

Strategy

Erste Group strives to be the leading retail and corporate bank in the eastern part of the European Union, including Austria. To achieve this goal, Erste Group aims to support its retail, corporate and public sector customers in realising their ambitions by offering excellent financial advice and solutions, lending responsibly and providing a safe harbour for deposits. Erste Group's business activities will continue to contribute to economic growth and financial stability and thus to prosperity in its region.

In all of its core markets in the eastern part of the European Union, Erste Group pursues a balanced business model focused on providing the best banking services to each of its customers. In this respect, digital innovations are playing an increasingly important role. Sustainability is reflected in the bank's ability to fund customer loans by customer deposits, with most customer deposits being stable retail deposits. Sustainability of the bank's strategy is also reflected in long-term client trust, which underpins strong market shares in almost all of Erste Group's core markets. However, market leadership is not an end in itself. Market leadership only creates value when it goes hand in hand with positive economies of scale and contributes to the long-term success of the company.

The banking business, however, should not only be run profitably but also reflect its corporate responsibility towards all material stakeholders, in particular customers, employees, society and the environment. Therefore, Erste Group pursues banking business in a socially responsible manner and aims to earn an adequate premium on the cost of capital.

Long-standing tradition in customer banking

Erste Group has been active in the retail business since 1819. This is where the largest part of Erste Group's capital is tied up, where Erste Group generates most of its income and where it funds the overwhelming part of its core activities by drawing on its customers' deposits. The retail business represents Erste Group's strength and is its top priority when developing products such as modern digital banking that enable it to meet customers' expectations more effectively.

Offering attractive, easy-to-understand products and services that meet the individual needs and objectives of bank customers is important in building and maintaining strong long-term customer relationships. Today, Erste Group serves a total of more than 16 million customers in seven core markets.

The bank's core activities also include advisory services and support for its corporate customers with regard to financing, investment, hedging activities and access to international capital markets. Public sector funding includes providing finance for infrastructure projects and acquiring sovereign bonds issued in the region.

To meet the short-term liquidity management needs of the customer business, Erste Group also operates in the interbank market.

Core markets in the eastern part of the European Union

When Erste Group went public as an Austrian savings bank with no meaningful foreign presence in 1997, it defined its target region as consisting of Austria and the part of Central and Eastern Europe that had realistic prospects of joining the European Union. The aim was to benefit from the attractive growth prospects in these countries. Against the backdrop of emerging European integration and limited potential for growth in Austria, Erste Group acquired savings banks and financial institutions in countries adjacent to Austria from the late 1990s onwards. While the financial and economic crisis has slowed the economic catch-up process across the countries of Central and Eastern Europe, the underlying convergence trend continues unabated. This part of Europe offered and still offers the best structural and therefore long-term growth prospects.

Today, Erste Group has an extensive presence in its core markets of Austria, the Czech Republic, Slovakia, Romania, Hungary and Croatia – all of which are members of the European Union. Following significant investments in its subsidiaries, Erste Group holds considerable market positions in these countries. In Serbia, which has been assigned European Union candidate status, Erste Group maintains a minor market presence but one that may be expanded through acquisitions or organic growth as the country makes progress towards European Union integration. In addition to its core markets, Erste Group also holds direct and indirect majority and minority banking participations in Slovenia, Montenegro, Bosnia and Herzegovina, Macedonia and Moldova.

Growing importance of innovation and digitalisation

The pace of digital transformation has accelerated considerably as a result of technological changes, demographic developments and also regulatory interventions in recent years. As a result, customer behaviour and customer expectations towards financial products have also changed significantly. Erste Group is convinced that the digital banking business will continue to gain in importance and will be essential for the economic success in the long term and therefore fosters digital innovation. Intra-group, interdisciplinary teams develop innovative solutions.

Erste Group's digital strategy is based on its own digital ecosystem. It aims at providing customers access to personalised products from Erste Group and also third-party suppliers through application programming interfaces (APIs) in the secure IT environment of a financial platform. APIs enable a wide range of co-operations, whether with fintechs or across industries, and can therefore help open up new markets.

The digital platform *George* was implemented in Austria in 2015. By the end of 2018, *George* should also be up and running in the Czech Republic, Slovakia and Romania while being rolled out successively in all of the other core markets. *George* is supplemented by the mobile application *George Go*. The range of digitally available products and services is constantly expanded.

Customers can activate applications of Erste Group or third parties via plug-ins and use them to manage their finances.

The omni-channel approach of Erste Group integrates the various sales and communication channels. Customers decide on how, when and where they do their banking business. Contact centers serve as interfaces between digital banking and traditional branch business. These contact centers offer advice and sales, thus going far beyond the traditional help desk function.

Focus on sustainability and profitability

Acting responsibly and earning a premium on the cost of capital is a key prerequisite for the long-term survival of any company and the creation of value for customers, investors and employees. Only a bank that operates in a sustainable manner – balancing the social, ecological and economic consequences of its business activities – and profitably, can achieve the following: provide products and services to customers that support them in achieving their financial ambitions; deliver the foundation for share price appreciation as well as dividend and coupon payments to investors; create a stable and rewarding work environment for employees and be a reliable contributor of tax revenues to society at large.

The management board adopted a Statement of Purpose to reaffirm and state in more detail the purpose of Erste Group to pro-

mote and secure prosperity across the region. Building on this statement of purpose, a Code of Conduct defines binding rules of the day-to-day business for employees and members of both the management and supervisory boards. At the same time, the Code of Conduct underlines that in pursuing its business activities, Erste Group values responsibility, respect and sustainability. The Code of Conduct is an important tool to preserve the reputation of Erste Group and to strengthen stakeholder confidence. Sustainability in this context means to operate the core business both in a socially and environmentally responsible manner and economically successfully.

Through a combination of stable revenues, low loan loss provisions, and cost efficiency profits can be achieved in the long term. This is helped by a strong retail-based funding profile. When growth opportunities are elusive, as they will be from time to time, or the market environment is less favourable as a result of factors including high taxation, increased regulation or low interest rates, there will be a stronger focus on cost cutting. When the operating environment improves, more time will be devoted to capturing growth in a responsible way. Irrespective of the environment, Erste Group should benefit materially from operating in the region of Europe that offers the best structural growth opportunities for some time to come.

Erste Group's strategy

Customer banking in Central and Eastern Europe				
Eastern part of the EU		Focus on CEE, limited exposure to other Europe		
Retail banking	SME/Corporate banking	Capital markets	Public sector	Interbank business
<p>Focus on local currency mortgage and consumer loans funded by local deposits</p> <p>FX loans (in Euro) only where funded by local FX deposits (Croatia and Serbia)</p> <p>Savings products, asset management and pension products</p> <p>Expansion of digital banking offering</p>	<p>SME and local corporate banking</p> <p>Advisory services, with focus on providing access to capital markets and corporate finance</p> <p>Real estate business that goes beyond financing</p>	<p>Focus on customer business, incl. customer-based trading activities</p> <p>In addition to core markets, presences in Poland, Germany and London with institutional client focus and selected product mix</p> <p>Building debt and equity capital markets in CEE</p>	<p>Financing sovereigns and municipalities with focus on infrastructure development in core markets</p> <p>Any sovereign holdings are held for market-making, liquidity or balance sheet management reasons</p>	<p>Focus on banks that operate in the core markets</p> <p>Any bank exposure is only held for liquidity or balance sheet management reasons or to support client business</p>

THE STRATEGY IN DETAIL

The basis of Erste Group's banking operations is the retail and corporate customer business in the eastern part of the European Union, including Austria. The capital markets and interbank activities as well as the public sector business are defined more broadly to be able to meet the bank's customer needs as effectively as possible.

Retail business

Erste Group's key business is the retail business, covering the entire spectrum from lending, deposit and investment products to current accounts and credit cards. Erste Group's core competence in retail banking has historical roots. In 1819, wealthy Viennese citizens donated funds to establish Erste Group's predecessor, the first savings bank in Central Europe. It was their aim to bring basic banking services such as safe savings accounts and mortgage loans to wide sections of the population. Today, the bank serves a total of more than 16 million customers in its markets and operates almost 2,600 branches. Wealthy private clients, trusts and foundations are served by the bank's private banking staff and benefit from services that are tailored to the needs of this target group.

In addition, the bank uses and promotes digital distribution channels such as internet and mobile banking as Erste Group is convinced that the importance of digital banking will further increase and will substantially change the future of retail business. This has already become visible through the activities of fintech companies, which offer financial services online and typically operate without a banking licence. *George*, Erste Group's new digital platform, was launched in Austria in 2015. By the end of 2018, *George* should also be up and running in the Czech Republic, Slovakia and Romania, while being rolled out successively in all of the other core markets.

Retail banking is attractive to Erste Group for a number of reasons: It offers a compelling business case that is built on market leadership, an attractive risk-reward profile and the principle of self-funding. In addition, it benefits from a comprehensive range of products that are simple and easy to understand and provide substantial cross-selling potential. Erste Group takes advantage of these factors in all core markets and makes best use of its resulting position of strength by pursuing an omni-channel strategy. In addition to the expansion of digital sales channels, the branch network remains an important component of the business strategy. Only a retail bank that offers modern digital services and operates an extensive distribution network is able to fund loans in local currency mainly from deposits made in the same currency. In short, Erste Group's retail banking model supports sustainable and deposit-funded growth even in economically more challenging times. Another positive factor is the diversification of the retail business across countries that are at different stages of economic development, such as Austria, the Czech Republic, Romania, Slovakia, Hungary, Croatia and Serbia.

Corporate business

The second main business line, which also contributes significantly to Erste Group's earnings, is the business with small and medium-sized enterprises, regional and multi-national groups and real estate companies. Erste Group's goal is to enhance the relationships with its clients beyond pure lending business. Specifically, the bank's goal is for SMEs and large corporate customers to choose Erste Group as their principal bank and also route their payment transfers through the Group's banking entities and, in fact, regard Erste Group as their first point of contact for any kind of banking service.

Catering to their different requirements, Erste Group serves small and medium-sized enterprises locally in branches or separate commercial centres, while multinational groups are serviced by the Group Corporates' units. This approach permits Erste Group to combine industry-specific and product expertise with an understanding of regional needs and the experience of the bank's local customer relationship managers. In view of the regulatory interventions, advising and supporting corporate customers in capital market transactions is becoming increasingly important.

Capital markets business

Client-driven capital markets activities are also part of the comprehensive portfolio of products and services that Erste Group offers to its retail and corporate customers. The strategic significance of the bank's centrally governed and locally rooted capital markets operations consists in supporting all other business areas in their dealings with the capital markets and, hence, in providing the bank's customers with professional access to the financial markets. Erste Group, therefore, views its capital markets business as a link between financial markets and its customers. As a key capital markets player in the region, Erste Group also performs important functions such as market-making, capital market research and product structuring.

The capital markets business serves the needs of Erste Group's retail and corporate customers as well as those of government entities and financial institutions. Due to Erste Group's strong network in the eastern part of the European Union, the bank has a thorough understanding of local markets and customer needs. In Erste Group's capital markets business, too, the bank concentrates on core markets of the retail, SME and large corporate business: Austria, the Czech Republic, Slovakia, Romania, Hungary, Croatia and Serbia. For institutional customers, specialised teams have been established in Germany and Poland as well as in London, Hong Kong and New York that offer these customers a tailor-made range of products.

In many countries where Erste Group operates, the local capital markets are not yet as highly developed as in Western Europe or in the United States of America. That means Erste Group's banking subsidiaries are pioneers in some of these markets. Therefore, building more efficient capital markets in the region is another strategic objective of Erste Group's capital markets activities.

Public sector business

Solid deposit business is one of the key pillars of Erste Group's business model. Customer deposits surpass lending volume in many of its geographic markets. Erste Group's banking entities make a significant part of this liquidity available as financing to the region's public sector entities. In this way, the bank facilitates essential public sector investment. Erste Group's public sector customers are primarily municipalities, regional entities and sovereigns that the bank additionally supports and advises in capital market issuance, infrastructure financing and project financing. Furthermore, Erste Group cooperates with supranational institutions.

In terms of sovereign bond investments, Erste Group is equally focusing on Central and Eastern Europe.

Adequate transport and energy infrastructure and municipal services are absolute key prerequisites for sustainable economic growth in the long term. Therefore, Erste Group views infrastructure finance and all associated financial services to be of extreme importance. Between 2014 and 2020, the European Union has earmarked about EUR 90 billion from structural and investment funds for the Czech Republic, Slovakia, Croatia, Hungary and Romania: This is one quarter of the total allocation under the European Union's cohesion policy. In this context, Erste Group's commitment to infrastructure development in Romania is to be highlighted. The Romanian subsidiary Banca Comercială Română supports investment in essential infrastructure by funding key companies in all sectors.

Interbank business

The interbank business is an integral part of Erste Group's business model that performs the strategic function to ensure that the liquidity needs of the bank's customer business are met. This involves, in particular, short-term borrowing and lending of liquid funds in the interbank market.

REGULATORY CHANGES IN BANKING

In recent years, regulation of the financial sector has been tightened substantially to strengthen the resilience of banks and prevent or at least minimise the adverse impact of any new crises on economies and market participants. The ultimate aim of these reforms has been to largely rule out reliance on state guarantees and taxpayers' money to absorb banks' losses.

A banking union has been established as a regulatory framework consisting of a European banking supervision mechanism, a banking resolution mechanism and common standards for deposit insurance. Implementing the requirements defined by the Basel Committee on Banking Supervision, the European Commission released in November 2016 a proposal for a comprehensive review of the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) as well as of the EU's Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) Regulation. The package of re-

vised EU regulations is not expected to enter into force before the beginning of 2019. Under a so-called fast-track procedure, though, a number of rules contained in this package of EU regulations – the regulations cluster IFRS 9, large exposures and creditor hierarchy – are implemented early, as of the beginning of 2018.

At the beginning of December 2017, the Basel Committee on Banking Supervision presented the final part of the Basel 3 reform package, which is designed to achieve a transparent and comparable calculation of the capital requirements of each institution. The standardised approaches for the individual risk categories have been revised and the use of internal models for calculating capital requirements will be restricted in the future. An output floor has been introduced to ensure that banks' calculations of risk-weighted assets (RWAs) generated by internal models cannot, in aggregate, fall below a certain percentage threshold of the risk-weighted assets computed by the standardised approaches; the output floor will be gradually raised to 72.5%. The use of internal models for the calculation of operational risks will no longer be permitted. The package is scheduled for implementation in the EU by 1 January 2022 and will be fully applicable after a transition period of up to five years.

The European Single Resolution Board (SRB) is working on the development of resolution plans and the definition of resolution strategies for significant institutions. For Erste Group Bank AG, a specific MREL (minimum requirement for own funds and eligible liabilities) was not defined yet in 2017.

Several provisions of the fourth Anti-Money Laundering Directive have meanwhile been transposed into Austrian law. On 1 January 2017, the Financial Markets Anti-Money Laundering Act (FM-GwG – Finanzmarkt-Geldwäschegesetz) took effect and, on 3 January 2017, the Austrian Financial Market Authority's Identification Regulation based on FM-GwG, which, among other things, permits video identification of customers if certain conditions are met. At the beginning of 2018, an amendment to the Ultimate Beneficial Ownership Register Act (WiEReG – Wirtschaftliche Eigentümer Registergesetz) entered into force, creating the legal basis for the register of beneficial owners of companies and other legal entities (e.g. foundations and trusts). Previously, the companies register only contained data of beneficial owners of companies and foundations.

The reform of the Banking Act and the Financial Market Authority Act that became effective in January 2018 provides, among other things, for an improvement in proportionality, transparency and legal certainty. At the same time, regulatory relief was granted to smaller institutions, e.g. with regard to the creation of committees. The Securities Supervision Act 2018 (Wertpapieraufsichtsgesetz, WAG 2018) implemented in Austria a substantial portion of the European rules of the Markets in Financial Instruments Directive (MiFID) 2 and Markets in Financial Instruments Regulation (MiFIR), which continue and expand the existing MiFID framework. The amendment to the Payment Services Act designed to

transpose the revised Payment Services Directive (PSD 2) into Austrian law is expected to be adopted in 2018.

To strengthen the Austrian banking industry, the Financial Market Authority (FMA) had already introduced, by way of ordinance (capital buffer ordinance), a systemic risk buffer for a number of Austrian credit institutions and a buffer for other systemically important institutions (O-SIIs) in December 2015. For Erste Group, the buffer amounts to 1% of RWAs as of 1 January 2018 and will be increased to 2% by 1 January 2019. The FMA's amendment to the capital buffer ordinance, which took effect on 1 January 2018, implemented a recommendation of the Financial Market Stability Board. Under the amendment, seven credit institutions, including Erste Group Bank AG, are required to hold systemic risk buffers also at single-entity level.

LONG-TERM GROWTH TRENDS IN CENTRAL AND EASTERN EUROPE

While the financial and economic crisis has temporarily slowed the economic catch-up process across the countries of Central and Eastern Europe, the underlying convergence trend continues. This is on the one hand due to the fact that the region has to make up for almost half a century of communist mismanagement of the economy and on the other hand due to the fact that banking activities were largely non-existent during that time.

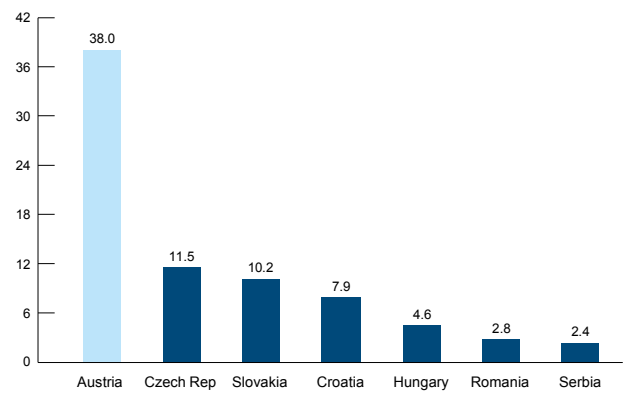
With the exception of deposit-taking, modern banking services were largely unknown in these countries after the fall of communism. On the lending side, this was due to high nominal and real interest rates and also to disposable incomes that did not support household credit growth. In addition, a healthy competitive environment was lacking due to extensive state ownership. All this has changed. Disposable income has risen strongly on the back of growing gross domestic products. Most formerly state-owned banks have been sold to strategic investors that have fostered product innovation and competition. Economic growth, which declined substantially in some countries in CEE following the economic and financial crisis, recovered recently. Despite such economic slowdowns and potential temporary negative impacts on the banking markets in Central and Eastern Europe, these factors will remain the driving force behind future development.

In addition, most countries of Central and Eastern Europe have human resources that are at least equivalent to those of Western European countries but do not need to struggle with the unaffordable costs in the long term of the western welfare states and have labour markets that are considerably more flexible. These

advantages are complemented by – on average – highly competitive export industries that benefit from wage costs that are low relative to workforce productivity and from investor-friendly tax and welfare systems.

A comparison of per capita private debt levels in Central and Eastern Europe with those of advanced economies reveals that even today an enormous gap exists between these markets. Countries such as the Czech Republic and Slovakia, but also Croatia and Hungary, are many years away from reaching Austrian or Western European levels of loans per capita; also in relative terms, these countries differ substantially regarding debt levels common in the West. The contrast to Serbia or Romania is even more pronounced - private debt levels and particularly household debt, are substantially lower than in the advanced economies. Even though the developments of very recent years will probably lead to a reassessment of what constitutes acceptable debt levels and to only a gradual rise in lending in Central and Eastern Europe, Erste Group still firmly believes that credit expansion accompanied by economic growth in this region will prove to be a lasting trend rather than a short-term process that has already peaked.

Customer loans/capita in CEE (2017) in EUR thousand



Source: Local central banks, Erste Group

Over the upcoming 15 to 20 years, on average, the countries of the eastern part of the European Union are therefore expected to experience higher growth rates than the countries of Western Europe, even though periods of expansion may alternate with times of economic stagnation or even setbacks on this long-term path of sustainable growth.