restrictions set by host regulators. Consequently, we rate Erste at the level of its SACP.

PROPOSED PERPETUAL AT1 INSTRUMENT

We assigned a 'BB' long-term issue rating to the proposed perpetual AT1 capital notes to be issued by Erste Group Bank AG. The rating is subject to our review of the notes' final documentation.

We understand that the AT1 issuance will comply with the European Commission's Capital Requirements Directive IV (CRD IV), which implements Basel III in the EU. This is Erste's first AT1 issuance since the CRD IV requirements were introduced. We also understand that the notes will rank senior to ordinary shares; subordinate to more senior debt, including Erste's Tier 2 debt; and pari passu with existing capital contribution securities.

We determine the issue rating on the notes by notching downward from our assessment of Erste's SACP, which we revised upward to 'bbb+'. The 'BB' issue rating therefore reflects our analysis of the proposed notes and our assessment of Erste's SACP (see "Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceId/8790886)," published on Jan. 29, 2015, on RatingsDirect).

The 'BB' issue rating is four notches lower than the SACP assessment, reflecting our deduction of:

One notch for subordination;
Two notches for the notes' status as Tier 1 regulatory capital; and
One notch because the instruments allow for the full or partial temporary write-down of the principal amount.

We do not apply additional notching because we consider the proposed instrument's 5.125% mandatory conversion trigger at both group and parent company level to be a nonviability trigger (see "Applying The Bank Hybrid Capital Criteria To Specific Instruments (/en_US/web/guest/article/-/view/sourceId/7032808)", published on Dec. 20, 2011). We note that in December 2015, the group's common equity Tier 1 (CET1 phased-in) ratio was 12.3%.

The stable outlook on Erste reflects our view that its improved risk-adjusted capitalization now provides the group with a sufficient buffer to withstand many unforeseen risks arising from its CEE operations in the next 12-24 months. We consider the operating environment in Erste's biggest core markets--Austria and the Czech Republic--to be stable, allowing it to generate steady revenues from its traditional customer-led retail and corporate customer business. In our view, this will support a further gradual capital build-up.

We could lower the rating if Erste was unable to maintain the RAC ratio above 7% or if, against our expectation, its asset quality deteriorated.

We consider a positive rating action unlikely at present. That said, it could be triggered by a shift in Erste's operations toward lower-risk countries while continuing to improve its capitalization. This would result in the anchor being revised to 'bbb+'.

RELATED CRITERIA AND RESEARCH

Related Criteria

Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity (/en_US/web/guest/article/-/view/sourceld/9138480), April 27, 2015

Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceld/8790886), Jan. 29, 2015

Group Rating Methodology (/en_US/web/guest/article/-/view/sourceld/8336067), Nov. 19, 2013

Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceld/8112403), July 17, 2013

Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, (/en_US/web/guest/article/-/view/sourceld/7394961) June 22, 2012

Banks: Rating Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceld/6921376), Nov. 9, 2011

Banking Industry Country Risk Assessment Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceld/6782163), Nov. 9, 2011

Bank Capital Methodology And Assumptions (/en_US/web/guest/article/-/view/sourceld/6338060), Dec. 6, 2010

Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks (/en_US/web/guest/article/-/view/sourceld/5996058), May 4, 2010

Use Of CreditWatch And Outlooks (/en_US/web/guest/article/-/view/sourceld/5612636), Sept. 14, 2009

Commercial Paper I: Banks (/en_US/web/guest/article/-/view/sourceld/2539162), March 23, 2004

Related Research

Erste Group Bank AG (/en_US/web/guest/article/-/view/sourceld/620615), June 25, 2015

Banking Industry Country Risk Assessment: Austria (/en_US/web/guest/article/-/view/sourceld/9173526), June 25, 2015

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