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Ad hoc release

Erste Group takes extraordinary charges with limited impact on core capital; substantially reduces euro zone peripheral exposure

The management board of Erste Group has today decided on a number of measures that affect the presentation of its CDS portfolio, its Hungarian and Romanian operations, and result in the uniform application of the effective interest rate method across the group.

- Erste Group has cut its sovereign exposure to Greece, Portugal, Spain, Ireland and Italy from EUR 1.9 billion at year-end 2010 to EUR 0.6 billion at 30 September 2011. 95% of this exposure is marked to market as at 30 September 2011. At the same time the combined sovereign exposure to Greece and Portugal declined to about EUR 10 million. In addition, Erste Group changes the presentation of its CDS portfolio (*protection sold*) from amortised cost to market values, leading to a one-off cumulative charge against shareholders' equity of EUR 280 million for the years prior to 2011. The impact on the 1-9 2011 income statement (profit and loss account) amounts to about EUR 180 million (post-tax).
- Erste Group will write down its entire Hungary-related goodwill in the amount of EUR 312 million pre-tax (EUR 312 million post-tax). Furthermore, Erste Group will take charges for additional risk provisions totalling EUR 450 million pre-tax (EUR 450 million post-tax). This is due to unprecedented government intervention in the Hungarian banking market, an increase in the target NPL coverage ratio and a deterioration in asset quality. The goodwill impairment does not impact regulatory capital or tangible equity.¹
- Erste Group will partially write down its Romania-related goodwill by EUR 700 million pre-tax (EUR 627 million post-tax) to reflect the slower than expected economic recovery. This measure does not impact regulatory capital or tangible equity. Following a successful buyout of the SIF minority shareholders – as announced on 14 September 2011 – the remaining goodwill will be supported by a substantially larger share of BCR's cash flow.
- In anticipation of IFRS 9 implementation, Erste Group will align the effective interest rate models used across the group, leading to a cumulative one-off charge against shareholders' equity of about EUR 210 million, as a result of recognising income over the life of a loan, rather than at the time of payment. This amount will be recouped through the income statement over the life of the loans. The impact on the 1-9 2011 income statement is about EUR 10 million (post-tax).
- Based on the above, Erste Group is set to report a net loss of about EUR 920-970 million in 1-9 2011. Adjusted for extraordinary charges (excluding the banking taxes in Austria and Hungary) Erste Group expects to post a net profit of about EUR 700 million in 1-9 2011. Due to the continued strong underlying operating profitability, Erste Group's core tier 1 ratio (total risk) at year-end 2010 of 9.2% is expected to be unchanged at year-end 2011.
- In response to the significantly deteriorated outlook for the euro zone economies and as a precautionary measure Erste Group will postpone the early repayment of the state portion of the participation capital (EUR 1.2 billion) by at least one year. The management board of Erste Group will propose to the AGM not to pay a dividend for FY 2011 but to continue servicing participation capital.

By adopting the above measures Erste Group's management board has decided to address the issues of the day head on: Erste Bank Hungary will be repositioned with a view to establish a bank that is more resilient to political event risk. The proactive and continued reduction of CDS and euro zone peripheral exposures is designed to reduce temporary income statement volatility. And, the acquisition of further shares in BCR is set to improve Erste Group's position in one of its key markets. All these measures are targeted at eliminating weaknesses and reinforcing the strengths of Erste Group: an inherently profitable retail and corporate business, a solid capital position and a sound funding profile.

¹ No impact as goodwill is already deducted from regulatory capital.

Background on the CDS portfolio (protection sold)

In the years up to 2008 Erste Group built up a diversified portfolio of off-balance sheet sovereign and bank risk positions (*CDS sold*), which – as credit surrogates (financial guarantees) – were held at amortised cost. As at 30 September 2011 the total volume amounted to EUR 5.2 billion (at amortised cost):

- EUR 2.4 billion related to financial institution exposures, and
- EUR 2.8 billion related sovereign exposures
- About 14% or EUR 0.7 billion of the total volume is related to banks and the sovereign in Greece, Portugal, Spain, Ireland and Italy

Following an interpretation issued in a staff paper of the IASB dated 28 July 2011 concerning the classification of CDS as derivatives versus financial guarantees, the management board of Erste Group decided to reclassify the aforementioned portfolio as of 30 September 2011, resulting in a mark-to-market valuation of the entire portfolio. Historical accounts will be adjusted as follows: the cumulative effect of EUR -149 million for the business years prior to 2010 will be booked against equity at the start of 2010; in the business years subsequent to 2009 the valuation result of this portfolio is included in the line item "*Net Trading Result*". The overall impact from the reclassification amounts to EUR -176 million pre-tax (EUR -132 million post-tax) in 2010. In 1-9 2011 the negative impact from valuations and from losses on disposal amounted to about EUR -234 million (about EUR -180 million post-tax).

With a view to minimise income statement volatility, Erste Group plans to sell these assets in an accelerated manner, taking advantage of windows of opportunity as and when they arise. As a substantial part of these assets are sovereign exposures, the disposal will have a correspondingly lower impact on risk-weighted assets.

Erste Group has also significantly reduced – mainly as a result of asset disposals – its net exposure (sovereign, bank, corporate and retail) to Greece, Portugal, Ireland, Spain and Italy from EUR 5.1 billion at year-end 2010 to EUR 3.6 billion at 30 September 2011; 81% of this exposure is related to Spain and Italy. Sovereign exposure to Greece, Portugal, Ireland, Spain and Italy was reduced from EUR 1.9 billion to EUR 0.6 billion, while bank exposure declined from EUR 2.3 billion to EUR 2.0 billion; corporate and retail exposure remained unchanged at about EUR 0.9 billion (mainly Spain and Italy). As of 30 September 2011 95% of Erste Group's sovereign exposure to Greece, Portugal, Spain, Ireland and Italy is carried at market value.

Background on Hungary

Continued and increasing government intervention in the Hungarian banking market has led Erste Group's management board to reassess the medium-term prospects of Hungary and to adjust its strategy and business model correspondingly. Following the introduction of a disproportionate banking tax as of 2010, the Hungarian parliament has recently passed legislation that cuts banks' FX claims against their private mortgage customers by about 25%², if a client registers by the end of 2011 to repay his loan in full. While Erste Group will challenge this legislation, it nonetheless has to take immediate action to provide for an expected 2011 net loss of about EUR 500 million at Erste Bank Hungary that stems from the direct and indirect effects of this legislation as well as the adaptation of its business strategy.

Erste Group will therefore:

- Write down the entire goodwill related to the acquisition of Postabank in 2003 in the amount of EUR 312 million pre-tax (EUR 312 million post-tax). This one-time charge will impact the income statement in 2011, but will not impact regulatory capital or tangible equity.
- Create a provision of EUR 200 million pre-tax (EUR 200 million post-tax) to cover the expected loss from the forced conversion of FX into HUF loans at non-market rates, assuming a participation rate of 20% and an expected exchange rate loss of 25%.

² Based on CHF/HUF exchange rate as at 7 October 2011.

- In light of the deteriorated legal certainty and economic prospects in Hungary raise its target NPL coverage ratio to 62%, leading to additional risk provisions of EUR 250 million pre-tax (EUR 250 million post-tax).
- Based on the above, recapitalise Erste Bank Hungary by injecting up to about EUR 600 million of new equity into the bank.

Going forward Erste Bank Hungary will focus on lending in local currency funded from locally sourced liquidity. Erste Bank Hungary has terminated its cooperation with external sales agents and will concentrate on significantly enhancing its client service capabilities in its existing branch network. This could lead to market share losses in the short term, but over time reduce the requirement for parent company funding and thus minimise Erste Group's exposure to political event risk.

In the immediate future Erste Bank Hungary will – while challenging the legality of the government's forced FX loan conversion scheme – stand by its existing customers. For customers who wish to participate in the scheme and who fulfil the underwriting criteria, but do not have sufficient savings to repay their FX loans, Erste Bank Hungary will provide HUF-based refinancing facilities by drawing on its existing HUF excess liquidity.

Background on Romania

Erste Group has recently entered into preliminary agreements with certain BCR minority shareholders to acquire their shares in BCR at a price that is substantially below the carrying value of the BCR participation in Erste Group's balance sheet. A point-in-time transaction pricing of minority shares does not necessarily reflect the underlying value of a business for the long-term controlling shareholder. A recent impairment test has warranted a goodwill write-down on the back of a slower than expected economic recovery and the corresponding weaker performance of the Romanian banking market.

As a consequence, Erste Group will partially write down its goodwill in Romania by EUR 700 million pre-tax (EUR 627 million post-tax). This one-time charge will impact the income statement in 2011, but will neither impact regulatory capital nor tangible equity.

Following a successful buyout of the SIF minority shareholders – as announced on 14 September 2011 – the remaining BCR goodwill of EUR 1.1 billion will be supported by a substantially larger share of BCR's cashflow.

Background on the effective interest rate adjustment

In preparation of the implementation of IFRS 9 (applicable as of 1 January 2015 at the latest) Erste Group is undergoing a group-wide process of aligning methodologies and models with regard to the recognition of income under the effective interest rate method. The cumulative impact of timing differences in income recognition for the years from 2005 to 2010 will be booked as one-time charges against shareholders' equity (about EUR 210 million) and minority capital (about EUR 100 million) and recouped through the income statement over the life of the loans. The impact on the 1-9 2011 income statement is about EUR 10 million (post-tax).

Summary table of extraordinary charges

Measure/post-tax impact on: in EUR million	Income statement (P&L)	IFRS shareholders' equity	Regulatory capital	Tangible equity
	1-9 2011	Cumulative historic impact to 30 September 2011		
Hungary goodwill	312	312	0	0
Hungary FX provision	200	200	200	200
Hungary general provision	250	250	250	250
Romania goodwill	627	627	0	0
CDS reclassification	180	460	310	460
Effective interest rate	10	220	0	220
Total impact (post-tax)	1,579	2,069	760	1,130
Forecast 2011 retained earnings before one-offs			+700-800	
Forecast regulatory capital impact			0	

Update on participation capital repayment

The regulatory capital impact of the above measures is confined to about EUR 760 million or 50 basis points and is more than offset by the bank's underlying profitability. Erste Group could therefore repay the government portion of the participation capital (EUR 1.2 billion) early, as planned. Resurfacing uncertainties about the global economic outlook and the lack of any resolution of global sovereign debt issues, has led Erste Group's management board to review this plan and postpone the early repayment of the state participation capital (EUR 1.2 billion) by at least one year.

Outlook

Erste Group will take all the above charges in its 1-9 2011 financial statements, due to be published on 28 October 2011; in addition, Erste Group will provide a full set of restated figures for 2010 and the first half of 2011 on the same date.

As a result of the above measures Erste Group is expected to post a net loss of about EUR 700-800 million in 2011 (before extraordinary charges a net profit of about EUR 850-950 million). Risk costs on group level are expected to amount to EUR 2.3 billion (before extraordinary charges: EUR 1.8 billion) in 2011.

Erste Group's operating profit will remain a pillar of strength in 2011 and is expected to fully offset the negative impact on regulatory capital from the above extraordinary charges. Accordingly, the core tier 1 ratio (total risk) at about 9.2% is expected to remain unchanged versus year-end 2010. In 2012 and beyond Erste Group's operating performance will be the main engine of renewed internal capital generation.

Erste Group's management board is of the firm belief that by aligning Erste Bank Hungary's business model with those employed in the Czech Republic and Slovakia, by extending its shareholding in BCR and by continuing the process of CDS disposals Erste Group's franchise will strengthen materially in the short, medium and long term, irrespective of the prevailing economic environment.

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