09 October 2018 Financial Institutions

KBC Group NV
Issuer Rating Report

STABLE
A+

Overview

Scope Ratings assigns an Issuer Rating of A+ and short-term debt rating of S-1+ to KBC Group, both with a Stable Outlook.

The ratings were not solicited by the issuer. Both the ratings and analysis are based solely on publicly available information. The issuer has participated in the rating process.

Highlights

- The ratings reflect KBC's solid franchise as a leading bancassurer in its home market of Belgium and in the Czech Republic.
- Moreover, the group has been strengthening its positioning in banking in Hungary, Bulgaria and Slovakia, and is now considering potential additive acquisitions. In Ireland, KBC is presenting itself as a challenger bank with a digital-first strategy.
- Asset quality continues to recover steadily, supported by improving macro conditions in Ireland and a recently announced legacy loan portfolio sale. KBC's solvency has strengthened to strong levels, and its liquidity position remains sound.
- When assigning our ratings, we have focused on the KBC Group rather than the standalone banking operations of KBC Bank, due to the group's integrated bank and insurance strategy. The KBC Group fully owns its two subsidiaries – KBC Bank and KBC Insurance.

Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Solid franchise as a leading bancassurer in Belgium coupled with strong positioning in the CEE region
- Strong solvency and liquidity positions
- Improving asset quality, but hurdles linked to legacy loans in Ireland remain
- Sustainable improvement in profitability across KBC's core geographies

Ratings & Outlook

Issuer Rating	A+
Outlook	Stable
Senior unsecured debt (non TLAC/MREL eligible)	A+
Senior unsecured debt (TLAC/MREL eligible)	A
Tier 2 instruments	BBB+
Additional Tier 1 instruments	BBB-
Short-term debt rating	S-1+

The A+ rating also applies to senior unsecured debt issued by KBC IFIMA SA. The ratings are not applicable to debt issued by KBC Insurance NV.

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Bloomberg: SCOP

Rating-change drivers

Change in business strategy which materially increases the group's risk profile. KBC is a geographically diversified lender, operating in well balanced mature and emerging markets. The group has been managing risks adequately so far. We would view negatively a change in strategy which increases risk – such as the pursuit of large acquisitions in non-core markets, investment in riskier assets or the development of higher-risk banking activities.

Material improvement in asset quality. The asset quality of the loan portfolio is still more challenged than peers', mainly because of exposures in Ireland. However, we note positively that KBC has recorded impairment releases in its Irish subsidiary for several quarters and is guiding for a positive EUR 100m to EUR 150m for FY 2018. Moreover, the sizeable portfolio sale announced in August 2018, and expected to close in Q4 2018, would take the non-performing loan ratio in KBC Ireland to 25% and KBC Group overall NPL ratio to 4.4% pro forma at Q2 2018.

Rating drivers (details)

Solid franchise as a leading bancassurer in Belgium coupled with strong positioning in the CEE region

KBC is a leading financial institution in Belgium (its home market) and the Czech Republic, serving mainly retail, SMEs and mid-cap customers. The group's market shares in these regions are significant: around 20% in loans and deposits, over 30% in investment funds in Belgium and 22% in the Czech Republic. Market shares in insurance are also relatively solid. Since the financial crisis, KBC has re-focused to concentrate on these two countries as well as on Slovakia, Hungary, Bulgaria and Ireland.

In Belgium, KBC aims to operate with integrated distribution and operations. In H1 2018 cross-selling between mortgage and property insurance stood at 84.5%, and at 80% between property and life insurance.

For core markets in Central Europe, the minimum aim is to operate with integrated distribution. With the acquisition of United Bulgarian Bank and Interlease in 2017, KBC has significantly improved its positioning in Bulgaria, where it now holds significant shares in lending, deposit taking and investment products. In 2018, the acquisition of MetLife's 40% stake in UBB-MetLife Life Insurance Company brought KBC's market share in life insurance to 21%.

In Ireland, the group only provides banking services directly (8% share in retail loans and deposits) and partners with external providers for its insurance offer. In 2015, KBC Ireland returned to profitability and Ireland was added to the group's core markets in 2017.

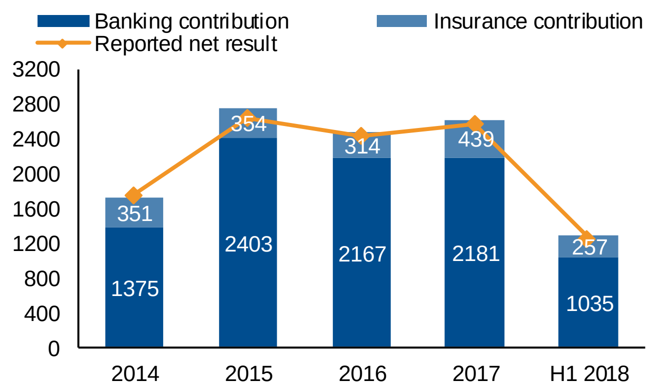
KBC's strategy for Irish operations is aligned with its strategy for other markets, but with one major difference – KBC Ireland is intended to lead the group's innovation effort, and its retail and micro SME products will be designed for digital channels. KBC's transformation programme, focused on digitalisation, was presented in June 2017. Despite being a groupwide effort, it is our opinion that KBC is justified in taking markets specificities into account when designing its digital offer. KBC is strengthening its omnichannel approach for banking and insurance products. This is a response to changing customer behaviour and is consistent with most of its peers. However, the EUR 1.5bn investment spread over four years is not only devoted to front-end investment but also includes regulatory-driven and core banking architecture investments.

Figure 1: Market shares in core markets, H1 2018

	Belgium	Czech Republic	Slovakia	Hungary	Bulgaria
Loans and deposits	20%	20%	11%	11%	10%
Investment funds	33%	22%	7%	13%	13%
Life insurance	14%	8%	4%	3%	21%
Non-life insurance	9%	7%	3%	7%	11%

Source: Company data, Scope Ratings

Figure 2: Banking and insurance business contribution



Note: Prior to 2015, banking and insurance results exclude legacy and own credit risk items. The difference between the sum of banking and insurance results and the group's results is accounted for by the HoldCo/group items
Source: Company data, Scope Ratings

Sound solvency and liquidity positions

KBC's capital position has strengthened considerably in the past few years, through a combination of retained earnings, a reduction of high-risk assets, and active capital management. On a CRD IV fully loaded basis, the group's CET1 and leverage ratios were 15.8% (under the Danish Compromise) and 6% respectively as of end-June 2018. Under the Deduction Method, the fully loaded CET1 ratio would be slightly lower at 15.7%.

The group continues to maintain its capital levels well above requirements, which stand at 9.875% for 2018 and 10.6% on a fully loaded basis. These requirements exclude the Pillar 2 guidance, which corresponds to an additional CET1 buffer of 1% for KBC. Management targets a minimum CET1 ratio of 14%, derived from the fully loaded median CET1 ratio of a peer group of banks. This starting point is revised yearly and KBC maintains a management buffer of up to 2% on top of this for potential M&A opportunities.

Figure 3: MREL stack as of H1 2018

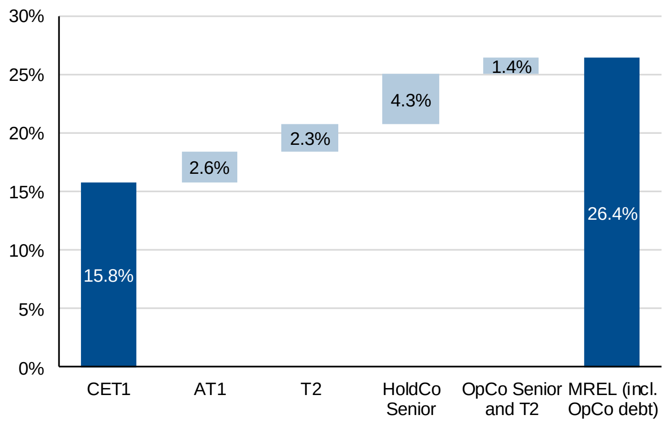
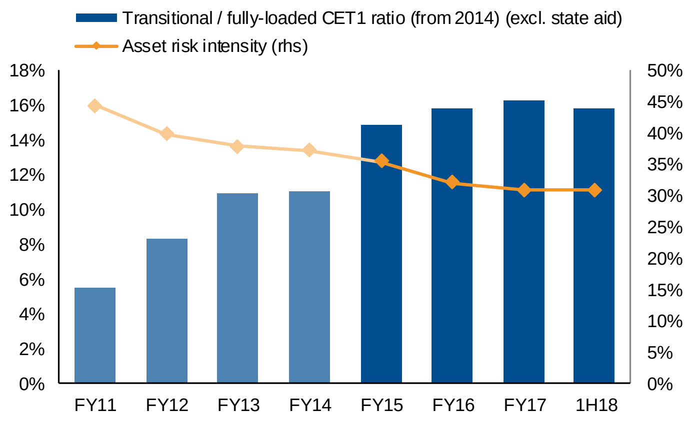


Figure 4: Capital position excluding state aid and asset risk intensity



Source: Company data, Scope Ratings

KBC Bank maintains a sound liquidity and funding profile. As of Q2 2018, funding from customers accounted for 72% of total funding: of this, 73% are retail and SME deposits, 21% are mid-cap deposits, and the remainder are deposits from the government and public-sector entities. Over the years, customer deposits have slightly increased in terms of their percentage in KBC's funding mix (from 69% in 2011 to 72% in H1 2018), net unsecured interbank funding has risen (from 3% in 2011 to 11% in H1 2018) and certificates of deposit have also increased.

Deposits are sufficient to fund loans in full. As at 30 June 2018, KBC Bank had EUR 15.2bn of net short-term unsecured funding outstanding, compared to approx. EUR 59bn of available liquid assets. The reported liquidity coverage ratio of 139% and net stable funding ratio of 136% are above regulatory minima.

KBC maintains diversified access to capital markets funding. The group has received communication of its MREL requirement of 25.9%, to be met by May 2019. KBC has a single point of entry resolution strategy, with the entry point as the KBC Group (the holding company). KBC has been building a sizeable holding company senior unsecured debt buffer (4.3% of risk-weighted assets). As operating company senior debt is in principle not eligible for MREL, KBC is planning to replace maturing instruments with HoldCo senior. This would allow the group to meet the requirement with a buffer, also thanks to 2.3% of Tier 2 and 2.6% of AT1s in risk-weighted assets issued by the KBC Group.

Following the introduction of the framework for Belgian covered bonds in late 2012, KBC has established a EUR 10bn covered bond programme based solely on a cover pool of Belgian residential mortgages. KBC has been a regular issuer of covered bonds to further diversify its funding. In March 2018, KBC Bank placed EUR 750m of covered bonds with an eight-year maturity and EUR 250m of covered bonds with a 20-year maturity.

Last but not least, June 2018 marked the KBC Group's inaugural green senior benchmark issue of EUR 500m with a five-year maturity. We regard positively KBC's renewed attention to sustainability from both an investment and a business perspective. The group is targeting a 50% share of renewables in its energy credit portfolio by 2030 (up from 41.2% in 2017). Moreover, KBC has undertaken a number of initiatives to limit negative externalities (i.e. reducing its environmental footprint) and increase sustainability awareness among staff and clients.

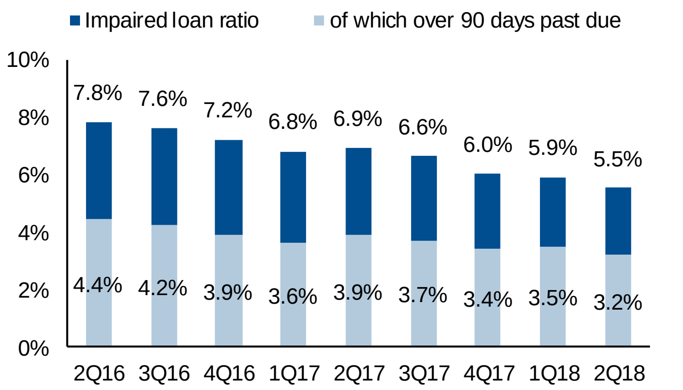
Improving asset quality, but hurdles linked to legacy loans in Ireland remain

In Q2 2018, pro-forma for the Irish and UK portfolio sale, the group's impaired-loan ratio declined to 4.4%: a level which is more in line with peers and accompanied by declining credit costs.

As at end-June 2018, the largest aggregate exposure in the loan portfolio is from Belgium (54%), with the second-largest exposure from the Czech Republic (approx. 15%), followed by Ireland (7%). About 40% of the loan portfolio comprises retail mortgages and ca. 38% consists of SME/corporate loans. The remainder is other retail loans and consumer finance.

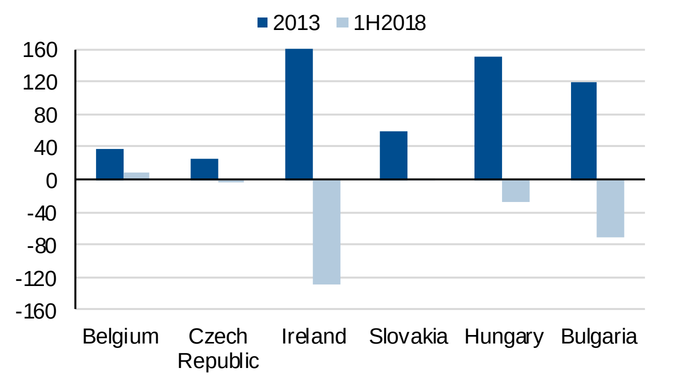
Roughly 90% of the Irish portfolio is comprised of retail mortgages (EUR 11.2bn), of which 13% have an average indexed loan/value ratio above 100%. Ireland accounts for approx. 47% of the group's impaired-loan portfolio: most of the outstanding balance consists of mortgages on owner-occupied dwellings, which perform better than buy-to-let mortgages and accordingly have a lower coverage ratio (28%, versus 41% for non-performing loans overall).

Figure 4: Development of impaired loans



Source: Company data, Scope Ratings

Figure 5: Credit cost ratio by business unit (bps)



Source: Company data, Scope Ratings

In August 2018, KBC Bank Ireland announced the sale of a ca. EUR 1.9bn loan portfolio to Goldman Sachs, comprising performing and non-performing UK buy-to-let mortgage loans, non-performing corporate book and non-performing Irish buy-to-let mortgage loans.

The transaction is expected to close in Q4 2018 and would cut KBCI's non-performing loan levels by approximately 40%, reducing its non-performing loan ratio by almost 11 percentage points from 35.6% to around 25% pro-forma at the end of the second quarter.

The deal is expected to achieve a net profit and loss impact of EUR +14m, releasing risk-weighted assets of ca. EUR 400m at the KBC Group and resulting in a 7bps improvement in the KBC Group's CET1 ratio.

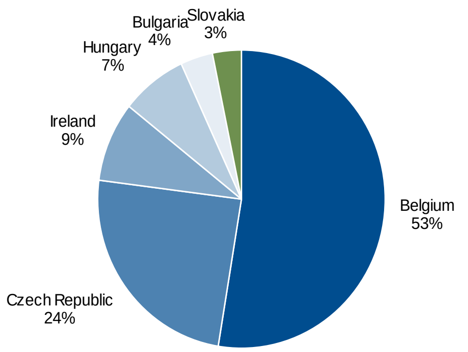
Management has indicated that it will release loan-loss provisions in the EUR 100m-150m range for 2018 for KBC Ireland, after releases of EUR 81m in H1 2018 and EUR 215m in 2017. Key measures such as GDP growth and residential property prices indicate continued recovery. We regard positively the announced portfolio sale, which will bring KBC Ireland's asset quality more in line with domestic peers.

As KBC winds down its corporate business in Ireland, it will continue to expand its mortgage business.

Sustainable improvement in profitability across KBC's core geographies

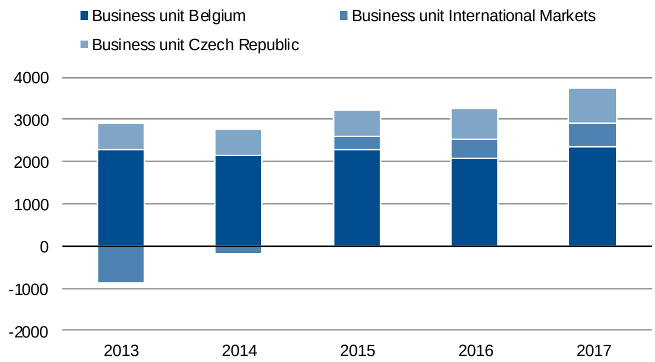
In the past five years, KBC's profitability has improved to solid levels, driven by stronger earnings and a progressive decline in credit costs. The insurance business has increasingly contributed to these positive results, as the group has taken advantage of cross-selling opportunities. KBC's return on equity is solidly above the average for Benelux and international peers (return on average equity of 16% in H1 2018).

Figure 6: Net result breakdown by geography



Source: Company data, Scope Ratings

Figure 7: Historical pre-tax profit by business unit (EUR m)



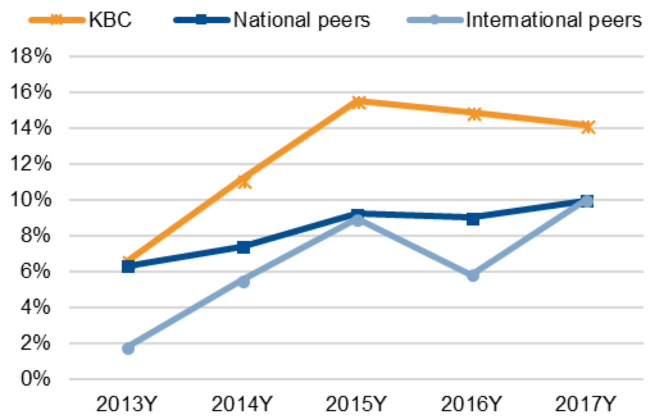
Source: Company data, Scope Ratings

With regard to KBC's main market of Belgium, Scope's GDP projections for 2018 and 2019 suggest a modest increase on growth of 1.7% in 2017, driven by solid investment, robust consumption growth, an improving fiscal position and job growth. However, fiscal consolidation remains key due to the high level of public debt.

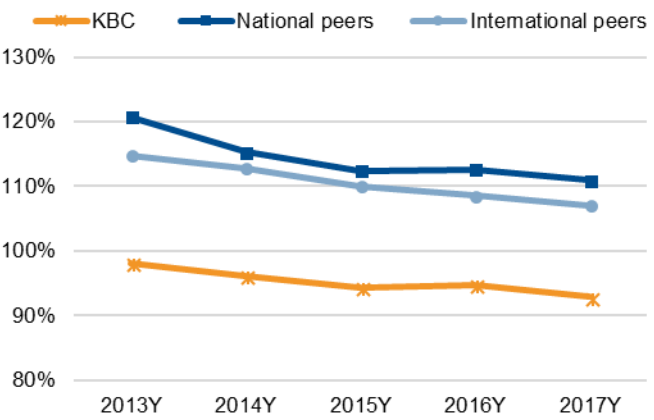
Scope highlights the favourable macro-environment in those CEE countries in which KBC operates (mainly the Czech Republic, Hungary, Slovakia and Bulgaria) where domestic demand has been one of the main drivers of growth over the past years. Private consumption has continued to benefit from solid job creation, rising wages and credit growth. However, certain challenges still loom, such as rising labour shortages, skills mismatches and increasing competitiveness. Despite these challenges, Scope has a positive view of these countries and expect KBC's earnings in the region to remain relevant contributors to KBC overall profitability in the medium to long term.

I. Appendix: Peer comparison

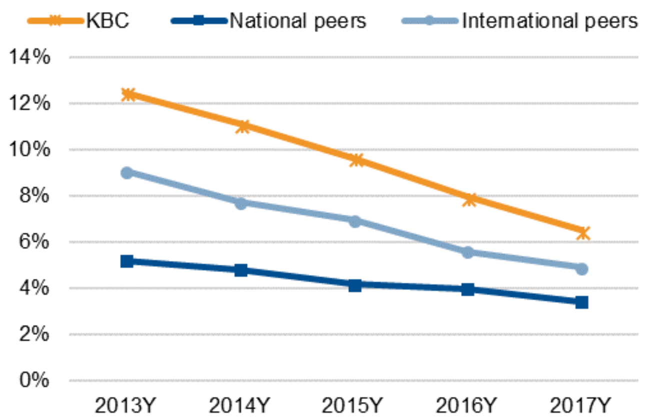
Return on average equity



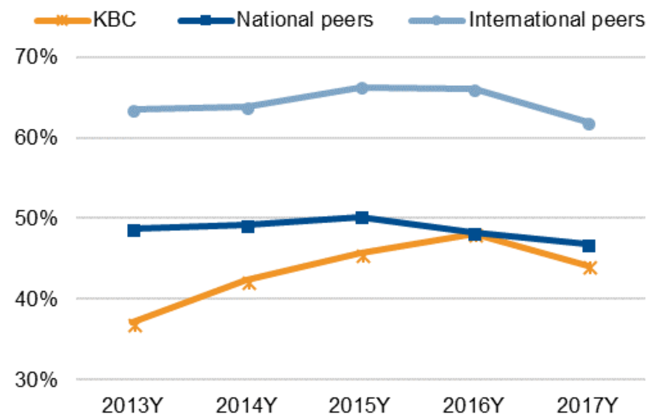
Amortised loans/deposits



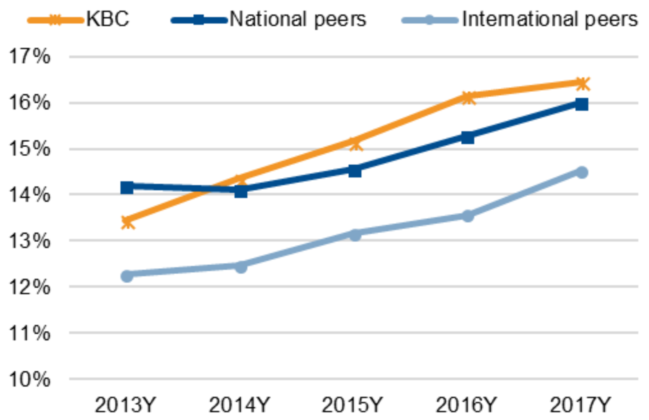
NPLs/net loans (%)



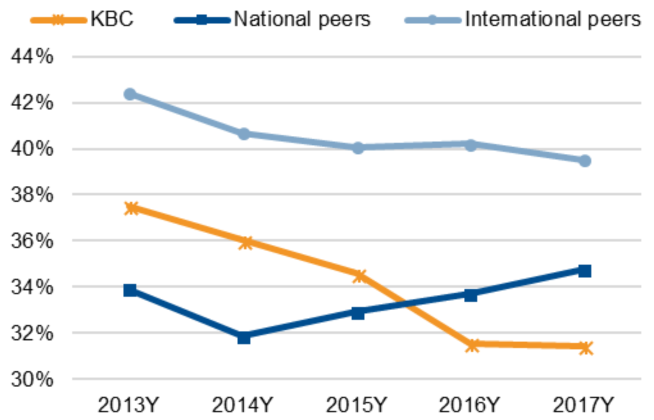
Loan-loss reserves/NPLs (%)



Common equity tier 1 ratio (%, transitional)



Risk-weighted assets/assets



Source: SNL
Benelux peers: KBC Group, Belfius, BNP Paribas Fortis, ING Bank, Rabobank, ABN AMRO Group.
*Business model peers: cross-border peers based on an international retail/commercial business model are KBC Group, Unicredit, Erste Bank, Nordea, ING Bank, Santander, BBVA.

II. Appendix: Selected financial information – KBC Group

	2014Y	2015Y	2016Y	2017Y	2018H1
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	18,361	20,669	37,615	54,177	60,103
Total securities	94,449	95,596	96,340	88,722	86,393
of which, derivatives	10,086	8,807	8,861	5,932	5,995
Net loans to customers	124,551	128,223	133,231	141,502	147,002
Other assets	7,813	7,868	8,014	7,941	8,436
Total assets	**245,174**	**252,356**	**275,200**	**292,342**	**301,934**
Liabilities					
Interbank liabilities	17,692	18,953	32,020	33,337	40,493
Senior debt	21,458	21,463	32,659	37,711	30,419
Derivatives	11,377	9,849	9,242	7,066	6,225
Deposits from customers	136,237	144,831	141,686	152,739	163,062
Subordinated debt	4,088	3,815	3,385	3,516	2,612
Other liabilities	37,800	37,634	38,851	39,171	40,107
Total liabilities	**228,652**	**236,545**	**257,843**	**273,540**	**282,918**
Ordinary equity	13,125	14,411	15,957	17,403	16,616
Equity hybrids	3,400	1,400	1,400	1,400	2,400
Minority interests	-3	0	0	0	0
Total liabilities and equity	**245,174**	**252,356**	**275,200**	**292,342**	**301,934**
Core tier 1/Common equity tier 1 capital	12,684	13,242	14,033	15,131	14,715
Income statement summary (EUR m)					
Net interest income	4,308	4,311	4,258	4,121	2,242
Net fee & commission income	1,573	1,678	1,450	1,707	889
Net trading income	381	560	629	1,061	170
Other income	683	727	818	808	504
Operating income	**6,945**	**7,276**	**7,155**	**7,697**	**3,805**
Operating expense	3,818	3,890	3,915	4,074	2,257
Pre-provision income	**3,127**	**3,386**	**3,240**	**3,623**	**1,548**
Credit and other financial impairments	615	368	182	-74	-84
Other impairments	-108	36	19	44	26
Non-recurring items	-200	-446	50	14	-20
Pre-tax profit	**2,420**	**2,535**	**3,090**	**3,667**	**1,585**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	657	-104	662	1,093	337
Net profit attributable to minority interests	0	0	0	0	0
Net profit attributable to parent	**1,762**	**2,639**	**2,427**	**2,575**	**1,248**

Source: SNL

III. Appendix: Ratios – KBC Group

	2014Y	2015Y	2016Y	2017Y	2018H1
Funding and liquidity					
Net loans/deposits (%)	96.2%	94.4%	94.8%	92.9%	90.3%
Liquidity coverage ratio (%)	120.1%	127.3%	138.9%	138.6%	138.9%
Net stable funding ratio (%)	123.0%	121.0%	125.4%	134.5%	136.1%
Asset mix, quality and growth					
Net loans/assets (%)	50.8%	50.8%	48.4%	48.4%	48.7%
NPLs/net loans (%)	11.1%	9.6%	7.9%	6.5%	6.2%
Loan-loss reserves/NPLs (%)	42.4%	45.7%	48.1%	44.2%	50.3%
Net loan growth (%)	3.5%	2.9%	3.9%	6.2%	7.8%
NPLs/tangible equity and reserves (%)	65.0%	60.1%	49.3%	42.4%	41.0%
Asset growth (%)	2.7%	2.9%	9.1%	6.2%	6.6%
Earnings and profitability					
Net interest margin (%)	1.8%	1.7%	1.7%	1.5%	1.5%
Net interest income/average RWAs (%)	NA	5.0%	4.8%	4.6%	4.8%
Net interest income/operating income (%)	62.0%	59.2%	59.5%	53.5%	58.9%
Net fees & commissions/operating income (%)	22.6%	23.1%	20.3%	22.2%	23.4%
Cost/income ratio (%)	55.0%	53.5%	54.7%	52.9%	59.3%
Operating expenses/average RWAs (%)	NA	4.5%	4.4%	4.5%	4.9%
Pre-impairment operating profit/average RWAs (%)	NA	3.9%	3.7%	4.0%	3.3%
Impairment on financial assets /pre-impairment income (%)	19.7%	10.9%	5.6%	-2.0%	-5.4%
Loan-loss provision charges/net loans (%)	0.5%	0.3%	0.1%	-0.1%	-0.1%
Pre-tax profit/average RWAs (%)	NA	2.9%	3.5%	4.1%	3.4%
Return on average assets (%)	0.7%	1.0%	0.9%	0.9%	0.8%
Return on average RWAs (%)	NA	3.0%	2.8%	2.9%	2.7%
Return on average equity (%)	11.2%	15.5%	14.9%	14.2%	13.3%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	14.3%	14.9%	15.8%	16.3%	15.8%
Common equity tier 1 ratio (%, transitional)	14.4%	15.2%	16.2%	16.5%	15.8%
Tier 1 capital ratio (%, transitional)	16.0%	16.8%	17.8%	18.0%	18.4%
Total capital ratio (%, transitional)	18.9%	19.8%	20.6%	20.4%	20.8%
Leverage ratio (%)	6.4%	6.3%	6.1%	6.1%	6.0%
Asset risk intensity (RWAs/total assets, %)	36.0%	34.6%	31.6%	31.5%	30.8%
Market indicators					
Price/book (x)	1.5x	1.7x	1.5x	1.7x	1.7x
Price/tangible book (x)	1.6x	1.8x	1.6x	1.8x	1.8x
Dividend payout ratio (%)	60.2%	0.0%	49.3%	49.8%	NA

Source: SNL

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