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**Research Update:**

## Austria-Based Erste Group Bank Upgraded To 'A/A-1' On Improved Operating Environment; Outlook Remains Positive

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### Table Of Contents

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Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria

Related Research

Ratings List

## Research Update:

# Austria-Based Erste Group Bank Upgraded To 'A/A-1' On Improved Operating Environment; Outlook Remains Positive

## Overview

- Erste Group Bank's operating environment in Central and Eastern Europe has improved and loan growth is expected to be in lower-risk countries over the next two years.
- At the same time, risks in the domestic market are abating, in our view.
- As a result, we are raising our issuer credit ratings on Erste Group Bank to 'A/A-1' from 'A-/A-2'.
- The positive outlook reflects our view that Erste will continue to strengthen its capitalization or improve its additional loss-absorbing capacity over the next two years.

## Rating Action

On Oct. 30, 2017, S&P Global Ratings raised its long- and short-term issuer credit ratings on Erste Group Bank AG to 'A/A-1' from 'A-/A-2'. The outlook is positive.

At the same time, we raised our issue ratings on Erste's subordinated debt instruments to 'BBB+' from 'BBB' and on its additional tier 1 (AT1) capital notes to 'BBB-' from 'BB+'.

## Rationale

The upgrade stems from our view that reduced economic risks in Erste's core markets in Central and Eastern Europe (CEE) should support sound earnings and asset quality at the group over the next few years. We understand that growth of Erste's retail and corporate lending will mainly be in lower-risk countries such as Czech Republic (20% of gross credit risk exposures as of June 30 2017), Slovakia (5%), and Austria (55%). We are therefore revising the anchor that starts our rating on Erste to 'bbb+' from 'bbb', mirroring the lower blended economic risk and industry risk in Austria.

We now regard the industry risk trend for the Austrian banking system as positive rather than stable. In our view, the system is steadily improving on the back of several material developments in recent years. The most prominent change is the strengthening of large banks' risk profiles after several years of derisking in CEE, with foreign exposure dropping to about one-fifth of banking system assets from about one-third. The composition of risks has also

shifted toward countries with lower risks, such as Czech Republic and Slovakia, with the exposure to higher-risk countries, such as Russia and Ukraine, reducing substantially. We think these changes have enhanced the stability of overall returns for the Austrian banking system and reduced tail risks in the future.

We consider Erste to have a competitive edge against the large domestic peers because it concluded the clean-up of its loan book in 2014 and has materially strengthened its financial profile over the past three years, especially in terms of capitalization, funding, and liquidity at CEE subsidiaries. This allows Erste to expand its loan book in selective CEE markets and invest in digitalization, while containing costs over the next two years. We also believe that Erste's digital agenda in conjunction with the Austrian savings banks will deepen the cohesiveness within the group, allowing Erste to remain competitive in the future. Erste's revenue base is not as diversified by business lines and products as that of some large European peers. However, we consider the broad geographic spread of its standard retail and corporate activities in Austria and CEE, and its sound risk-adjusted earnings, support greater business stability. This continues to underpin our assessment of Erste's business position as strong, also relative to international peers with a 'bbb+' anchor.

We now assess Erste's stand-alone credit profile (SACP) at 'a', and consider that Erste has a leading market position in Austria and several core CEE countries. We project a risk-adjusted capital (RAC) ratio in the range of 9.5%-10.0% in the next 24 months, partly reflecting the likely issuance of hybrid capital. Erste's RAC ratio was 8.3% as of year-end 2016 (8.5% if adjusted for the improved economic risks in some CEE countries since then). We also view Erste's asset-quality metrics as sound, benefitting from the group's diversified loan portfolio, and its funding is supported by a strong deposit franchise and ample liquidity buffers, both at the group and subsidiary level.

Our assessment of Erste's additional loss-absorbing capacity (ALAC) does not currently lead us to add any uplift to the ratings. We include all of the consolidated 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 about 4.6% at year-end 2016, and we project this buffer will increase to 5.0%-5.5% by 2018, mainly on the back of the buildup of excess total-adjusted capital beyond our 7% threshold for adequate capital and earnings. However, the buffer will likely stay below our 5.5% adjusted threshold of risk-weighted assets for a one-notch uplift.

## **Outlook**

The positive outlook on Erste reflects our view that, over the next two years, the group will continue to strengthen its risk-adjusted capitalization, partly supported by the issuance of further hybrid capital instruments. We expect

that the operating environment in Erste's biggest core markets will remain stable, facilitating the generation of sound earnings in its traditional customer-led retail and corporate customer business.

We could raise our ratings by one notch, if Erste were to continue strengthening its RAC ratio or if there was greater insight into the pace and size of its buildup of bail-inable capital buffers. Such improvement could lead to a better capital assessment, if the RAC ratio were to increase and remain higher than 10% or to an uplift based on ALAC if the buffer strengthened sufficiently. An upgrade would, however, hinge on our view of the group's creditworthiness as being clearly and sustainably consistent with that of similarly rated peers at that higher rating level, in particular regarding profitability, diversification, and asset quality.

We could revise the outlook to stable if, for example, we observe aggressive growth in higher-risk countries that suggests limited scope for improvement of Erste's creditworthiness, or if we see a lower likelihood of a substantial rise in the RAC or ALAC metrics.

## Ratings Score Snapshot

	To	From
Issuer Credit Rating	A/Positive/A-1	A-/Positive/A-2
SACP	a	a-
Anchor	bbb+	bbb
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Adequate (0)	Adequate (0)
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Above average	Above average
	Adequate (+1)	Adequate (+1)
Support	(0)	(0)
ALAC Support	(0)	(0)
GRE Support	(0)	(0)
Group Support	(0)	(0)
Sovereign Support	(0)	(0)
Additional Factors	(0)	(0)

## Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

## Related Research

- Positive Rating Actions Taken On Four Austrian Banks On Improving Industry Conditions, Oct. 30, 2017

## Ratings List

### Upgraded

	To	From
Erste Group Bank AG		
Counterparty Credit Rating	A/Positive/A-1	A-/Positive/A-2
Senior Unsecured	A	A-
Subordinated	BBB+	BBB
Junior Subordinated	BBB-	BB+
Commercial Paper	A-1	A-2
Erste Finance (Delaware) LLC		
Commercial Paper*	A-1	A-2

### Rating Affirmed

Erste Group Bank AG, Hong Kong Branch		
Commercial Paper*	A-1	A-1

\*Guarantor: Erste Group Bank AG.

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