Notes to the group financial statements of Erste Group

A. GENERAL INFORMATION

Erste Group Bank AG is Austria's oldest savings bank and listed on the Vienna Stock Exchange. It is also quoted on the Prague Stock Exchange (since October 2002) and on the Bucharest Stock Exchange (since February 2008). The registered office of Erste Group Bank AG is located at Am Belvedere 1, 1100 Vienna, Austria.

The group of Erste Group Bank AG (hereinafter referred to as 'Erste Group') offers a complete range of banking and other financial services, such as savings accounts, asset management (including investment funds), consumer credit and mortgage lending, investment banking, securities and derivatives trading, portfolio management, project finance, foreign trade financing, corporate finance, capital market and money market services, foreign exchange trading, leasing and factoring.

It is planned for the management to approve the consolidated financial statements for publication on 28 February 2018.

Erste Group is subject to the regulatory requirements of Austrian and European supervisory bodies (National Bank, Financial Market Authority, Single Supervisory Mechanism). These regulations include those pertaining to minimum capital adequacy requirements, categorisation of exposures and off-balance sheet commitments, credit risk connected with clients of the Group, liquidity and interest rate risk, items denominated in foreign currencies and operating risk.

In addition to the banking entities, some Group companies are subject to regulatory requirements, specifically in relation to asset management.

B. SIGNIFICANT ACCOUNTING POLICIES

a) Basis of preparation

The consolidated financial statements of Erste Group for the financial year ending on 31 December 2017 and the related comparative information were prepared in compliance with applicable International Financial Reporting Standards (IFRS) as adopted by the European Union on the basis of IAS Regulation (EC) No. 1606/2002. The requirements of Section 59a of the Austrian Banking Act and Section 245a of the Austrian Commercial Code are fulfilled.

In accordance with the applicable measurement models prescribed or permitted under IFRS, the consolidated financial statements have been prepared on a cost (or amortised cost) basis, except for financial assets - available for sale, financial assets and liabilities held for trading (including derivatives), instruments subject to hedge accounting and financial assets and liabilities designated at fair value through profit or loss, all of which have been measured at fair value.

The consolidated financial statements have been prepared on a going concern basis.

Except for regulatory restrictions on capital distributions stemming from the EU-wide capital requirements regulations applicable to all financial institutions based in Austria and Central and Eastern Europe, Erste Group does not have any other significant restrictions on its ability to access or use the assets and settle the liabilities of the Group. Also, the owners of non-controlling interests in Group subsidiaries do not have rights that can restrict the Group's ability to access or use the assets and settle the liabilities of the Group.

Except as otherwise indicated, all amounts are stated in millions of euro. The tables in this report may contain rounding differences.

The consolidated financial statements have not been accepted by the supervisory board and the financial statements of Erste Group Bank AG have not been approved by the supervisory board yet.

b) Basis of consolidation

Subsidiaries

All entities directly or indirectly controlled by Erste Group Bank AG are consolidated in the Group financial statements on the basis of their annual accounts as of 31 December 2017, and for the year then ended.

Subsidiaries are consolidated from the date when control is obtained until the date when control is lost. Control is achieved when Erste Group is exposed to, or has rights to, variable returns from its involvement with the investee and has the ability to affect those returns through its power to direct the relevant activities of the investee. Relevant activities are those which most significantly affect the variable returns of an entity.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated statement of income and consolidated statement of comprehensive income from the date of acquisition or up to the date of disposal. The financial statements of the bank's subsidiaries are prepared for the same reporting year as that of Erste Group Bank AG and using consistent accounting policies. All intra-Group balances, transactions, income and expenses as well as unrealised gains and losses and dividends are eliminated.

Non-controlling interests represent those portions of total comprehensive income and net assets that are not attributable directly or indirectly to the owners of Erste Group Bank AG. Non-controlling interests are presented separately in the consolidated statement of income, in the consolidated statement of comprehensive income and within equity on the consolidated balance sheet. Acquisitions of non-controlling interests as well as disposals of non-controlling interests that do not lead to a change of control are accounted for as equity transactions, whereby the difference between the consideration transferred and the share in the carrying amount of the net assets acquired is recognised as equity.

Investments in associates and joint ventures

Investments in associates and joint ventures are accounted for using the equity method. Under the equity method, an interest in an associate or joint venture is recognised on the balance sheet at cost plus post-acquisition changes in the Group's share of the net assets of the entity. The Group's share of the associate's or joint venture's result is recognised in the statement of income and comprehensive income. Entities accounted for using the equity method are recognised on the basis of annual financial statements as of 31 December 2017 and for the year then ended.

Associates are entities over which Erste Group exercises significant influence ('associates'). Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies. As a general rule, significant influence is presumed to mean an ownership interest of between 20% and 50%.

Joint ventures are joint arrangements over which Erste Group exercises control jointly with one or more other venturers, with the venturers having rights to the net assets of the arrangement, rather than to the assets and liabilities relating to the arrangement. Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. Erste Group is not involved in joint arrangements which take form of joint operations.

Scope of consolidation

As of 31 December 2017, Erste Group Bank AG, as parent entity of Erste Group, includes in its IFRS scope of consolidation a total of 421 subsidiaries (31 December 2016: 448). This includes a total of 47 local savings banks which, alongside Erste Group Bank AG and Erste Bank der oesterreichischen Sparkassen AG, are members of the Haftungsverbund (cross-guarantee system) of the Austrian savings bank sector (please refer to 'd) Significant accounting judgements, assumptions and estimates' for further details).

In 2014, following the implementation of the new agreements of the cross-guarantee system (please refer to chapter 'd) Significant accounting judgements, assumptions and estimates') and the related financial support of the members, an 'ex-ante fund' was established. The fund is managed by a civil law company named IPS GesbR. The assets of the fund – the members of the cross-guarantee system are required to pay into the fund over a period of ten years - are bound and can be used solely for the purpose to cover loss events of members of the cross-guarantee system. The company IPS GesbR was included in the scope of consolidation in 2014.

For further details regarding the scope of consolidation please refer to Note 55 Details of the companies wholly or partly owned by Erste Group as of 31 December 2017.

Additions in 2017. The additions had no material impact on the financial position and performance of the Group.

Disposals in 2017. The disposals had no material impact on the financial position and performance of the Group.

Sale of shares to EBRD and Corvinus

As of 11 August 2016, Erste Group Bank AG has sold respectively 15% of the shares held in Erste Bank Hungary Zrt. (EBHU) to the European Bank for Reconstruction and Development (EBRD) and to Corvinus Nemzetközi Befektetési Zrt. (Corvinus) - a related party to the Hungarian state. Erste Group Bank AG received EUR 250 million for the sale of the shares. At the same time, call-put option agreements were concluded between Erste Group Bank AG and EBRD and Corvinus for the acquisition of 30% of the shares. In the consolidated financial statements of Erste Group Bank AG, the option agreements are accounted for as a liability in the amount of the present value of the expected exercise price. Due to the structure of the option agreements, for the 30% no share in non-controlling interest is recognised.

c) Accounting and measurement methods

Foreign currency translation

The consolidated financial statements are presented in euro, which is the functional currency of Erste Group Bank AG. The functional currency is the currency of the primary business environment in which an entity operates. Each entity in the Group determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency.

For foreign currency translation, exchange rates quoted by the central banks in each country are used. For Group entities with the euro as functional currency, these are the European Central Bank reference rates.

i. Transactions and balances in foreign currency

Transactions in foreign currencies are initially recorded at the functional currency exchange rate effective as of the date of the transaction. Subsequently, monetary assets and liabilities denominated in foreign currencies are translated at the functional currency exchange rate as of the balance sheet date. All resulting exchange differences that arise are recognised in the statement of income under the line item 'Net trading result'. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as of the dates of the initial transactions. Non-monetary items that are measured at fair value (such as equity investments) in a foreign currency are translated using the exchange rates at the date when the fair value was measured, thus the exchange differences are part of the fair value gains or losses.

ii. Translation of the statements of Group companies

Assets and liabilities of foreign operations (foreign subsidiaries and branches) are translated into Erste Group's presentation currency, the euro, at the rate of exchange as of the balance sheet date (closing rate). Their consolidated statement of income and consolidated statement of comprehensive income are translated at the average exchange rate of the respective reporting period calculated on the basis of daily rates. Goodwill, intangible assets recognised on acquisition of foreign subsidiaries (i.e. customer relationships and brand) and fair value adjustments to the carrying amounts of assets and liabilities on the acquisition are treated as assets and liabilities of the foreign subsidiaries and are translated at the closing rate. Exchange differences arising on translation are recognised in other comprehensive income. On disposal of a foreign subsidiary, the cumulative amount of translation differences recognised in other comprehensive income is recognised in the statement of income under the line item 'Other operating result'.

Financial instruments – recognition and measurement

A financial instrument is any contract giving rise to a financial asset of one party and a financial liability or equity instrument of another party. In accordance with IAS 39, all financial assets and liabilities – which also include derivative financial instruments – have to be recognised on the balance sheet and measured in accordance with their assigned categories.

Erste Group uses the following categories of financial instruments:

- financial assets or financial liabilities at fair value through profit or loss
- available-for-sale financial assets
- held-to-maturity investments
- loans and receivables
- financial liabilities measured at amortised cost

The line items as presented on the balance sheet are not necessarily corresponding with the IAS 39 categories of financial instruments. The correspondence between the balance sheet line items and categories of financial instruments is described in the table at point (xi).

i. Initial recognition
Financial instruments are initially recognised when Erste Group becomes a party to the contractual provisions of the instrument. Regular way (spot) purchases and sales of financial assets are recognised at the settlement date, which is the date that an asset is delivered. The classification of financial instruments at initial recognition depends on their characteristics as well as the purpose and management's intention for which the financial instruments were acquired.

ii. Initial measurement of financial instruments
Financial instruments are measured initially at their fair value including transaction costs. In the case of financial instruments at fair value through profit or loss, however, transaction costs are not included but are recognised directly in profit or loss. Subsequent measurement is described in the chapters below.

iii. Cash and cash balances
Cash balances include only claims (deposits) against central banks and credit institutions that are repayable on demand. Repayable on demand means that they may be withdrawn at any time or with a term of notice of only one business day or 24 hours. Mandatory minimum reserves are also shown under this item.

iv. Derivative financial instruments
Derivative financial instruments are used by Erste Group to manage exposures to interest rate, foreign currency and other market price risks. Derivatives used by Erste Group include mainly interest rate swaps, futures, forward rate agreements, interest rate options, currency swaps and currency options as well as credit default swaps.

For presentation purposes derivatives are split into:
- Derivatives – held for trading; and
- Derivatives – hedge accounting

Derivative financial instruments are carried at fair value (dirty price) on the Consolidated Balance Sheet - regardless of whether they are held for trading or hedge accounting purposes. Derivatives are carried as assets if their fair value is positive and as liabilities if their fair value is negative.

Derivatives – held for trading are those which are not designated as hedging instruments for hedge accounting. They are presented in the line item 'Derivatives' under the heading 'Financial assets / financial liabilities – held for trading'. All kinds of non-hedging derivatives without regard to their internal classification, i.e. both derivatives held in the trading book and banking book are presented in this line item.

Changes in the fair value (clean price) of derivatives held for trading are reported in the statement of income in the line item 'Net trading result'. Interest income/expense related to derivatives – held for trading is recognised in the statement of income under the line item 'Net interest income' if held in the banking book or under the line item 'Net trading result' if held in the trading book.

Derivatives – hedge accounting are those which are designated as hedging instruments in hedge accounting relationships fulfilling the conditions of IAS 39 (please refer to Hedge Accounting). In the balance sheet, they are presented in the line item 'Derivatives - hedge accounting' on asset or liability side.

Changes in the fair value of derivatives (clean price) in fair value hedges are recognised in the statement of income in the line item 'Net trading result'. Interest income/expense related to derivatives in fair value hedges is reported in the statement of income in the line item 'Net interest income'.

The effective part of changes in the fair value (clean price) of derivatives in cash flow hedges is reported in other comprehensive income in the line item 'Cash flow hedge reserve'. The ineffective part of changes in the fair value (clean price) of derivatives in cash flow hedges is recognised in profit or loss under the line item 'Net trading result'. Interest income/expense from hedging derivatives in cash flow hedges is disclosed in the statement of income in the line item 'Net interest income'.

v. Financial assets and financial liabilities - held for trading
Financial assets and financial liabilities – held for trading comprise derivatives and other trading assets and liabilities. Treatment of derivatives – held for trading is discussed above in (iv).

Other trading assets and liabilities are non-derivative instruments. They include debt securities as well as equity instruments acquired or issued principally for the purpose of selling or repurchasing in the near term. In the balance sheet, they are presented as 'Other trading assets' or 'Other trading liabilities' under the heading 'Financial assets / financial liabilities – held for trading'.

Changes in fair value (clean price for debt instruments) resulting from other trading assets and liabilities are reported in the statement of income under the line item 'Net trading result'. Interest income and expenses are reported in the statement of income under the line item 'Net interest income'. Dividend income is shown under the line item 'Dividend income'.

If securities purchased under agreement to resell or borrowed through securities lending transactions are subsequently sold to third parties, the obligation to return the securities is recorded as a short sale within 'Other trading liabilities'.

vi. Financial assets or financial liabilities designated at fair value through profit or loss

Financial assets or financial liabilities classified in this category are those that have been designated by management on initial recognition (fair value option).

Erste Group uses the fair value option in the case of financial assets managed on a fair value basis. In accordance with a documented investment strategy, the performance of the portfolio is evaluated and regularly reported to the management board. The portfolio contains mostly funds and bonds.

Financial assets - designated at fair value through profit or loss are recorded on the balance sheet at fair value under the line item 'Financial assets - designated at fair value through profit or loss', with changes in fair value recognised in the statement of income under the line item 'Result from financial assets and liabilities designated at fair value through profit or loss'. Interest earned on debt instruments is reported under the line item 'Net interest income'. Dividend income on equity instruments is shown under the line item 'Dividend income'.

Furthermore, Erste Group uses the fair value option in the case of some hybrid financial liabilities. This is relevant when:

- such classification eliminates or significantly reduces an accounting mismatch between the financial liability otherwise measured at amortised cost and the related derivative measured at fair value; or
- the entire hybrid contract is designated at fair value through profit or loss due to the existence of an embedded derivative.

The amount of fair value change attributable to changes in own credit risk for financial liabilities designated at fair value through profit or loss is calculated by the method described by IFRS 7. This amount is the difference between the present value of the liability and the observed market price of the liability at the end of the period. The rate used for discounting the liability is the sum of the observed (benchmark) interest rate at the end of the period and the instrument-specific component of the internal rate of return determined at the start of the period.

Financial liabilities designated at fair value through profit or loss are reported on the balance sheet under the line item 'Financial liabilities designated at fair value through profit or loss' further broken down into 'Deposits from customers' and 'Debt securities issued'. Changes in fair value are recognised in the statement of income under the line item 'Result from financial assets and liabilities designated at fair value through profit or loss'. Interest incurred is reported under the line item 'Net interest income'.

vii. Financial assets – available for sale

Available-for-sale financial assets include debt and equity securities as well as other interests in entities with lower than significant influence. Equity investments classified as available for sale are those that are neither classified as held for trading nor designated at fair value through profit or loss. Debt securities in this category are those that are intended to be held for an indefinite period of time and that may be sold in response to needs for liquidity or in response to changes in market conditions.

Available-for-sale financial assets are measured at fair value. On the balance sheet, available-for-sale financial assets are disclosed under the line item 'Financial assets – available for sale'.

Unrealised gains and losses are recognised in other comprehensive income and reported in the 'Available for sale reserve' until the financial asset is disposed of or impaired. If available-for-sale assets are disposed of or impaired, the cumulative gain or loss previously recognised in other comprehensive income is reclassified to profit or loss and reported in the line item 'Gains/losses on financial assets and liabilities not measured at fair value through profit or loss, net' in the case of sale or in the line item 'Net impairment loss on financial assets' in the case of impairment.

Interest income on available-for-sale financial assets is reported under the line item 'Net interest income'. Dividend income is reported under the line item 'Dividend income'.

In 2017, as part of IFRS 9 implementation, valuation models for investments in unquoted equities were developed. Erste Group considers that these models deliver reliable fair value measurement. As a result, these investments were remeasured to fair value throughout 2017. The remeasurement effects are disclosed in Note 16 Financial assets – available for sale.

If the fair value of investments in non-quoted equity instruments could not be measured reliably in the comparative period, they were recorded at cost less impairment. This was the case when the range of reasonable fair value estimates as calculated by valuation models was significant and the probabilities of the various estimates could not be reasonably assessed. There was no market for these investments.

viii. Financial assets – held to maturity

Non-derivative financial assets with fixed or determinable payments and fixed maturities are classified as held-to-maturity and reported on the balance sheet as 'Financial assets – held to maturity' if Erste Group has the intention and ability to hold them until maturity. After initial recognition, held-to-maturity financial assets are measured at amortised cost. Amortised cost is calculated by taking into account any discount, premium and/or transaction costs that are an integral part of the effective interest rate.

Interest earned on financial assets held to maturity is reported in the statement of income under the line item 'Net interest income'. Losses arising from impairment of such financial assets are presented as 'Net impairment loss on financial assets'. Realised gains or losses from selling are recognised in the statement of income under the line item 'Gains/losses on financial assets and liabilities not measured at fair value through profit or loss, net'.

ix. Loans and receivables

The balance sheet line items 'Loans and receivables to credit institutions' includes financial instruments which are allocated to financial instrument category loans and receivables with a contractual maturity of more than 24 hours. The balance sheet line item 'Loans and receivables to customers' includes financial instruments which are allocated to financial instrument category loans and receivables regardless of their contractual maturity. Furthermore, finance lease receivables that are accounted for using IAS 17 are presented under these balance sheet line items.

Loans and receivables are non-derivative financial assets (including debt securities) with fixed or determinable payments that are not quoted in an active market, other than:

- those that Erste Group intends to sell immediately or in the near term and those that Erste Group upon initial recognition designates as at fair value through profit or loss;
- those that Erste Group, upon initial recognition, designates as available for sale; or
- those for which Erste Group may not recover substantially all of its initial investment, other than because of credit deterioration.

After initial recognition, loans and receivables are measured at amortised cost. Finance lease receivables are subsequently measured as specified in the chapter 'Leasing' Interest income earned is included under the line item 'Net interest income' in the statement of income.

Impairment losses arising from loans and receivables are recognised in the statement of income under the line item 'Net impairment loss on financial assets'.

x. Financial liabilities measured at amortised cost

Financial liabilities are measured at amortised cost, unless they are measured at fair value through profit or loss.

For presentation on the balance sheet, the line item 'Financial liabilities measured at amortised cost' is used. The liabilities are further broken down by 'Deposits from banks', 'Deposits from customers', 'Debt securities issued' and 'Other financial liabilities'.

Interest expenses incurred are reported in the line item 'Net interest income' in the statement of income. Gains and losses from derecognition (mainly repurchase) of financial liabilities at amortised cost are reported under the line item 'Gains/losses from financial assets and liabilities not measured at fair value through profit or loss, net'.

xi. Relationships between balance sheet items, measurement methods and categories of financial instruments

	Measurement principle			Financial instrument category
Balance sheet position	Fair value	At amortised cost	Other	
ASSETS				
Cash and cash balances		x	Nominal value	n/a / Loans and receivables
Financial assets - held for trading				
Derivatives	x			Financial assets at fair value through profit or loss
Other trading assets	x			Financial assets at fair value through profit or loss
Financial assets - at fair value through profit or loss	x			Financial assets at fair value through profit or loss
Financial assets - available for sale	x			Available for sale financial assets
Financial assets - held to maturity		x		Held to maturity investments
Loans and receivables to credit institutions		x		Loans and receivables
thereof Finance lease			IAS 17	n/a
Loans and receivables to customers		x		Loans and receivables
thereof Finance lease			IAS 17	n/a
Derivatives - hedge accounting	x			n/a
LIABILITIES AND EQUITY				
Financial liabilities - held for trading				
Derivatives	x			Financial liabilities - at fair value through profit or loss
Other trading liabilities	x			Financial liabilities - at fair value through profit or loss
Financial liabilities - at fair value through profit or loss	x			Financial liabilities - at fair value through profit or loss
Financial liabilities measured at amortised cost		x		Financial liabilities measured at amortised cost
Derivatives - hedge accounting	x			n/a

Furthermore, two additional classes of financial instruments which are not presented in the table above are part of IFRS 7 disclosures. These are financial guarantees and irrevocable credit commitments.

Embedded derivatives

Erste Group is involved in business with debt instruments containing structured features. Structured features mean that a derivative is embedded in the host instruments. Embedded derivatives are separated from the host debt instruments if:

_ the economic characteristics of the derivatives are not closely related to the economic characteristics and risks of the host debt instruments;
_ the embedded derivative meets the IAS 39 definition of derivative; and
_ the hybrid instrument is not a financial asset or liability held for trading or designated at fair value through profit or loss.

Embedded derivatives that are separated are accounted for as stand-alone derivatives and presented on the balance sheet under the line item 'Derivatives' in financial assets – held for trading and financial liabilities – held for trading.

At Erste Group, derivatives that are not closely related and are separated are predominantly embedded in issued host debt instruments recognised as liabilities. The most typical cases are issues of bonds and deposits that contain interest caps, floors or collars in the money, CMS bonds without appropriate cap, contractual features linking payments to non-interest variables such as FX rates, equity and commodity prices and indices, or third-party credit risk.

Reclassifications of financial assets

IAS 39 provides various possibilities to reclassify financial assets between categories of financial instruments. It also places restrictions on some reclassifications. Erste Group makes use of reclassification alternatives only in the case of held-to-maturity financial assets. If a significant credit deterioration in a held-to-maturity financial asset results in a change in the intention and ability to hold the asset until maturity, the asset is reclassified into the available-for-sale financial assets category. Furthermore, reclassifications may relate to sales, which are performed close to the maturity date. Such reclassifications are not triggering a reclassification of the entire held-to-maturity portfolio.

Derecognition of financial assets and financial liabilities

A financial asset (or where applicable part of a financial asset or part of a group of similar financial assets) is derecognised when:

_ the contractual rights to receive cash flows from the asset have expired; or
_ Erste Group has transferred its rights to receive cash flows from the asset
_ or has assumed an obligation to pay the received cash flows in full without material delay to a third party under a 'pass-through' arrangement;

and either:
_ it has transferred substantially all the risks and rewards connected with the ownership of the asset, or
_ has neither transferred nor retained substantially all the risks and rewards connected with the ownership of the asset but has transferred control of the asset.

A financial liability is derecognised when the obligation under the liability is discharged, cancelled or expires.

Repurchase and reverse repurchase agreements

Transactions where securities are sold under an agreement to repurchase at a specified future date are also known as ‘repos’ or ‘sale and repurchase agreements’. Securities sold are not derecognised from the balance sheet, as Erste Group retains substantially all the risks and rewards of ownership because the securities are repurchased at a fixed price when the repo transaction ends. Furthermore, Erste Group is the beneficiary of all the coupons and other income payments received on the transferred assets over the period of the repo transactions. These payments are remitted to Erste Group or are reflected in the repurchase price.

The corresponding cash received is recognised on the balance sheet with a corresponding obligation to return it as a liability under the line item ‘Financial liabilities measured at amortised cost’, sub-items ‘Deposits from banks’ or ‘Deposits from customers’ reflecting the transaction’s economic substance as a loan to Erste Group. The difference between the sale and repurchase prices is treated as interest expense and recorded in the statement of income under the line item ‘Net interest income’ and is accrued over the life of the agreement. Financial assets transferred out by Erste Group under repurchase agreements remain on the Group’s balance sheet and are measured according to the rules applicable to the respective balance sheet item. Moreover, they are presented in ‘thereof pledged as collateral’ positions under the respective balance sheet items.

Conversely, securities purchased under agreements to resell at a specified future date are not recognised on the balance sheet. Such transactions are also known as ‘reverse repos’. The consideration paid is recorded on the balance sheet under the respective line items ‘Loans and receivables to credit institutions’ or ‘Loans and receivables to customers’, reflecting the transaction’s economic substance as a loan by Erste Group. The difference between the purchase and resale prices is treated as interest income and is accrued over the life of the agreement and recorded in the statement of income under the line item ‘Net interest income’.

Securities lending and borrowing

In securities lending transactions, the lender transfers ownership of securities to the borrower on the condition that the borrower will retransfer, at the end of the agreed loan term, ownership of instruments of the same type, quality and quantity and will pay a fee determined by the duration of the lending. The transfer of the securities to counterparties via securities lending does not result in derecognition. Substantially all the risks and rewards of ownership are retained by Erste Group as a lender because the securities are received at the end of the securities lending transaction. Furthermore, Erste Group is the beneficiary of all the coupons and other income payments received on the transferred assets over the period of the securities lendings. The securities lent are presented in ‘thereof pledged as collateral’ positions under the respective balance sheet items.

Securities borrowed are not recognised on the balance sheet unless they are then sold to third parties. In this case, the obligation to return the securities is recorded as a short sale within ‘Other trading liability’.

Impairment of financial assets and credit risk losses of contingent liabilities

Erste Group assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. A financial asset or group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset (an incurred ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated.

Erste Group uses the CRR definition of default as a primary indicator of loss events. Default, as a loss event, occurs when:
_ the obligor is more than 90 days past due on any material credit obligation;
_ as a result of specific information or an event, the obligor is unlikely to fulfil its credit obligations in full, without recourse to actions such as realising security;
_ the obligor is subject to distressed restructuring, i.e. a change in contract terms, for clients in financial difficulties, resulting in a material loss;
_ the obligor is subject to bankruptcy or similar protection proceedings.

In order to maximise collection opportunities and minimise the number of defaults, Erste Group renegotiates loans to customers in financial difficulties (referred to as forbearance cases). Both retail and corporate loans can be subject to forbearance. Under the Erste Group's forbearance policy, loan forbearance can be granted if the debtor is currently in default or if there is a high risk of default, there is evidence that the debtor made all efforts to pay according to the original contractual terms and it is expected that the debtor is able to meet the revised terms. Revised terms could be extended maturity, instalment reduction, changing the timing of the interest payments, interest reduction or forgiveness, revolving exposure change to instalments.

Loans subject to forbearance are generally not derecognised and are considered for impairment based on renegotiated conditions. However, in certain cases (like for FX loan conversions) when the renegotiation is qualitatively assessed as a substantial extinguishment of the rights to collect the cash flows due to material changes in the timing and amount of the cash flows, the loan is derecognised and the renegotiated loan is recognised as a new loan initially measured at fair value.

For assessment at portfolio level, Erste Group uses the incurred but not reported losses concept. It identifies the time period between the moment of the loss event causing future problems and actual detection of the problems by the bank at the moment of default.

Credit risk losses resulting from contingent liabilities are recognised if it is probable that there will be an outflow of resources to settle a credit risk bearing contingent liability that will result in a loss.

For more detailed information see Note 44.4.

i. Financial assets carried at amortised cost

Erste Group first assesses individually for significant loans and held-to-maturity securities whether objective evidence of impairment exists. If no objective evidence of impairment exists for an individually assessed financial asset, Erste Group includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is, or continues to be, recognised are not included in a collective assessment of impairment.

If an impairment loss has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the original effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralised financial asset also reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral.

Impairment losses on financial assets carried at amortised cost are recognised as loss allowance. On the balance sheet, loss allowances decrease the value of the assets. I.e. the net carrying amount of the financial asset presented on the balance sheet is the difference between the gross carrying amount and the cumulative loss allowance. This treatment holds for loss allowances for loans and receivables and for incurred but not reported losses (i.e. portfolio allowances) on held-to-maturity financial assets. Reconciliation of changes in these loss allowance accounts is disclosed in the notes. However, individual loss allowances for held to maturity financial assets are treated as direct reduction of the asset carrying amount and therefore reconciliation of changes is not disclosed in the notes.

In the statement of income, impairment losses and their reversals are presented in the line item 'Net impairment loss on financial assets'. Loans together with the associated allowance are removed from the balance sheet when there is no realistic prospect of future recovery and all collaterals have been realised by Erste Group.

If, in a subsequent year, the amount of the estimated impairment loss increases or decreases, the previously recognised impairment loss is increased or reduced by adjusting the loss allowance.

ii. Available-for-sale financial assets

In cases of debt instruments classified as available for sale, Erste Group assesses individually whether there is objective evidence of impairment based on the same criteria as used for financial assets carried at amortised cost. However, the amount recorded for impairment is the cumulative loss measured as the difference between the amortised cost and the current fair value, less any impairment loss on that asset previously recognised in the statement of income. On recognising impairment, any loss retained in the other comprehensive income item 'Available for sale reserve' is reclassified to the statement of income and shown as an impairment loss under the line item 'Net impairment loss on financial assets'.

If, in a subsequent period, the fair value of a debt instrument increases, which can be related objectively to an event occurring after the impairment was recognised, impairment loss is reversed through the statement of income under the line item 'Net impairment loss on financial assets'. Impairment losses and their reversals are recognised directly against the assets on the balance sheet.

In cases of equity investments classified as available for sale, objective evidence of impairment also includes a 'significant' or ' prolonged' decline in the fair value of the investment below its cost. For this purpose at Erste Group, 'significant' decline means a market price below 80% of the acquisition cost and 'prolonged' decline refers to a market price that is permanently below the acquisition cost for a period of nine months up to the reporting date.

Where there is evidence of impairment on equity investments, the cumulative loss measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that investment previously recognised in the statement of income, is shown as an impairment loss in the statement of income under the line item 'Net impairment loss on financial assets'. Any loss previously recognised under the other comprehensive income item 'Available for sale reserve' has to be reclassified to the statement of income as part of an impairment loss under the line item 'Net impairment loss on financial assets'.

Impairment losses on equity investments are not reversed through the statement of income; increases in the fair value after impairment are recognised directly in other comprehensive income. Impairment losses and their reversals are recognised directly against the assets on the balance sheet.

For investment in unquoted equity instruments carried at cost because their fair value cannot be determined reliably, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses shall not be reversed.

iii. Contingent liabilities
Provisions for credit losses of contingent liabilities (particularly financial guarantees as well as credit commitments) are included under the balance sheet line item 'Provisions'. The related expense or its reversal is reported in the statement of income under the line item 'Other operating result'.

Hedge accounting

Erste Group makes use of derivative instruments to manage exposures to interest rate risk and foreign currency risk. At inception of a hedge relationship, the bank formally documents the relationship between the hedged item and the hedging instrument, including the nature of the risk, the objective and strategy for undertaking the hedge and the method that will be used to assess the effectiveness of the hedging relationship. A hedge is considered as highly effective if the changes in fair value or cash flows attributable to the hedged risk offset the fair value changes of the hedging instrument in a range of 80% to 125%. This is assessed both prospectively, i.e. whether the results are expected to be in the range, and retrospectively, i.e. whether the actual results are in the range. Hedge effectiveness is assessed at inception and throughout the term of each hedging relationship. Exact conditions for particular types of hedges and for testing the hedge effectiveness by Erste Group are specified internally in the hedge accounting policy.

i. Fair value hedges
Fair value hedges are employed to reduce market risk. For qualifying and designated fair value hedges, the change in the fair value (clean price) of a hedging instrument is recognised in the statement of income under the line item 'Net trading result'. Interest income and expenses on hedging derivatives are reported under the line item 'Net interest income'. The change in the fair value of the hedged item attributable to the hedged risk is also recognised in the statement of income under the line item 'Net trading result' and adjusts the carrying amount of the hedged item.

Erste Group also uses portfolio fair value hedges of interest rate risk as regulated by IAS 39.AG114-AG132. Currently only interest rate risk from issued bonds is being hedged (i.e. no assets are included as hedged items). The change in the fair value of the hedged items attributable to the hedged interest risk is presented on the balance sheet under the line item 'Changes in fair value of portfolio hedged items'. Erste Group does not make use of the relaxation of hedge accounting requirements provided for portfolio fair value hedges by the EU carve-out.

If the hedging instrument expires, is sold, is terminated or is exercised, or when the hedge no longer meets the criteria for hedge accounting, the hedge relationship is terminated. In this case, the fair value adjustment of the hedged item is amortised to the statement of income under the line item 'Net interest income' until maturity of the financial instrument.

ii. Cash flow hedges
Cash flow hedges are used to eliminate uncertainty in the future cash flows in order to stabilise net interest income. For designated and qualifying cash flow hedges, the effective portion of the gain or loss on the hedging instrument is recognised in other comprehensive income and reported under the 'Cash flow hedge reserve'. The ineffective portion of the gain or loss on the hedging instrument is recognised in the statement of income under the line item 'Net trading result'. For determination of the effective and ineffective portions, the derivative is considered at its clean price, i.e. excluding the interest component. If the hedged cash flow affects the statement of income, the gain or loss on the hedging instrument is reclassified from other comprehensive income on the corresponding income or expense line item in the statement of income (mainly 'Net interest income'). As far as accounting for hedged items in cash flow hedges is concerned there is no change compared to the situation when no hedging is applied.

When a hedging instrument expires, is sold, is terminated, is exercised, or when a hedge no longer meets the criteria for hedge accounting, the hedge relationship is terminated. In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income remains in 'Cash flow hedge reserve' until the transaction occurs.

Offsetting financial instruments
Financial assets and financial liabilities are offset and the net amount is reported on the balance sheet if, and only if, there is a currently enforceable legal right to offset the recognised amounts and there is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously. Erste Group undertakes interest rate derivative transactions via London Clearing House and credit derivative transactions via ICE Clear Europe Ltd by fulfilling all offsetting requirements according IAS 32. The offsetting is carried out between asset and liability derivative positions while the net position is further offset with variation margin amounts. The amounts offset are disclosed in Note 13 Derivatives – held for trading and Note 22 Derivatives – hedge accounting as well as in Note 43 Offsetting of financial instruments.

Determination of fair value
Fair value is the price that would be received if an asset were sold or paid, if a liability were transferred in an orderly transaction between market participants on the measurement date. Details on valuation techniques applied for fair value measurement and on the fair value hierarchy are disclosed in Note 46 Fair value of financial instruments.

Leasing
A lease is an agreement whereby the lessor conveys to the lessee the right to use an asset for an agreed period of time in return for a payment or series of payments. A finance lease at Erste Group is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. All other lease agreements at Erste Group are classified as operating leases. This mainly includes the leasing of commercial real estate, automobiles and small trucks.

Erste Group as a lessor
The lessor in the case of a finance lease reports a receivable from the lessee under the line item 'Loans and receivables to customers' or 'Loans and receivables to credit institutions'. The receivable is equal to the present value of the contractually agreed payments taking into account any residual value. Interest income on the receivable is reported in the statement of income under the line item 'Net interest income'.

In the case of operating leases, the leased asset is reported by the lessor in 'Property and equipment' or in 'Investment properties' and is depreciated in accordance with the principles applicable to the assets involved. Lease income is recognised on a straight-line basis over the lease term in the statement of income under the line item 'Rental income from investment properties & other operating leases'.

The vast majority of lease agreements in which Erste Group operates as a lessor are finance leases.

Erste Group as a lessee
As a lessee, Erste Group has not entered into any leases meeting the conditions of finance leases. Operating lease payments are recognised as an expense in the statement of income on the line item 'Other administrative expenses' on a straight-line basis over the lease term.

Business combinations and goodwill
i. Business combinations
Business combinations are accounted for using the acquisition method of accounting. Goodwill represents the future economic benefits resulting from the business combination, arising from assets that are not individually identified and separately recognised. Goodwill is measured as the excess of the sum of the consideration transferred, the amount of any non-controlling interests and the fair value of the

previously held equity interest over the net of the acquisition-date amounts of the identifiable assets acquired as well as the liabilities assumed. At the acquisition date, the identifiable assets acquired and the liabilities assumed are generally recognised at their fair values.

If, after reassessment of all components described above, the calculation results in a negative amount, it is recognised as a bargain purchase gain and reported in the statement of income under the line item 'Other operating result' in the year of acquisition.

Non-controlling interests that are present ownership interests in the acquiree are measured at the proportionate share of the acquiree's identifiable net assets. Other types of non-controlling interests are measured at fair value or, when applicable, on the basis specified in another IFRS. Acquisition costs incurred are expensed and included under the statement of income line item 'Other operating result'.

ii. Goodwill and goodwill impairment testing

Goodwill arising on acquisition of a business is carried at cost as established as of the date of acquisition of the business less accumulated subsequent impairment losses, if any. Goodwill is tested for impairment annually in November, or whenever there is an indication of possible impairment during the year, with any impairment determined recognised in profit or loss. The impairment test is carried out for each cash-generating unit (CGU) to which goodwill has been allocated. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Goodwill is tested for impairment by comparing the recoverable amount of each CGU to which goodwill has been allocated with its carrying amount. The carrying amount of a CGU is based on the amount of net asset value allocated to the CGU taking into account any goodwill and intangible assets recognised at the time of business combination if they are allocated to the CGU.

The recoverable amount is the higher of a CGU's fair value less costs of disposal and its value in use. Where available, the fair value less costs of disposal is determined based on recent transactions, market quotations or appraisals. The value in use is determined using a discounted cash flow model (DCF model), which incorporates the specifics of the banking business and its regulatory environment. In determining value in use, the present value of future earnings distributable to shareholders is calculated.

The estimation of future earnings distributable to shareholders is based on financial plans for the CGUs as agreed by the management while taking into account the fulfilment of the respective regulatory capital requirements. The planning period is five years. Any forecasted earnings beyond the planning period are derived on the basis of the last year of the planning period and a long-term growth rate. The present value of such perpetual earnings growing at a stable rate (referred to as terminal value) takes into consideration macroeconomic parameters and economically sustainable cash flows for each CGU. Values for the long-term growth rates are disclosed in Note 27 Intangible assets in the subsection 'Development of goodwill'.

The cash flows are determined by subtracting the annual capital requirement generated by a change in the amount of risk-weighted assets from the net profit. The capital requirement was defined through the target tier 1 ratio in light of the expected future minimum regulatory capital requirements.

The value in use is determined by discounting the cash flows at a rate that takes into account present market rates and the specific risks of the CGU. The discount rates have been determined based on the capital asset pricing model (CAPM). According to the CAPM, the discount rate comprises a risk-free interest rate together with a market risk premium that itself is multiplied by a factor that represents the systematic market risk (beta factor). Furthermore, a country-risk premium component is considered in calculation of the discount rate. The values used to establish the discount rates are determined using external sources of information. Discount rates applied to determine the value in use are disclosed in Note 27 Intangible assets in the subsection 'Development of goodwill'.

Where the recoverable amount of a CGU is less than its carrying amount, the difference is recognised as an impairment loss in the statement of income under the line item 'Other operating result'. The impairment loss is allocated first to write down the CGU's goodwill. Any remaining impairment loss reduces the carrying amount of the CGU's other assets, though not to an amount lower than their fair value less costs of disposal. No impairment loss is recognised if the recoverable amount of the CGU is higher than or equal to its carrying amount. Impairment losses relating to goodwill cannot be reversed in future periods.

The goodwill included in the acquisition cost of investments in associates and joint ventures is not tested separately by performing the recurring impairment assessments applicable to goodwill. Instead, the entire carrying amount of the investment is tested for impairment as a single asset by comparing its recoverable amount (higher of fair value in use and fair value less costs of disposal) with its carrying amount (after application of the equity method) whenever relevant objective evidence of impairment is identified. Such evidence includes

information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environments in which associates and joint ventures operate, indicating that the cost of the investment may not be recovered.

Property and equipment

Property and equipment is measured at cost less accumulated depreciation and accumulated impairment. Borrowing costs for qualifying assets are capitalised into the costs of property and equipment.

Depreciation is calculated using the straight-line method to write down the cost of property and equipment to their residual values over their estimated useful lives. Depreciation is recognised in the statement of income on the line item 'Depreciation and amortisation' and impairment under the line item 'Other operating result'.

The estimated useful lives are as follows:

Useful life in years	
Buildings	30-50
Re-buildings on own and foreign real estates	15-50
Office furniture and equipment	4-10
Passenger cars	4-8
Computer hardware	4-6

Land is not depreciated.

Property and equipment is derecognised on disposal or when no future economic benefits are expected from its use. Any gain or loss arising on disposal of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is recognised in the statement of income under the line item 'Other operating result'.

Investment properties

Investment property is property (land and buildings or part of a building or both) held for the purpose of earning rental income or for capital appreciation. In the case of partial own use, the property is investment property only if the owner-occupied portion is insignificant. Investments in land and buildings under construction, where the future use is expected to be the same as for investment property, are treated as investment property.

Investment property is measured initially at cost, including transaction costs. Subsequent to initial recognition, investment property is measured at cost less accumulated depreciation and impairment. Investment property is presented on the balance sheet in the line item 'Investment properties'.

Rental income is recognised in the statement of income in the line item 'Rental income from investment properties and other operating leases'. Depreciation is presented in the statement of income in the line item 'Depreciation and amortisation' using the straight-line method over an estimated useful life. The useful lives of investment properties are in the range of 15-100 years. Any impairment losses, as well as their reversals, are recognised under the line item 'Other operating result'.

Property Held for Sale (Inventory)

The Group also invests in property that is held for sale in the ordinary course of business or property in the process of construction or development for such sale. This property is presented as 'Other assets' and is measured at the lower of cost and net realisable value in accordance with IAS 2 Inventories.

The cost of acquiring inventory includes not only the purchase price but also all other directly attributable expenses, such as transportation costs, customs duties, other taxes and costs of conversion of inventories, etc. Borrowing costs are capitalised to the extent to which they directly relate to the acquisition of real estate.

Sales of these assets are recognised as revenues under the statement of income line item 'Other operating result', together with costs of sales and other costs incurred in selling the assets.

Intangible assets

In addition to goodwill, Erste Group's intangible assets include computer software and customer relationships, the brand and other intangible assets. An intangible asset is recognised only when its cost can be measured reliably and it is probable that the expected future economic benefits that are attributable to it will flow to the bank.

Costs of internally generated software are capitalised if Erste Group can demonstrate the technical feasibility and intention of completing the software, the ability to use it, how it will generate probable economic benefits, the availability of resources and the ability to measure the expenditures reliably. Intangible assets acquired separately are measured on initial recognition at cost. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses.

The cost of intangible assets acquired in a business combination is their fair value as of the date of acquisition. In the case of Erste Group, these are brands and customer relationships, and they are capitalised on acquisition if they can be measured with sufficient reliability.

Intangible assets with finite lives are amortised over their useful economic lives using the straight-line method. The amortisation period and method are reviewed at least at each financial year-end and adjusted if necessary. The amortisation expense on intangible assets with finite lives is recognised in the statement of income under the line item 'Depreciation and amortisation'.

The estimated useful lives are as follows:

Useful life in years	
Computer software	4-8
Customer relationships	10-20

Brands are not amortised as they are assumed to have an indefinite useful life. An intangible asset has an indefinite useful life, if there are no legal, contractual, regulatory or other factors limiting that useful life. Brands are tested for impairment annually within the cash-generating unit to which they belong, and impairment is recognised if appropriate. Furthermore, each period brands are reviewed as to whether current circumstances continue to support the conclusion as to indefinite life. In the event of impairment, impairment losses are recognised in the statement of income under the line item 'Other operating result'.

Impairment of non-financial assets (property and equipment, investment properties, intangible assets)

The bank assesses at each reporting date whether there is an indication that a non-financial asset may be impaired. Testing for impairment is done at individual asset level if the asset generates cash inflows that are largely independent of those from other assets. The typical case is investment property. Otherwise the impairment test is carried out at the level of the cash-generating unit (CGU) to which the asset belongs. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. For specific rules related to impairment of goodwill and impairment allocation rules for CGUs please see the chapter 'Business combinations and goodwill', part (ii) Goodwill and goodwill impairment testing.

If any indication of impairment exists, or when annual impairment testing for an asset is required, the bank estimates the asset's recoverable amount. An asset's recoverable amount is the higher of the asset's or CGU's fair value less costs of disposal and its value in use. If the carrying amount of an asset or CGU exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In measuring value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

At each reporting date an assessment is made as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such an indication exists, the bank estimates the asset's or CGU's recoverable amount. The previously recognised impairment loss is reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognised. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount or does not exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years.

Impairments and their reversals are recognised in the statement of income under the line item 'Other operating result'.

Non-current assets and disposal groups held for sale

Non-current assets are classified as held for sale if they can be sold in their present condition and the sale is highly probable within 12 months of classification as held for sale. If assets are to be sold as part of a group that may also contain liabilities (e.g. a subsidiary) they are referred to as disposal group held for sale.

Assets classified as held for sale and assets belonging to disposal groups held for sale are reported under the balance sheet line item 'Assets held for sale'. Liabilities belonging to the disposal groups held for sale are presented on the balance sheet under the line item 'Liabilities associated with assets held for sale'.

Non-current assets and disposal groups that are classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. Should the impairment loss in a disposal group exceed the carrying amount of the assets that are within the scope of IFRS 5 measurement requirements, there is no specific guidance on how to treat such a difference. Erste Group recognises this difference as a provision under the balance sheet line item 'Provisions'.

Financial guarantees

In the ordinary course of business, Erste Group provides financial guarantees, consisting of various types of letters of credit and guarantees. According to IAS 39, a financial guarantee is a contract that requires the guarantor to make specified payments to reimburse the holder for a loss it incurs in case a specified debtor fails to make a payment when due in accordance with the original or modified terms of a debt instrument.

If Erste Group is in a position of being a guarantee holder, the financial guarantee is not recorded on the balance sheet but is taken into consideration as collateral when determining impairment of the guaranteed asset.

Erste Group as a guarantor recognises financial guarantees as soon as it becomes a contracting party (i.e. when the guarantee offer is accepted). Financial guarantees are initially measured at fair value. Generally, the initial measurement is the premium received for a guarantee. If no premium is received at contract inception (i.e. the initial transaction price is zero), this is the price that would be paid to transfer the liability in an orderly transaction between market participants. As a result, the fair value of such a financial guarantee and thus the initial measurement is nil. Subsequent to initial recognition, the financial guarantee contract is reviewed for the possibility that provisioning will be required under IAS 37. Such provisions are presented on the balance sheet under the line 'Provisions'. The premium received is recognised in the statement of income under the line item 'Net fee and commission income' on a straight-line basis over the life of the guarantee.

Defined employee benefit plans

Defined employee benefit plans operated by Erste Group are for pensions, severance and jubilee benefits. From IAS 19 categorisation perspective pension and severance benefits qualify as post-employment defined benefits plans whereas jubilee benefits are other long-term employee benefits.

In Austria, the defined benefit pension plans relate only to retired employees. The pension obligations for current employees were transferred to external pension funds in previous years. Remaining with Erste Group is a defined-benefit obligation for entitlements of former employees who were already retired as of 31 December 1998 before the pension reform took effect, and for those former employees who retired only in 1999 but remained entitled to a direct pension from Erste Group under individual agreements. Also included are entitlements to resulting survivor pensions.

Severance benefit obligations exist in relation to Austrian employees who entered the Group's employment before 1 January 2003. The severance benefit is one-time remuneration to which employees are entitled when their employment relationship ends. The entitlement to this severance payment arises after three years of employment.

Defined-benefit plans include jubilee benefits. Jubilee payments (payments for long service and/or loyal service) are remuneration tied to the length of an employee's service to the employer. The entitlement to jubilee benefits is established by the applicable collective agreement, which defines both the conditions and amount of the entitlement.

In addition, there are defined employee benefit plans for foreign subsidiaries and branches, mainly in Romania, Croatia, Serbia and Slovakia.

Obligations ensuing from defined employee benefit plans are determined using the projected unit credit method. Future obligations are determined based on actuarial expert opinions. The calculation takes into account not only those salaries, pensions and vested rights to future pension payments known as of the balance sheet date but also anticipated future rates of increase in salaries and pensions.

The liability recognised under a defined-benefit plan represents the present value of the defined benefit obligation less the fair value of the plan assets available for the direct settlement of obligations. For all plans, the present value of the obligation exceeds the fair value of the plan assets. The resulting defined benefit liability is reported on the balance sheet under the line item 'Provisions'. At Erste Group, the plan assets consist of qualifying insurance policies purchased to back severance and jubilee benefit provisions. Plan assets for pension provision are held by a long-term employee benefit fund.

Remeasurements consist of actuarial gains and losses on the defined benefit obligations and the return on plan assets. Remeasurements of pension and severance defined-benefit plans are recognised in other comprehensive income. Remeasurements of jubilee defined-benefit plans are recognised in the statement of income under the line item 'Personnel expenses'.

Erste Group board members bonus program

Every year Erste Group grants to its board members a bonus program. It relates to the services rendered by the Board Members in this year (i.e. 'service year'). The actual payments are conditional on Erste Group performance in the service year and following 5 years. In this respect, they are split into a first tranche and five deferred tranches. Fifty percent of the bonuses are paid out in cash and meet the definition other long-term employee benefits in IAS 19. Remaining fifty percent depend on changes in the average share price of Erste Group Bank, AG and thus meet the conditions of cash-settled share-based payment in IFRS 2.

For both parts of the program, the full bonus is recognised as an expense against a liability in the estimated amount in the service year. The liability from the cash-settled share-based payment part is recognised in the balance sheet under 'Other liabilities'. The liability from the employee benefit part is recognised in the balance sheet under 'Provisions'. The expenses including any subsequent adjustments to the liability reflecting the decisions about the actual amount of the bonuses, fulfilment of performance conditions and share price changes are presented in the statement of income under 'Personnel expenses'.

Further details about the bonus program and relevant disclosures about can be found in Note 40 Related-party transaction and principal shareholders, section 'Performance-linked remuneration'.

Provisions

Provisions are recognised when the Group has a present obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. On the balance sheet, provisions are reported under the line item 'Provisions'. They include credit risk loss provisions for contingent liabilities (particularly financial guarantees and loan commitments) as well as provisions for litigation and restructuring. Expenses or income related to provisions are reported in the statement of income under the line item 'Other operating result'.

Levies

Erste Group recognises a liability or a provision for the levy when the activity that triggers payment, as identified by the relevant legislation, occurs.

Income taxes

i. Current tax

Current tax assets and liabilities for the current and prior years are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amounts are those enacted by the balance sheet date.

ii. Deferred tax

Deferred tax is recognised for temporary differences between the tax bases of assets and liabilities and their carrying amounts as of the balance sheet date. Deferred tax liabilities are recognised for all taxable temporary differences. Deferred tax assets are recognised for all deductible temporary differences and unused tax losses to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and carry forward of unused tax losses can be utilised. Deferred taxes are not recognised on temporary differences arising from the initial recognition of goodwill.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilised. Unrecognised deferred tax assets are reassessed at each balance sheet date and are recognised to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the year when the temporary difference is reversed or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted as at balance sheet date and are expected to apply when the temporary differences are reversed. For the subsidiaries, local tax environments apply.
Deferred tax relating to items recognised in other comprehensive income is recognised in other comprehensive income and not in the statement of income.

Deferred tax assets and deferred tax liabilities are offset if a legally enforceable right to offset exists and the deferred taxes relate to the same taxation authority.

Treasury shares and contracts on treasury shares

Equity instruments of Erste Group that it or any of its subsidiaries acquire (referred to as treasury shares) are deducted from equity. Consideration paid or received on the purchase, sale, issue or cancellation of Erste Group's own equity instruments, including transaction costs, is recognised directly in equity. No gain or loss is recognised in the statement of comprehensive income on the purchase, sale, issue or cancellation of its own equity instruments.

Fiduciary assets

The Group provides trust and other fiduciary services that result in the holding or investing of assets on behalf of its clients. Assets held in a fiduciary capacity are not reported in the financial statements, as they are not the assets of Erste Group.

Dividends on own equity instruments

Dividends on own equity instruments are recognised as a liability and deducted from equity when their payment is confirmed by the Annual General Meeting.

Recognition of income and expenses

Revenue is recognised to the extent that the economic benefits will flow to the entity and the revenue can be reliably measured. The description and revenue recognition criteria of the line items reported in the statement of income are as follows:

i. Net interest income

Interest income and interest expense is recorded using the effective interest rate (EIR) method. The calculation includes origination fees resulting from the lending business as well as transaction costs that are directly attributable to the instrument and are an integral part of the EIR (apart from financial instruments at fair value through profit or loss), but no future credit losses. Interest income from individually impaired loans and receivables and held-to-maturity financial assets is calculated by applying the original effective interest rate used to discount the estimated cash flows for the purpose of measuring the impairment loss.

Interest income includes interest income on loans and receivables to credit institutions and customers, on cash balances and on bonds and other interest-bearing securities in all financial assets categories. Interest expenses include interest paid on deposits from customers, deposits from banks, debt securities issued and other financial liabilities in all financial liabilities categories. Net interest income also includes interest on derivative financial instruments held in the banking book. In addition, net interest cost on severance payment, pension and jubilee obligations is presented here.

Furthermore negative interest from financial liabilities and financial assets are presented in 'Net interest income'.

ii. Net fee and commission income

Erste Group earns fee and commission income from a diverse range of services that it provides to its customers.

Fees earned for the provision of services over a period of time are accrued over that period. These fees include lending fees, guarantee fees, commission income from asset management, custody and other management and advisory fees as well as fees from insurance brokerage, building society brokerage and foreign exchange transactions.

Fee income earned from providing transaction services, such as arranging the acquisition of shares or other securities or the purchase or sale of businesses, is recognised upon completion of the underlying transaction.

iii. Dividend income

Dividend income is recognised when the right to receive the payment is established. This line item includes dividend from shares and other equity-related securities in all portfolios as well as income from other investments in companies categorised as available for sale.

iv. Net trading result

Results arising from trading activities include all gains and losses from changes in the fair value (clean price) of financial assets and financial liabilities classified as held for trading, including all derivatives not designated as hedging instruments. In addition, for derivative financial instruments held in the trading book, the net trading result also contains interest income or expense. However, interest income or expenses related to non-derivative trading assets and liabilities and to derivatives held in the banking book are not part of the net trading result as they are reported as 'Net interest income'. The net trading result also includes any ineffective portions recorded in fair value and cash flow hedge transactions as well as foreign exchange gains and losses.

v. Result from financial assets and liabilities designated at fair value through profit or loss

The gains and losses presented in this line item relate to changes in the clean price of assets and liabilities designated at fair value through profit or loss.

vi. Net result from equity method investments

The line item contains result from associates and joint ventures recorded by applying the equity method (measured as the investor's share of profit or loss in the associates and joint ventures). However, impairment losses, reversal of impairment losses and realised gains and losses on investments in associates or joint ventures accounted for using the equity method are reported under the line item 'Other operating result'.

vii. Rental income from investment properties & other operating leases

Rental income from investment properties and other operating leases is recognised on a straight-line basis over the lease term.

viii. Personnel expenses

Personnel expenses include wages and salaries, bonuses, statutory and voluntary social security contributions, staff-related taxes and levies. They also include service cost for severance payment, pension and jubilee obligations and remeasurements of jubilee obligations. Furthermore, restructuring provisions expenses may be part of personnel expenses.

ix. Other administrative expenses

Other administrative expenses include primarily information technology expenses, expenses for office space, office operating expenses, advertising and marketing and expenditures for legal and other consultants. Furthermore, the line item contains deposit insurance contributions expenses. Restructuring provisions expenses may also be presented in other administrative expenses.

x. Depreciation and amortisation

This line item comprises depreciation of property and equipment, depreciation of investment property and amortisation of intangible assets.

xi. Gains/losses on financial assets and liabilities not measured at fair value through profit or loss, net

This line item includes selling and other derecognition gains or losses on available-for-sale and held-to-maturity financial assets, loans and receivables and financial liabilities measured at amortised cost. However, if such gains/losses relate to individually impaired financial assets they are included as part of net impairment loss.

xii. Net impairment loss on financial assets

Net impairment losses on financial assets comprise impairment losses and reversals of impairment on loans and receivables, held-to-maturity and available-for-sale financial assets. Net impairment losses relate to allowances recognised both at individual and portfolio (incurred but not reported) level. Direct write-offs are considered as part of impairment losses. This line item also includes recoveries on written-off loans removed from the balance sheet.

xiii. Other operating result

The other operating result reflects all other income and expenses not directly attributable to Erste Group's ordinary activities. Furthermore, levies on banking activities are considered as part of the other operating result. The other operating result includes impairment losses or any reversal of impairment losses as well as results on the sale of property and equipment and intangible assets. Also included here are any impairment losses on goodwill. In addition, the other operating result encompasses the following: expenses for other taxes; income from the release of and expenses for allocations to provisions; impairment losses (and their reversal if any) as well as selling gains and losses on equity investments accounted for using the equity method; and gains or losses from derecognition of subsidiaries.

d) Significant accounting judgements, assumptions and estimates

The consolidated financial statements contain amounts that have been determined on the basis of judgements and by the use of estimates and assumptions. The estimates and assumptions used are based on historical experience and other factors, such as planning as well as expectations and forecasts of future events that are currently deemed to be reasonable. As a consequence of the uncertainty associated with these assumptions and estimates, actual results could in future periods lead to adjustments in the carrying amounts of the related assets or liabilities. The most significant uses of judgements, assumptions and estimates are as follows:

Control

IFRS 10 'Consolidated Financial Statements' defines the investor's control over an investee in terms of the investor having all of the following:

- power to direct the relevant activities of the investee, i.e. activities that significantly affect the investee's returns;
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect the amount of the investor's returns.

Hence, assessing the existence of control under this definition may require considerable accounting judgements, assumptions and estimates, notably in non-standard situations such as:

- power stemming both from voting rights and from contractual arrangements (or mostly from the latter);
- exposure stemming both from on-balance investments and from off-balance commitments or guarantees (or mostly from the latter); or
- variable returns stemming both from readily identifiable income streams (e.g. dividends, interest, fees) and from cost savings, economies of scale and/or operational synergies (or mostly from the latter).

In the case of Erste Group, such accounting judgements, assumptions and estimates have been primarily relevant for the assessment of the following cases:

i. The savings bank members of the Austrian cross-guarantee system (Haftungsverbund)

Erste Group Bank AG is a member of the Haftungsverbund (cross-guarantee system) of the Austrian savings bank sector. As of the balance sheet date, all of Austria's savings banks, in addition to Erste Group Bank AG and Erste Bank der oesterreichischen Sparkassen AG, formed part of this cross-guarantee system. The provisions of the agreement governing the Haftungsverbund are implemented by the steering company Haftungsverbund GmbH. Erste Group Bank AG always holds directly and indirectly at least 51% of the voting rights of the steering company, through Erste Bank der oesterreichischen Sparkassen AG and through savings banks in which the Group holds the majority of voting rights.

For all savings banks in which Erste Group holds less than 50% of the voting rights, an assessment of whether control is achieved through the provisions of the Haftungsverbund agreement has been performed.

Based on the contractual agreement, Haftungsverbund GmbH as the steering company is vested with the following substantive rights related to the savings banks:

- participation in the appointment of board members;
- approval of budgets including capital decisions;
- provision of binding guidelines in the areas of risk and liquidity management as well as internal audit; and
- determination of thresholds for capital requirement including the payout of dividends.

Furthermore, taking into account the magnitude of Erste Group's involvement with the member banks - whether in the form of synergies, investments, commitments, guarantees, or access to common resources - the Group has significant exposure to each of the member banks' variable returns. As Haftungsverbund GmbH is able to affect the variable returns through its power, it has been assessed that Haftungsverbund GmbH has control over the savings banks.

As Erste Group Bank AG controls the steering company, it exercises control over the members of the cross-guarantee system.

ii. Investment funds under own management

The Group has assessed whether the investment funds it manages through its asset management subsidiaries are controlled and hence shall be consolidated. This assessment has been made on the basis that power over such investment funds is generally conferred based on the contractual arrangements appointing an Erste Group subsidiary as fund manager, without any substantive removal rights the by fund's investors. Furthermore, Erste Group made the conclusive judgement that its exposure to such own-managed funds' variable returns is

basically considered as significant if, additionally to the exposure through management fees, the Group is also exposed in the form of at least 20% investment in the fund. Furthermore, in its capacity as fund manager, Erste Group is also able to affect the returns of the funds through its power. Following this assessment, investment funds under own management in which the Group – directly or through its subsidiaries – has significant unit holdings are deemed to be controlled and included in the scope of consolidation.

iii. Pension funds under own management

The Group has assessed whether the contractual arrangements appointing an Erste Group subsidiary as pension fund manager (with no substantive removal rights by the fund's participants) are generally expected to confer power over such funds, followed by an assessment of the Group's exposure/rights to the pension fund's variable returns. The relevant legal requirements regulating the activities of such pension funds in their respective jurisdictions were also considered, notably in assessing the significance of the rights to variable returns from management fees, as well as of the exposure to losses from any guarantees that the fund manager may be legally bound to. As a result of this review, the Czech pension fund 'Transformovaný fond penzijního připojištění se státním příspěvkem Česká spořitelna – penzijní společnost, a.s' (the 'Transformed pension fund') is not consolidated. There are no further cases of application in Erste Group.

Significant influence

IAS 28 'Investments in Associates and Joint Ventures' defines significant influence as the power to participate in the financial and operating policy decisions of the investee without having control or joint control of those policies. Furthermore, IAS 28 indicates that if an entity holds, directly or indirectly 20% or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case.

In the case of Erste Group, all equity method investments are direct or indirect investments in associates and joint ventures over which the Group exercises significant influence or joint control stemming from voting power higher than 20% up to 50%.

Interests in structured entities

IFRS 12 'Interests in Other Entities' defines structured entities as entities that have been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to the administrative tasks only and the relevant activities are directed by means of contractual arrangements. IFRS 12 defines the interests as contractual and non-contractual involvements exposing an entity to the variability of returns from the performance of the other entity.

Hence, assessing which entities are structured entities, and which involvements in such entities are interests, may require considerable accounting judgements and assumptions.

In the case of Erste Group, such accounting judgements, assumptions and estimates have been primarily relevant for assessing involvements with securitisation vehicles and investment funds. In respect to securitisation vehicles, Erste Group assessed that on-balance or off-balance exposures to entities involved in securitisation activities meet the definition of interests in structured entities.

For investment funds, Erste Group reached the conclusion that direct Group exposure would typically indicate an interest in these structured entities, irrespective of whether such exposure comes from on-balance financial assets, off-balance commitments given or management fees varying in relation to the assets under management (for own-managed funds in general). In alignment with the accounting judgement described under the paragraph 'Investment funds under own management' above, own-managed funds where the Group cumulatively holds less than 20% of the related fund units in issue are not consolidated due to lack of control and thus are subject to specific disclosures for unconsolidated structured entities. All on-balance or off-balance exposures to investment funds - mostly in the form of units held in such funds - were considered as being interests in structured entities.

For the ensuing IFRS 12-driven disclosures applicable to structured entities, please refer to Note 24 Unconsolidated structured entities.

Fair value of financial instruments

Where the fair values of financial assets and financial liabilities recorded on the balance sheet cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The inputs to these models are derived from observable market data where possible, but where observable market data is not available judgement is required to establish fair values. Disclosures for valuation models, the fair value hierarchy and fair values of financial instruments can be found in Note 46 Fair value of financial instruments. Based on an analysis performed in 2016 it was decided that for the valuation of OTC derivatives no Funding Value Adjustment (FVA) would be considered.

Impairment of financial assets
Erste Group reviews its financial assets not measured at fair value through profit or loss at each balance sheet date to assess whether an impairment loss should be recorded in the statement of income. In particular, it is required to determine whether there is objective evidence of impairment as a result of a loss event occurring after initial recognition and to estimate the amount and timing of future cash flows when determining an impairment loss.

Disclosures concerning impairment are provided in Note 44 Risk management in the subsection 'Credit risk' – 'Non-performing credit risk exposure and credit risk provisions'. The development of loan loss provisions is described in Note 21 Impairment loss for financial instruments.

Impairment of non-financial assets
Erste Group reviews its non-financial assets at each balance sheet date to assess whether there is an indication of impairment loss that should be recorded in the statement of income. Furthermore, cash-generating units to which goodwill is allocated are tested for impairment on a yearly basis. Judgement and estimates are required to determine the value in use and fair value less costs of disposal by estimating the timing and amount of future expected cash flows and the discount rates. Assumptions and estimates used for impairment on non-financial asset calculations are described in the parts 'Business combinations and goodwill' and 'Impairment of non-financial assets (property and equipment, investment property, intangible assets)' in the Accounting Policies. Inputs used for goodwill impairment testing and their sensitivities can be found in Note 27 Intangible assets in the section 'Development of goodwill'.

Deferred tax assets
Deferred tax assets are recognised in respect of tax losses and deductible temporary differences to the extent that it is probable that taxable profit will be available against which the losses can be utilised. Judgement is required to determine the amount of deferred tax assets that can be recognised, based upon the likely timing and level of future taxable profits, together with future tax planning strategies. For this purpose a planning period of 5 years is used. Disclosures concerning deferred taxes are in Note 28 Tax assets and liabilities.

Defined benefit obligation plans
The cost of the defined benefit pension plan is determined using an actuarial valuation. The actuarial valuation involves making assumptions about discount rates, expected rates of return on assets, future salary increases, mortality rates and future pension increases. Assumptions, estimates and sensitivities used for the defined benefit obligation calculations as well as related amounts are disclosed in Note 34 a) Long-term employee provisions.

Provisions
Recognition of provisions requires judgement with respect to whether Erste Group has a present obligation as a result of a past event and whether it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. Furthermore, estimates are necessary with respect to the amount and timing of future cash flows when determining the amount of provisions. Provisions are disclosed in Note 34 Provisions and further details on provisions for contingent credit liabilities in Note 44.4 Credit risk. Legal proceedings that do not meet the criteria for recognition of provisions are described in Note 50 Contingent liabilities.

e) Application of amended and new IFRS/IAS

The accounting policies adopted are consistent with those used in the previous financial year except for standards and interpretations that became effective for financial years beginning after 1 January 2017. As regards new standards and interpretations and their amendments, only those that are relevant for the business of Erste Group are listed below.

Effective standards and interpretations
The following standards and their amendments have become mandatory for our financial year 2017, endorsed by the EU:

- Amendments to IAS 7: Disclosure Initiative
- Amendments to IAS 12: Recognition of deferred tax assets for unrealised losses
- Annual Improvements to IFRSs 2014-2016 Cycle (amendments to IFRS 12)

Application of the above mentioned amendments did not have a significant impact on Erste Group's financial statements.

Standards and interpretations not yet effective

The standards, amendments and interpretations shown below were issued by the IASB but are not yet effective.

Following standards, amendments and interpretations are already endorsed by the EU:
- IFRS 9: Financial Instruments
- IFRS 15: Revenue from Contracts with Customers including Amendments to IFRS 15: Effective date of IFRS 15
- Clarifications to IFRS 15 Revenue from Contracts with Customers
- IFRS 16: Leases
- Annual Improvements to IFRSs 2014-2016 Cycle (amendments to IAS 28 and IFRS 1)

Following standards, amendments and interpretations have not yet been endorsed by the EU until 23 February 2018:
- Amendments to IFRS 2: Classification and Measurement of Share-based Payment Transactions
- Amendments to IAS 19: Plan Amendment, Curtailment or Settlement
- Amendments to IAS 28: Long-term Interests in Associates and Joint Ventures
- Amendments to IAS 40: Transfers of Investment Property
- Annual Improvements to IFRSs 2015-2017 Cycle (amendments to IFRS 3, IFRS 11, IAS 12 and IAS 23)
- IFRIC 22: Foreign Currency Transactions and Advance Consideration
- IFRIC 23: Uncertainty over Income Tax Treatments

IFRS 9: Financial Instruments. IFRS 9 was issued in July 2014 and is effective for annual periods beginning on or after 1 January 2018. IFRS 9 addresses the classification and measurement of financial assets and liabilities, introduces new principles for hedge accounting and a new impairment model for financial assets.

The Group has reviewed its financial assets and financial liabilities in order to evaluate the impact of the first application of IFRS 9 on Group's equity and regulatory capital as of 1 January 2018 ('transition impact'). This review involved iterative financial impact studies across the Group which continued throughout 2017. Furthermore, starting with the second half of 2017, a fully-fledged parallel run of the IAS 39 production environment and the IFRS 9 test environment has been undertaken in multiple iterations. This parallel run provided significant benefits with regards to ensuring a technically correct transition to IFRS 9, but also with regards to refining the transition impact expectations. At the same time, the parallel run outputs bear an inherent degree of approximation that has been reducing along with different IFRS 9-driven functionalities being user-tested and transferred into production. Post-transition activities will continue throughout the year 2018, notably in respect of:
- finalisation of the testing and assessment of controls over new IT-systems and changes to their governance framework;
- validation and potential refinement of the models for expected credit loss calculations;
- updating the policy landscape at Group and local entity level, in all business lines directly or indirectly affected by IFRS 9.

IFRS 9 introduces two criteria for classification and measurement of financial assets: 1) an entity's business model for managing the financial assets, and 2) the contractual cash flow characteristics of the financial assets. As a result, a financial asset is measured at amortised cost ('AC') only if both of the following conditions are met: a) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows ('held to collect') and b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest ('SPPI') on the principal amount outstanding. Measurement at fair value through other comprehensive income ('FVOCI') is applicable to financial assets held within a business model whose objective is achieved by both collecting contractual cash flows and selling the assets ('hold and sell') while the condition b) is also fulfilled. All other financial assets are measured at fair value through profit or loss ('FVTPL'). The main impacts resulting from the classification and measurement model upon transition to IFRS 9 are described below.

In respect of the business model criterion, the main changes relate to financial assets classified as available-for-sale and thus measured at FVOCI under IAS 39. Debt securities which are part of the portfolios connected to asset and liability management activities at a carrying amount EUR 4 billion will be classified and measured at AC under IFRS 9 due to insignificant or infrequent sales expected. Further, financial assets held by investment funds consolidated by Erste Group at a carrying amount of approximately EUR 1 billion will be measured at FVTPL due to being managed and evaluated on a fair value basis.

In applying the business model criterion Erste Group has to assess the expected selling activity of financial assets. At Erste Group, sales due to increases in credit risk, sales close to assets' maturity, infrequent sales triggered by a non-recurring event (such as changes in regulatory environment, severe liquidity crisis) are considered as not contradicting the 'held to collect' business model. Other kinds of sales are expected to be insignificant as to their volume. As a result, sales are incidental in the 'held to collect' business model. On the other

hand, in the 'hold and sell' business model the sales of debt securities are significant and frequent and thus they are integral to meeting the business model objectives. Erste Group will carry out such sales in order to optimise the liquidity position or to realise the fair value gains or losses.

Regarding the contractual cash flows characteristics criterion Erste Group concluded that the vast majority of its loan portfolio amounting to EUR 149 billion which is currently classified as loans and receivables will continue to be measured at AC. The carrying amount of loans that will be measured at FVTPL is below EUR 0.5 billion; such loans typically bear interest mismatch features (e.g. floating rate loans with interest rate reset every year but their tenor being linked to a long term secondary market interest rate). This outcome reflects completion of all mitigation activities undertaken since 2015 across Erste Group to reduce the volume of loans which would otherwise have been subject to FVTPL measurement. Further, investments in non-consolidated funds at a fair value amount of EUR 0.6 billion classified as available-for-sale and measured at FVOCI under IAS 39 will be measured at FVTPL.

Investments in equity instruments at a carrying amount of approximately EUR 0.3 billion currently categorised as available-for-sale will be categorised as FVTPL. The new standard provides an option to designate non-trading equity instruments at FVOCI at initial recognition. Erste Group will make use of this option for some equity investments that represent strategic business relationships.

Regarding classification and measurement of financial liabilities, upon transition to IFRS 9, Erste Group will designate a large portion of the portfolio of own bond issues measured at AC under IAS 39 and subject to portfolio fair value hedges of interest rate risk in carrying amount of approximately EUR 11 billion as measured at FVTPL. The effect of fair value changes resulting from credit risk of the financial liabilities designated at FVTPL which, based on IFRS 9 requirements, are recognised in other comprehensive income (OCI) amounts to approximately EUR 0.7 billion, thereof EUR 0.6 billion attributable to newly designated own issues.

Erste Group does not expect any effects of the new standard resulting from its accounting for hedges as it will continue to apply the requirements in IAS 39. However, the new designations of bond liabilities as FVTPL as discussed above will result in the termination of existing portfolio fair value hedges of interest rate risk.

The new impairment model requires recognition of credit loss allowances ('CLA') based on expected credit losses ('ECL') rather than only incurred credit losses as is the case under IAS 39. It applies to credit risk exposures stemming from debt instruments classified at AC or FVOCI, lease receivables, financial guarantee contracts and certain loan commitments.

For credit risk exposures that are not credit-impaired at initial recognition, Erste Group will recognise CLA at an amount equal to 12-month ECL (referred to as 'Stage 1') for as long as no significant increase in credit risk since initial recognition ('SICR') is identified at the reporting date. In the other cases, the CLA is measured at lifetime ECL and the related instruments are referred to as 'Stage 2', unless they are found to be credit-impaired at the reporting date (referred to as 'Stage 3'). For purchased or originated credit-impaired financial assets ('POCI'), only adverse changes in lifetime ECL after the initial recognition are distinctly recognised as CLA, whilst favourable changes are recognized as impairment gains increasing the carrying amount of the related POCI assets. The measurement of ECL reflects a probability-weighted outcome, the time value of money and reasonable and supportable forward-looking information.

For lease receivables and trade receivables containing a significant financing component (where Erste Group also includes its factoring receivables), IFRS 9 allows a simplified impairment approach, whereby credit loss allowances are always measured at lifetime ECL. Erste Group will not apply this simplification.

In the area of ECL modelling and CLA calculation, Erste Group has identified a number of key drivers, as follows:

a) the 'credit-impaired' definition
In respect of applying the 'credit-impaired' concept of IFRS 9, Erste Group generally adopted the approach of aligning it with the regulatory concept of 'default' for lending exposures. If the default status exists already at an exposure's initial recognition (e.g. in the context of a significant distressed restructuring), then that exposure is identified as POCI.

b) the SICR indicators applicable to not credit-impaired exposures
Across portfolios and product types, a number of quantitative and qualitative SICR indicators have been defined, in addition to the SICR indicator of 30 days-past-due.

SICR is quantitatively measured by reference to the adverse change, since instrument's initial recognition, in the current annualised remaining lifetime probability of default ('PD') and in the current 12-month PD. Significance of such change is assessed by reference to

a combination of relative and absolute change thresholds. Current PDs are determined to reflect the current default risk as a 'point-in-time' measure. The thresholds are established at PD segment level or client rating level, as appropriate, and are subject to initial and on-going validation.

Qualitative SICR indicators include forbearance-type flags, a work-out transfer flag, information from early-warning-system that is not sufficiently reflected in the rating grades, as well as fraud indicators. The assignment of some specific qualitative indicators inherently relies on experienced credit risk judgment being exercised adequately and timely. Besides the qualitative indicators defined on client level, the assessment of significant increase in credit risk is performed on portfolio level if the increase in credit risk on individual instrument or client level is only available with a certain time lag or is observable exclusively on portfolio level.

Upon transition to IFRS 9 the SICR has to be determined in respect of PDs which existed at instruments' initial recognition. Where retrospective identification PDs at initial recognition was not possible without undue cost or effort, Erste Group implemented the following sequence of approximation methods: closest rating to initial recognition, re-rating based on historic data with current rating model, best possible rating for the relevant portfolio at the instrument's initial recognition, first available rating.

Application of the 'low credit risk exemption' allowed by IFRS 9 for 'investment grade' or other 'low risk'-deemed assets (and resulting in 12 months expected credit losses being calculated irrespective of SICR quantitative measures) will be limited to particular types of debt securities and counterparty categories, and only if supported by sufficient 'low risk' evidence at local level.

c) ECL modelling
The key risk parameters used in the measurement of ECLs - PD, loss given default ('LGD') and exposure at default ('EAD') - are derived from internally developed statistical models and other historical data that leverage regulatory models.
The PD describes a probability that a client will default on the related loan obligation. The 12-month PD reflects the estimated probability of default within one year from the reporting date, whilst the lifetime PD indicates the estimated probability of default until instrument's maturity and cumulates conditional marginal 12-month PD estimates attributable to each year until maturity. The PD estimation methods used in Erste Group depend on the segmentation criteria defined by the relevant local strategic risk management units. The applicable estimation methods include average default rate analysis and internal/external migration matrices and consider adjustments to the point-in-time-estimate.
The LGD captures the loss rate in the case of default. In general, the selection of estimation method depends on portfolio, and whether the curve is defined on LGD segment, client or account level. The LGD estimation methods applicable in Erste Group include a simple scenario approach and an advanced multiple scenario approach. For defaulted exposures, the calculation methodology provides for a probability-weighted average of pre-defined work-out scenarios (Austria: cure, restructuring or liquidation; CEE: cooperative or non-cooperative client).
The EAD that is attributable to any given future year throughout an on-balance exposure's remaining maturity is approximated on the basis of exposure's current gross carrying amount multiplied by an amortization coefficient that depends on exposure's contractual repayment type. For off-balance not credit-impaired exposures, the EAD approximation is based on the current nominal amount of the exposure, multiplied by the credit conversion factor.

d) Consideration of forward-looking information ('FLI')
Measurement of ECLs and SICR assessment require further consideration of FLI, which Erste Group has addressed by introducing a baseline forecast and a number of alternative scenarios for selected macroeconomic variables. These are derived, together with their probabilities of occurrence, as a deviation from baseline forecasts, where the baseline forecasts are, with a few exceptions, internally determined by Erste Group's research department. Given multiple scenarios, the 'neutral' PD (and also LGD, with a few exceptions) are adjusted through macro models which link relevant macroeconomic variables with risk drivers. Thus, the unbiased, probability-weighted ECL is derived with the weights representing the occurrence probabilities of each macroeconomic scenario. Typical macroeconomic variables may include real gross domestic product, unemployment rate, inflation rate, production index as well as market interest rates. The selection of variables also depends on the availability of reliable forecasts for the given local market.

e) Period of exposure to credit risk
Apart from using a maximum of a 12-month PD for financial assets for which credit risk has not significantly increased, the Group will measure ECLs considering the risk of default over the maximum contractual period (including any borrower's extension options). This extends to the date at which the Group has the right to require repayment of an advance or terminate a loan commitment or guarantee.

However, for revolving credit facilities with unspecified maturity and/or cancellable at short notice and for which the day-to-day internal credit risk management activities are customarily performed on a portfolio basis only, best estimates of the period of exposure to credit

risk have been developed at entity level across the Group, based on the available data history and expert judgement. Such estimates generally range from 2 to 4 years, with few exceptions, and vary depending on product type, client segment and lender entity. Retail credit cards and overdrafts are among the exposure types the most relevant for such estimates.

Transition to IFRS 9 is expected to result in an increase of the 2018 opening balance of credit loss allowances compared to the 2017 closing balance of loan loss provisions under IAS 39 (including provisions for off-balance exposures treated under IAS 37) in the range of 4 to 5 %. This expected change includes both equity-neutral changes and changes that impact accounting equity. Also, it combines effects due to changes in the scope of impairment and changes triggered by the adoption of the expected loss model.

Overall, the IFRS 9 transition is expected to result in a before-tax decrease of Group's consolidated accounting equity by approximately EUR 0.8 billion, thereof approximately EUR 0.4 billion represents an increase retained earnings (accumulated effects which would have impacted profit or loss in previous periods, in connection with all financial instruments subject to classification-driven re-measurement and/or ECL calculation upon transition) and approximately EUR 1.1 billion represents a negative impact to accumulated OCI (accumulated effects which would have impacted other comprehensive income in previous periods, in connection with both financial assets classified at FVOCI and financial liabilities retrospectively designated at FVTPL upon transition). Further, the associated decrease of the CET1 ratio (before consideration of tax effects) is estimated below 20 basis points. This decrease in CET1 is less significant than the decrease in the accounting equity due to two main factors. The first factor is the accounting adverse change in accumulated OCI due to fair value changes resulting from credit risk of the financial liabilities retrospectively designated at FVTPL upon transition to IFRS 9, which would be added back for CET1 purposes. The second factor is the reduction in the IRB shortfall-related CET1 deduction, in response to the increase in the accounting impairments.

The related deferred tax impact depends on the fiscal treatment of the incremental differences between the tax values and the IFRS 9-based re-measured accounting values of the affected assets and liabilities, which can vary across the tax jurisdictions of Erste Group and which, in several of these jurisdictions is yet to be decided by the relevant fiscal authorities. Currently, Erste Group estimates that the consolidated deferred tax impact upon transition to IFRS 9 is likely to be favourable, meaning that it would mitigate the above estimates of decrease in accounting equity and CET1. Erste Group does not apply the transitional provisions for IFRS 9 acc. to Art. 473a CRR when calculating regulatory own funds.

The new standard also resulted in amended IFRS requirements regarding presentation and disclosure. These are expected to change the nature and extent of the group's disclosures about its financial instruments particularly in the year of the adoption of the new standard. In anticipation of such changes, Erste Group has already implemented significant updates of the structure of the financial statements (both main components and explanatory notes). Such updates have also taken into account the applicable changes in the regulatory reporting requirements (notably FINREP related) as stipulated by the EU Commission or the relevant national regulators, respectively.

IFRS 15: Revenue from Contracts with Customers. IFRS 15 was issued in May 2014 and is effective for annual periods beginning on or after 1 January 2018. Clarifications to IFRS 15 were issued in April 2016. IFRS 15 specifies how and when an entity recognises revenue from contracts with customers. It also requires such entities to provide users of financial statements with more informative and more relevant disclosures. The standard provides a single, principles based five-step model to be applied to all contracts with customers. Also in the areas of variable considerations and capitalisation of cost IFRS 15 provides modified regulations. The standard is not focused on recognition of revenues from financial instruments. Hence, on the basis of the analyses performed throughout 2017, the application of this standard is not expected to have a significant impact on Erste Group's financial statements.

IFRS 16: Leases. In January 2016, the IASB issued IFRS 16 being effective for annual periods beginning on or after 1 January 2019. IFRS 16 specifies the depiction of lease arrangements in the financial statements. Compared to the previous standard IAS 17, there is a fundamental alteration in respect of the recognition of operating leasing arrangements for the lessee. As defined in IFRS 16, the standard requires the lessee to recognise a right of use asset on the debit side of the balance sheet as well as a corresponding lease liability on the credit side of the balance sheet except for immateriality in cases of short term leasing arrangements and small ticket leasing arrangements for low-value assets. By contrast, accounting changes for the lessor are only minor compared to IAS 17. Compared to IAS 17 the notes will be much more comprehensive under IFRS 16.

The analysis and planning of proper IT solutions for the requirements of IFRS 16 have continued throughout 2017. At the same time the assessment of the contracts has been in focus. The role out of proper IT structure is planned to be realised in 2018.

Since the analysis of the impact of IFRS 16 has not yet been completed, no quantitative estimates with respect to the effects of the transition to IFRS 16 can be made at this time. However an immaterial enhancement of the balance sheet is expected.

Regarding the transition method Erste Group is planning to follow the modified retrospective approach with recognition of the adjustments arising out of the first time application of IFRS 16, if any, in equity at the date of initial application. The applicable discount rate will be the one determined at the date of initial application.

Amendments to IFRS 2: Classification and Measurement of Share-based Payment Transactions. Amendments to IFRS 2 were issued in June 2016 and are effective for annual periods beginning on or after 1 January 2018. The amendments clarify treatment for the effects of vesting conditions on a cash-settled share-based payment transaction, the classification of a share-based payment with net settlement features for withholding tax obligations and the accounting for modifications of share-based payment transactions from cash-settled to equity-settled. Application of these amendments is not expected to have a significant impact on Erste Group's financial statements.

Amendments to IAS 19: Plan Amendment, Curtailment or Settlement. Amendments to IAS 19 were issued in February 2018 and are effective for annual periods beginning on or after 1 January 2019. The amendments require that if a plan amendment, curtailment or settlement occurs, it is mandatory that the current service cost and the net interest for the period after the remeasurement are determined using the assumptions used for the remeasurement. In addition, the amendments clarify the effect of a plan amendment, curtailment or settlement on the requirements regarding the asset ceiling. Application of these amendments is not expected to have a significant impact on Erste Group's financial statements.

Amendments to IAS 28: Long-term Interests in Associates and Joint Ventures. Amendments to IAS 39 were issued in October 2017 and are effective for annual periods beginning on or after 1 January 2019. The amendments clarify that a company applies IFRS 9 Financial Instruments including its impairment requirements to long-term interests in an associate or joint venture that form part of the net investment in the associate or joint venture. Application of these amendments is not expected to have a significant impact on Erste Group's financial statements.

Amendments to IAS 40: Transfers of Investment Property. Amendments to IAS 40 were issued in December 2016 and are effective for annual periods beginning on or after 1 January 2018. The amendments reinforce the principle for transfers into, or out of, investment property in IAS 40 and specify that such a transfer should only be made when there has been a change in use of the property. Application of these amendments is not expected to have a significant impact on Erste Group's financial statements.

Annual Improvements to IFRSs 2014-2016 Cycle. In December 2016, the IASB issued a set of amendments to various standards. The amendments to IFRS 1 and IAS 28 are effective for annual periods beginning on or after 1 January 2018. Application of these amendments is not expected to have a significant impact on Erste Group's financial statements.

Annual Improvements to IFRSs 2015-2017 Cycle. In December 2017, the IASB issued a set of amendments to various standards. The amendments to IFRS 3, IFRS 11, IAS 12 and IAS 23 are effective for annual periods beginning on or after 1 January 2019. Application of these amendments is not expected to have a significant impact on Erste Group's financial statements.

IFRIC 22: Foreign Currency Transactions and Advance Consideration. IFRIC 22 was issued in December 2016 and is effective for annual periods beginning on or after 1 January 2018. The interpretation relates to considerations denominated in a foreign currency received or paid in advance of the recognition of the related asset, expense or income. It clarifies, that the date of the transaction, for the purpose of determining the exchange rate, is the date of initial recognition of the non-monetary prepayment asset or deferred income liability in such cases. If there are multiple payments or receipts in advance, a date of transaction is established for each payment or receipt. Application of the interpretation is not expected to have a significant impact on Erste Group's financial statements.

IFRIC 23: Uncertainty over Income Tax Treatments. IFRIC 23 was issued in June 2017 and is effective for annual periods beginning on or after 1 January 2019. The interpretation is to be applied to the determination of taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates, when there is uncertainty over income tax treatments under IAS 12. An entity is required to use judgement to determine whether each tax treatment should be considered independently or whether some tax treatments should be considered together. If the entity concludes that it is not probable that a particular tax treatment is accepted by a taxation authority, the entity has to use the most likely amount or the expected value of the tax treatment. Otherwise the treatment used in the tax filings is applied. An entity has to reassess its judgements and estimates if facts and circumstances change. Application of the interpretation is not expected to have a significant impact on Erste Group's financial statements.