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Research Update:

Erste Group Bank AG Upgraded To 'A-/A-2' On Stronger Financial Profile; Outlook Positive

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Overview

- We believe the strong consolidated funding and liquidity ratios we observe at the Erste group level are now also evident at the main operating subsidiaries.
- We consider that Erste's financial profile strengthened materially in 2016, owing to the group's portfolio clean-up, stronger earnings, and, in turn, higher earnings retention, which reflect the stable to improving operating environment in Erste's principal markets.
- We are upgrading Erste to 'A-/A-2' from 'BBB+/A-2'.
- The outlook is positive, reflecting our view that Erste might start to build up a buffer of gone-concern, bail-in-able instruments over the next two years that could merit rating uplift for additional loss-absorbing capacity.

Rating Action

On March 14, 2017, S&P Global Ratings raised its long-term issuer credit rating on Erste Group Bank AG to 'A-' from 'BBB+'. The outlook is positive. We affirmed the short-term rating at 'A-2'.

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 'BB+' from 'BB'.

Rationale

The upgrade reflects our positive reassessment of Erste's combined funding and liquidity position, based on our view that the strong consolidated funding and liquidity ratios that we observe at the group level are now also evident at the main operating subsidiaries. We already considered that Erste benefits from an above-average funding profile compared with its domestic and international peers. This is owing to Erste's leading retail franchise in Austria and main operating markets across Central and Eastern Europe (CEE), underpinned by self-funded operations by the core CEE subsidiaries. Accordingly, we have revised upward our assessment of the bank's stand-alone credit profile (SACP) to 'a-' from 'bbb+', leading us to raise the issuer credit ratings on Erste and the issue credit ratings on Erste's debt by one notch.

The upgrade is also supported by our view that Erste's asset quality and pre-tax profitability has improved substantially in the past 12-24 months, owing mainly to a strong focus on restructuring and divesting nonperforming loans, as well as the stabilized operating environment in Austria and its home markets in CEE. This translated into stable revenues, materially lower credit losses than our base-case assumption, and strengthened earnings in 2016, demonstrating continued progress beyond the improvements in the bank's capitalization that we recognized in our review in May 2016. We do not anticipate further substantial improvements in profitability since the impairment charge has likely bottomed and revenue growth remains challenged amid ultra-low base rates in the eurozone. However, we anticipate that retained earnings and further issuance of additional tier 1 instruments will lead to a moderate rise in the bank's S&P Global Ratings' risk-adjusted capital (RAC) ratio to 8.5%-9.0% from our estimate of approximately 8.4% for end-2016.

On a consolidated group basis, Erste has long demonstrated superior funding and liquidity metrics compared with many of its peers. For example, we estimate the group's one-year liquidity ratio (broad liquid assets to short-term wholesale funding) to be 3.8x as of year-end 2016, compared with the 1.0x-2.0x ratios that we observe among many of the other large European banks. These metrics reflect the structural strengths of Erste's deposit-heavy funding profile, in addition to management's policy of maintaining ample buffers of unencumbered high-quality securities eligible for refinancing by the European Central Bank. As of year-end 2016, the consolidated liquidity buffer (defined as unencumbered collateral plus cash) stood at €51.2 billion or 26.7% of total liabilities.

The changed assessment reflects the overall improvement in the funding profiles in Erste's network banks, demonstrated by a marked reduction of intragroup funding from the parent bank over the past five years that exceeded our expectations. We now see each network bank as being able to deal with potential liquidity stresses on its own, which we consider a critical factor given the restrictions on intra-group liquidity transfers. In our view, Erste and its main operating subsidiaries would likely benefit from customers' flight to quality in financial crises, and their liquidity coverage would enable them to withstand a lack of access to wholesale funding for more than 12 months, as well as moderate reductions in customer deposits. While we do not place great weight on the regulatory liquidity coverage ratio (LCR) given its one-month horizon, the ratio incorporates regulatory restrictions on intra-group liquidity transfers. We note that the LCR for the Erste group was 142.6% as of Dec. 31, 2016, and we understand the ratio for each of the main subsidiaries also stood well above 100%.

Similar to other systemically important banks in Europe, Erste will need to build its buffer of bail-in capacity to meet what will likely be a substantial regulatory minimum requirement for eligible liabilities (MREL). As such, we anticipate that its buffer of additional loss-absorbing capacity (ALAC) will rise modestly in the next 12-24 months from our estimate of approximately 4.4% for year-end 2016 to about 4.5%-5.0% by 2018. This will principally be on the back of a small rise in total adjusted capital beyond that taken into account in our capital assessment and a rollover of existing capital instruments. However, this leaves the bank below our 5.5% threshold of risk-weighted assets for a one-notch uplift. We use an adjusted threshold for the Erste group, as opposed to the usual 5.0%, because we anticipate that Erste will have to deploy substantial ALAC--primarily consisting of excess core capital--in its CEE subsidiaries, and we see fungibility of such resources as constrained by capital restrictions set by host regulators.

Therefore, we currently do not incorporate any additional uplift into the ratings for ALAC. In the next 12 months, however, we expect to have more clarity on the resolution strategy for Erste, the MREL requirement, and management's approach for building and downstreaming that MREL. This could reveal details regarding the size and pace of Erste's ramp-up of ALAC that could lead us to reconsider the size of the threshold adjustment, possibly benefiting the ratings on Erste.

Outlook

The positive outlook on Erste reflects our view that, over the next two years, a clearer indication of the pace and size of Erste's build-up of ALAC could eventually lead us to include one notch of uplift in the rating. We expect that the operating environment in Erste's biggest core markets will remain stable, facilitating the generation of sound earnings from its traditional customer-led retail and corporate customer business.

We would most likely raise the rating if greater insight into the ramp-up leads us to add to the rating one notch of support for ALAC. However, this would hinge on our view of the group's creditworthiness as being clearly in line with that of 'A'-rated peers.

While less likely, an upgrade could stem or be supported by an improvement in Erste's operating environment or a moderate shift in operations toward lower-risk countries that lead us to revise the anchor to 'bbb+' from 'bbb'. However, at this stage, we do not see a strong probability that this would lead us to reassess upward the SACP to 'a' because we would take into account our view of Erste's other rating factors, such as its business position, relative to peers with 'bbb+' anchors.

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

Ratings Score Snapshot

Issuer Credit Rating	A-/Positive/A-2	BBB+/Stable/A-2

GCP	a-	bbb+
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 and Strong (+1)	Above average and Adequate (0)
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

- 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: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 06, 2010
- Criteria - Financial Institutions - Banks: Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 04, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- Erste Group Bank AG Outlook Revised To Stable On Improving Capitalization; 'BBB+/A-2' Ratings Affirmed, May 17, 2016

Ratings List

Upgraded; Ratings Affirmed

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

[1]Co-issued by Erste Group Bank AG, Hong Kong Branch.
[2]Guaranteed by Erste Group Bank AG.

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.