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Research Update:

KBC Bank And CSOB Outlook To Positive On Expected Further Build-Up Of Loss Absorption Capacity; 'A/A-1' Ratings Affirmed

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Overview

- Belgian financial group KBC is building a sizable stock of senior debt to comply with EU regulations, in particular its expected level of minimum requirements for own funds and eligible liabilities (MREL).
- KBC Group N.V., the nonoperating holding company, as the preferred single point of entry in a resolution scenario for the group, is instrumental in the group's strategy to build up this material buffer protecting KBC Bank's senior creditors in a resolution scenario.
- We are revising to positive our outlook on KBC Bank and Ceskoslovenska Obchodni Banka A.S. (CSOB), core banking entities of the KBC group, and affirming our 'A/A-1' ratings on the two banks.
- The outlooks on the nonbanking entities of the group--KBC Insurance, KBC Group Re, and KBC Group N.V.--remain unchanged and are all stable.
- The outlooks and long-term ratings on strategically important subsidiaries KBC Ireland and United Bulgarian Bank also remain unchanged.

Rating Action

On Oct. 27, 2017, S&P Global Ratings revised to positive from stable its outlooks on the core banking entities of the KBC bancassurance group (KBC), namely Belgium-based KBC Bank N.V. and Czech Republic-based Ceskoslovenska Obchodni Banka A.S. (CSOB). We affirmed our long- and short-term issuer credit ratings on the two banks at 'A/A-1'.

We affirmed the ratings on the nonoperating holding company (NOHC) KBC Group N.V. at 'BBB+/A-2'. The outlook on the NOHC remains stable.

We also affirmed our 'A-' issuer credit and financial strength ratings on KBC Insurance N.V. and insurance subsidiary KBC Group Re S.A. The outlook on both entities is stable.

Additionally, we affirmed the issue ratings on the subordinated and hybrid capital instruments issued by these entities.

The outlooks on the two banking subsidiaries in Ireland and Bulgaria, namely KBC Bank Ireland PLC (BBB-/Stable/A-3) and United Bulgarian Bank AD (BB+/Positive/B), are also unchanged.

Rationale

The outlook revision on KBC Bank and CSOB reflects the gradual build-up of an additional loss-absorption capacity (ALAC) buffer, mainly at the holding entity, KBC Group N.V. We think KBC's strategy will result in ALAC increasing above our 8% threshold within two years from now, and that KBC will maintain a buffer of that size beyond this horizon. In particular, KBC Group N.V. is issuing a sizable stock of senior debt, which in our view will contribute to protect KBC Bank's senior creditors in a resolution scenario. We expect that it will continue to do so steadily to comply with the EU Bank Recovery and Resolution Directive's minimum requirement for own funds and eligible liabilities (MREL).

We estimate that the ALAC buffer represented about 4.0%-4.5% of S&P Global Ratings' risk-weighted assets (RWA) at year-end 2016 and that it will already stand above 7% at year-end 2017, given internal capital generation and the continuing issuance of tier 2 debt instruments and senior debt by the NOHC.

We include in our ALAC assessment subordinated instruments protecting KBC Bank's senior creditors. We are still uncertain whether regulatory authorities will ultimately confirm the choice of the NOHC as the resolution entity for the group, but we believe that this is a very likely scenario and view positively the already sizable amount of debt the NOHC has issued so far (€3.5 billion as of June 30, 2017, versus nil at year-end 2015).

The projected ALAC ratio reflects our expectations that:

- The KBC group will replace maturing Tier 2 capital instruments with ALAC-eligible instruments and the NOHC will continue to issue senior debt in each of the coming two years to comply with an estimated MREL level of about 26.25% in 2020, compared with 22.8% at end-June 2017.
- Excess S&P Global Ratings' risk-adjusted capital (RAC) ratio will increase in the next two years, with a projected RAC ratio in the 9.25%-9.75% range, which is above the 7% threshold to qualify for an adequate capital and earnings position under our criteria. This excess total adjusted capital will contribute to the build-up of the ALAC buffer, in accordance with our criteria.

We estimated that the RAC ratio before diversification at end-2016 stood at 8.8% under our updated RAC framework methodology and taking into account the positive revisions we made to our risk assessments for banks operating in Ireland and Czech Republic (see Related Research). Our RAC ratio projection in the 9.25%-9.75% range by year-end 2018 is based on the following assumptions:

- On average a 4%-5% annual increase in S&P Global Ratings' RWA over 2016-2018, as the group continues to expand its balance sheet in European countries where it already operates, excluding Ireland.
- Annual net profits in the €2.0 billion-€2.5 billion range in 2017 and 2018, thanks to a resilient net interest margin especially in the two largest markets Belgium and Czech Republic, which we view as benefiting

from good growth prospects, healthy contribution of insurance activities and assets under management, stable operating expenses, and a low cost of risk overall. Cost of risk is declining in Ireland, in particular, where it used to be very high.
- A dividend payout ratio in the 50%-60% range.
- No change in the group's perimeter in our base-case scenario.

Given these expectations and assumptions, and our views on KBC's strategic positioning and financial performance, we have maintained the unsupported group credit profile (GCP) at 'a-' and one notch of uplift for ALAC for the core banking entities of the KBC group. As we do not believe ALAC support will be available for insurance subsidiaries, we continue to equalize their ratings with the unchanged 'a-' unsupported GCP. We still view KBC Insurance as a core entity of the group though, as it is integral to the long-term strategy.

We continue to view KBC Bank Ireland PLC and United Bulgarian Bank as strategically important subsidiaries of the KBC group.

Outlook

KBC Bank

The positive outlook on KBC Bank N.V. reflects our expectation that, over the next two years, the bank will steadily implement its strategy to maintain a high core regulatory capital ratio and build a large buffer of instruments protecting senior creditors, in excess of 8% of S&P Global Ratings' RWAs. We will therefore likely incorporate a second notch of uplift for ALAC into our ratings in the next two years, all other factors remaining unchanged. In our view, KBC is opting for a conservative financial strategy, which could lead to a stronger balance sheet over time. We do not assume any material acquisitions over the coming two years.

The outlook also reflects our expectation that the group will continue to perform well in the core markets where it operates and display resilient earnings, as it leverages its efficient bancassurance operating model, which helps to offset pressure from the low-interest-rate environment.

We could revise the outlook to stable if the issuance of bail-in-able debt falls short of our projections of 8% of S&P RWAs in the next 24 months, either because the group is opting for a more acquisitive or shareholder-friendly strategy, or because capital market conditions complicate the issuance of large amount of bail-in-able debt.

KBC Group N.V.

The outlook on the NOHC KBC Group N.V. is stable and reflects our expectation that, in the next two years, the group will continue to grow and perform well in the core markets where it operates and further build-up its core capital. We expect the overall group to display resilient earnings, as it leverages its efficient bancassurance operating model, which helps to offset pressure from the low-interest-rate environment.

We could lower the ratings if we were to revise the unsupported GCP downward. This could happen if the group departed from the prudent expansion strategy and increased substantially its exposures in higher-risk areas, or if it exhibited a more aggressive growth pattern, organically or via acquisitions.

We could raise the ratings if we were to revise the unsupported GCP upward to 'a'. This could happen if we were to observe a sustainable improvement of the group's capital metrics or stronger diversity of its business model.

Ceskoslovenska Obchodni Banka

The outlook on the core banking subsidiary CSOB is positive and mirrors the outlook on KBC Bank. Any rating action on KBC Bank would translate into a similar rating action on this core subsidiary.

Despite the prevailing regulatory uncertainties in the Czech Republic, we use the supported GCP as the reference point for equalization of the ratings because we anticipate that the group would be subject to a single resolution process and this would seek to ensure that CSOB continued to service its senior obligations on time and in full. If we concluded that the ALAC support incorporated in our ratings on the parent would not extend to the Czech subsidiary (for example because it would potentially be subject to separate resolution), we would likely equalize the ratings on CSOB with the unsupported GCP of 'a-'.

Other group entities

The outlooks on the other group entities are unchanged. The outlook on core insurance entities KBC Insurance and KBC Group Re is stable because we do not expect downward pressure on their core group membership in the next two years, as insurance remains an integral part of the group's strategy. We also expect the unsupported GCP to remain unchanged over the next two years.

The outlook on KBC Bank Ireland is stable and reflects our expectation of a gradual strengthening of the bank's capital position and repositioning of the franchise, while it continues to work through its very large stock of nonperforming assets.

The outlook on United Bulgarian Bank is positive and reflects our view that we could raise the ratings on the bank over the next 12 months if we raised the sovereign credit ratings on Bulgaria and we saw an improvement in the bank's business profile, in particular a more focused growth strategy and operating performance improvements.

Ratings Score Snapshot

KBC Bank N.V.

	To	From
Issuer Credit Rating	A/Positive/A-1	A/Stable/A-1
SACP	a-	a-
Anchor	bbb+	bbb+
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Adequate (0)	Adequate (0)
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Average and (0) Adequate	Average and (0) Adequate
Support	+1	+1
ALAC Support	+1	+1
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0
Additional Factors	0	0

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- United Bulgarian Bank AD, Aug. 4, 2017
- Various Rating Actions Taken On Four Czech Banks On Continued Economic Recovery, March 16, 2017
- Various Positive Rating Actions Taken On Irish Banks On Reduced Economic Risk, Jan. 13, 2017
- KBC Bank Ireland PLC, July 27, 2016

Ratings List

Ratings Affirmed; Outlook Action

	To	From
KBC Bank N.V.		
Ceskoslovenska Obchodni Banka A.S.		
Counterparty Credit Rating	A/Positive/A-1	A/Stable/A-1

Ratings Affirmed

KBC Group N.V.	
Counterparty Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+
Subordinated	BBB-
Junior Subordinated	BB
KBC Group Re S.A.	
KBC Insurance N.V.	
Counterparty Credit Rating	
Local Currency	A-/Stable/--
Financial Strength Rating	
Local Currency	A-/Stable/--
KBC Bank N.V.	
Junior Subordinated	BB+
Junior Subordinated	BBB-
Commercial Paper	A-1
Certificate Of Deposit	A/A-1
KBC Ifima N.V.	
Senior Unsecured*	A
Senior Unsecured*	Ap
Subordinated*	BBB

*Guaranteed by KBC Bank N.V.

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