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KBC Group  
Risk Report 2011



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# Introduction: highlights in 2011 and disclosure policy

KBC is an integrated bancassurance group, whose main focus is on retail customers, small and medium-sized enterprises and private banking clientele. It occupies leading positions on its home markets of Belgium and Central and Eastern Europe, where it specialises in retail bancassurance and asset management activities. Elsewhere around the globe, the group has established a presence in selected countries and regions.

## Highlights

In the wake of the global financial crisis, 2011 – like 2010 – was a year in which there were many internal and external changes and challenges for KBC.

### Firmly embedding risk management

Since 2009, KBC has been reshaping its risk management governance and structure throughout the group. It continued in the same vein in 2011, making further improvements. More information in this regard can be found in the 'Risk management governance' section of this report.

### Concerns regarding sovereign debt

Market concerns regarding the sovereign debt of Southern European countries (more particularly Greece) and Ireland, amongst other countries, continued to dominate the financial sector in 2011. More information on 'sovereign exposure' can be found in the 'Credit risk' section of this report, as well as in the 'Risk Management' section of the 2011 annual report of KBC Group NV (see [www.kbc.com](http://www.kbc.com)).

### Stress testing at European level

To assess the resilience of a significant sample of European financial institutions, the European Banking Authority (EBA) conducted stress tests during 2011, as it had done in the first half of 2010. KBC's results under the EBA stress scenarios illustrated its ability to meet legal and market requirements with regard to solvency. KBC also participated in the stress tests conducted by the European Insurance and Occupational Pension Authority (EIOPA) in 2011 and achieved a satisfactory solvency ratio. For more information on the results of the 2011 stress tests, see the 'Capital adequacy' section of this report.

### Regulatory challenges

*Basel III* and the corresponding draft 'European CRD IV Directive and Regulation' will gradually introduce more stringent capital and liquidity requirements for financial institutions from 2013 onwards. The new CRD III regulatory capital charge (also known as Basel 2.5) came into effect at year-end 2011 and enhances the measurement of risks related to securitisation and trading book exposures and introduces higher capital requirements for this type of exposure. As regards the current Basel III proposal, KBC will – based on estimates and barring any unforeseen circumstances – be compliant with the new capital and liquidity standards as currently contemplated. For more information, see the section on 'Capital adequacy' in this report. *Solvency II*, which is the successor to the Solvency I capital requirements for insurance undertakings, will establish new capital requirements and risk management standards across the industry (in Europe) from 2014 onwards. Solvency II was intended to come into effect at the end of 2012, but the European authorities have postponed the date for its full implementation until 2014. Based on the most recent estimates, the KBC Insurance group largely meets the targets set by Solvency II. For more information, see the section on 'Capital adequacy' in this report.

### Credit portfolios under stress

Given the specific economic situation in Ireland and Hungary, more information on KBC's credit portfolios in these countries can be found in the 'Credit risk' section of the 2011 annual report of KBC Group NV (see [www.kbc.com](http://www.kbc.com)).

### Reducing risks linked to structured credit

During 2011, KBC continued its de-risking strategy related to the CDO and structured credit exposures, which resulted in a notional reduction of 6.8 billion euros. More information can be found in the 'Overview of outstanding structured credit exposure' section of the 2011 annual report of KBC Group NV (see [www.kbc.com](http://www.kbc.com)).



## Disclosure policy

In line with its general communication policy, KBC aims to be as open as possible when communicating to the market about its exposure to risk. Risk management information is therefore provided in a separate section of the 2011 annual report and – more extensively – in this publication.

The most important regulations governing risk and capital management are the Basel II capital requirements applying to banking entities, and the Solvency I capital framework applying to insurance entities. In the coming years, the Basel II capital requirements will be altered or complemented by the Basel III framework. Solvency I will be replaced by the fundamentally reformed Solvency II framework, which is based on Basel II principles. Basel III will become gradually into effect from 2013 onwards while Solvency II was intended to come into effect at the end of 2012, but the European authorities have postponed the date for its full implementation to 1 January 2014.

This risk report is based on Basel II's third pillar and the resulting disclosure requirements of the Capital Requirements Directive (as transposed into Belgian law). Although the disclosures are set up according to the first Basel II pillar and focus on banking entities, KBC – as a *bancassurance* company looking ahead to the disclosure requirements of Solvency II – decided to extend the scope for the insurance activities in order to provide an overall view of the KBC group's risk exposure and risk management activities.

Since the end of 2011, CRD III also requires the disclosure of information on the remuneration policy of financial institutions. More information can be found in the 'Corporate governance' section of the 2011 annual report of KBC Group NV and at [www.kbc.com](http://www.kbc.com).

To ensure that a comprehensive view is provided, the credit risk inherent in KBC Insurance has also been included in the section on credit risk management. Furthermore, as they are managed in an overarching group-wide fashion, the disclosures on structured credit products, market risks (non-trading-related, i.e. Asset and Liability Management), liquidity risk and non-financial risks have been drawn up to include detailed information at KBC group level (banking and insurance combined). Detailed information on the technical insurance risk borne by KBC Insurance has also been included.

Disclosures required under Pillar 3 are only incorporated if they are deemed relevant for KBC.

Information is disclosed at the highest consolidated level. Additional information, specifically on the material entities, is confined to the capital information in the section on 'Capital adequacy'. For more detailed information, please refer to the local capital disclosures of the entity concerned (for instance, those provided on their websites).

Unless otherwise stated, KBL EPB (in 2010 and 2011), Fidea (2011) and WARTA (2011), which have been recognised as disposal groups under IFRS 5, have been excluded from the various tables (information is provided separately in footnotes) in order to maintain consistency with the treatment in the balance sheet, Kredyt Bank (2012) is still included in the tables. Following the change in the strategic plan in mid-2011 (see the 'Strategy and company profile' section of the 2011 annual report of KBC Group NV (see [www.kbc.com](http://www.kbc.com))), the breakdown of some figures into business units was changed with retroactive effect, to enhance comparability.

KBC ensures that a representative picture is given at all times in its disclosures. The scope of the reported information – which can differ according to the matter being dealt with – is clearly indicated.

A comparison with the previous year is provided unless this is not possible due to differences in scope and/or methodology.

The information provided in this document has not been subject to an external audit. However, the disclosures have been checked for consistency with other existing risk reports and were subjected to a final screening by authorised risk management representatives to ensure quality.

Information disclosed under IFRS 7, which has been audited, is presented in KBC's annual report. Broadly speaking, the information in the annual report coincides with the information in this risk report, but a one-to-one comparison cannot always be made due to the different risk concepts used under IFRS and Basel II. In order not to compromise on the readability of this document, relevant parts of the annual report have been reproduced here.

This risk report is available in English on the KBC website and is updated on a yearly basis. KBC's next update is scheduled for the beginning of April 2013. Depending on market requirements, KBC may however decide to provide more frequent updates.



# Risk management governance

## General risk governance model

*KBC's risk governance model is characterised primarily by:*

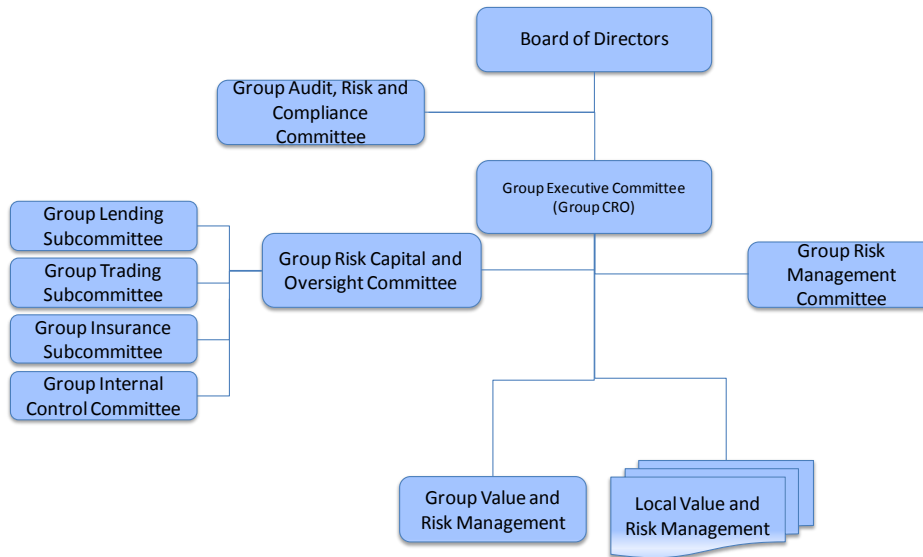
- the Board of Directors (assisted by the Audit, Risk and Compliance Committee (ARC Committee)) which sets the risk appetite each year, monitors risks and proposes actions where necessary. More information on the Board of Directors and the Audit, Risk and Compliance Committee can be found in the section entitled 'Corporate governance statement' in the 2011 annual report of KBC Group NV (see [www.kbc.com](http://www.kbc.com)).
- an integrated, Executive-Committee-centred architecture that links risk appetite, strategy and performance goal setting via capital allocation to limits and targets. Along with a consequential monitoring process, this creates the parameters for the business to take risks within the overall strategic choices and risk appetite of the group.
- the Group Risk and Capital Oversight Committee, the Group Risk Management Committee and activity-based risk subcommittees that leverage the time of the Executive Committee.
- a single, independent, group-wide risk function that comprises the Group Chief Risk Officer (CRO), local CROs, and group and local risk functions.
- risk-aware business people, who act as the first line of defence for conducting sound risk management in the group. The Risk and Compliance functions act as the second line of defence, while Internal Audit is the third line.

Relevant risk management bodies and control functions:

- *Group Executive Committee:*
  - makes proposals to the Board of Directors about risk and capital strategy, and about risk appetite;
  - agrees on the risk and capital governance framework to be implemented throughout the group;
  - allocates capital to activities in order to maximise the risk-adjusted return;
  - monitors the group's major risk exposure to ensure conformity with the risk appetite.
- *Group Risk and Capital Oversight Committee (GRCOC):*
  - monitors the integrated risk profile to ensure consistency with risk limits and risk appetite, and recommends mitigating actions to the Group Executive Committee when the risk exposure is not in line with these limits or risk appetite.
  - advises the Group Executive Committee on all decisions or matters that (may) involve material risks and takes autonomous decisions on less material risks.
  - The permanent committee members are the Group CRO and Group Chief Finance Officer, the senior general managers of the Group Value and Risk Management Directorate and Group Finance, the Group Treasurer, the general manager of the Group Strategy Unit and senior business managers.
  - Four activity-based risk subcommittees (lending, trading, insurance and internal control) support the GRCOC in its tasks. At least one member of the Group Executive Committee sits on each subcommittee, with the Group CRO acting as chairman. Besides comprising members of the Group Executive Committee, the subcommittees contain the senior general manager of the Group Value and Risk Management Directorate and the (senior) managers of the relevant business activities. These subcommittees have been granted decision rights.
- *Group Risk Management Committee:*
  - monitors and ensures the adequacy of risk and capital governance, and informs the Group Executive Committee on gaps and inefficiencies;
  - makes recommendations to the Group Executive Committee about material changes to the risk and capital governance frameworks, and decides on non-material changes to these frameworks on an autonomous basis;
  - manages and supervises model frameworks and their implementation;
  - The permanent members of this committee are the Group CRO, the senior general manager of the Group Value and Risk Management Directorate and local CROs. The business is heard via the local CROs or by inviting the relevant senior managers to provide input on all topics and/or frameworks that affect them.
- *Local Chief Risk Officers (LCROs)* are situated throughout the group according to a logical segmentation based on entity and/or business unit. Close collaboration with the business is assured since they take part in the local decision-making process. Independence of the LCROs is achieved through a direct reporting line to the Group CRO.
- *Group risk function (within the Group Value and Risk Management Directorate)*, which among other things monitors risks and capital at an overarching group-wide level, develops risk models (while business models are developed by business), performs independent (thus segregated from the modelling staff) validations of all the risk and business models developed, develops group-wide frameworks, gathers group-wide warnings

and observations for the GRCOC, and advises/reports on issues handled by the Group Executive Committee and the risk committees.

- *Group Internal Audit Division*, which is responsible for audit planning and thus audits the compliance of the risk management framework with legal and regulatory requirements, the efficiency and the effectiveness of the risk management system and its compliance with the risk management framework, as well as the way in which line management handles risks outside this formal framework.
- *New and Active Product Process*, which establishes a smooth, but robust and transparent process for approving new products and (regularly) reviewing existing products, whereby commercial issues are balanced against risk and operational issues.



# Capital adequacy

Capital adequacy measures the financial strength of an institution. It relates to the level of capital a financial institution needs to implement its business plans, taking into consideration the risks that threaten the realisation of such plans.

## Strategy and Processes

In order to assess capital adequacy within the group, KBC uses a multi-dimensional approach where the capital situation is assessed and set off against minimum targets at group and local entity level

- from a regulatory (i.e. pillar 1 of Basel II) and an economic (i.e. pillar 2 of Basel II) point of view
- in the current situation and over a 3-year time horizon
- under different macroeconomic and business conditions: likely (including base case scenario) recession and internally defined stress scenarios

The purpose of this assessment is to make sure that KBC holds enough capital to cover the risks that it takes. It also gives KBC the opportunity to manage capital in a pro-active way. Taking into account the multi-dimensional approach, this broad capital picture allows top management to assess whether business plans are in line with the capital that is available in the group and – when necessary – to take action in a timely manner. In order to maximise the impact of the capital adequacy assessment on decision processes, it is embedded in the planning process. As a result, the planning process also qualifies as an Internal Capital Adequacy Assessment Process (ICAAP), as required under pillar 2 of the Basel II accord. In the future, this process will be further expanded with the Own Risk and Solvency Assessment (ORSA), as required under pillar 2 of the Solvency II regime for the insurance activities of the KBC group.

The outcome of the ICAAP is discussed by KBC's Group Executive Committee, its Audit Risk and Compliance Committee and its Board of Directors. ICAAP as such is also subject to regulatory examination by the National Bank of Belgium, which has resulted in a Supervisory Review and Evaluation Process (SREP).

KBC focuses on the group situation when assessing its capital adequacy, since the sound capital situation at group level provides adequate assurance that the group will be able to support local entities if necessary. Nevertheless, KBC also established ICAAPs in significant banking subsidiaries.

Within the limits of regulatory constraints, KBC has no current or foreseen material or legal obstacles to the transfer of capital or the repayment of debts among parent companies and their subsidiaries.

Further on in this section, a distinction is made between regulatory solvency disclosures – linked to pillar 1 of Basel II – and economic capital disclosures – linked to pillar 2 of Basel II. A brief reference is also made to the expected impact of regulatory adjustments.

## Regulatory solvency disclosures

### Scope of solvency disclosures

The capital profile is disclosed for the KBC group as a whole, i.e. fully consolidated, as well as for the major activities of the group, i.e. banking (KBC Bank consolidated) and insurance (KBC Insurance consolidated). In addition, the solvency information is also disclosed for a number of significant banking subsidiaries (see further).

KBC calculates its solvency position on the basis of IFRS figures and the relevant guidelines issued by the Belgian regulator.

### Solvency in 2011, group overview

For group solvency, the so-called 'building block' method is used. This entails comparing the available regulatory group capital with the sum of the separate minimum regulatory solvency requirements for KBC Bank, KBL EPB, the holding company (after deduction of intercompany transactions between these entities) and KBC Insurance. The total risk-weighted volume of KBC Insurance is calculated as the required solvency margin under Solvency I divided by 8%.

The scope of consolidation used in the solvency calculation is identical to the scope used in the financial statements, as determined by IFRS rules.

The KBC Group tier-1 solvency target under Basel II is 11%. Regulatory minimum solvency targets were amply exceeded in 2011, not only at year-end, but also throughout the entire year.

Solvency at group level (consolidated, including KBL EPB, Basel II) (in millions of EUR)	31-12-2010	31-12-2011
<b>Total regulatory capital, after profit appropriation</b>	<b>21 726</b>	<b>19 687</b>
<b>Tier-1 capital<sup>1</sup></b>	<b>16 656</b>	<b>15 523</b>
Parent shareholders' equity	11 147	9 756
Non-voting core-capital securities	7 000	6 500
Intangible fixed assets (-)	-429	-446
Goodwill on consolidation (-)	-2 517	-1 804
Innovative hybrid tier-1 instruments	598	420
Non-innovative hybrid tier-1 instruments	1 689	1 690
Minority interests	161	145
Equity guarantee (Belgian State)	446	564
Revaluation reserve, available-for-sale assets (-)	-66	117
Hedging reserve, cashflow hedges (-)	443	594
Valuation differences in financial liabilities at fair value – own credit risk (-)	-190	-550
Minority interests in available-for-sale reserve and hedging reserve, cashflow hedges (-)	-3	-3
Equalisation reserves (-)	-128	-139
Dividend payout (-) <sup>2</sup>	-854	-598
IRB provision shortfall (50%) (-) <sup>4</sup>	0	0
Limitation of deferred tax assets	-243	-384
Items to be deducted (-) <sup>3</sup>	-397	-338
<b>Tier-2 and tier-3 capital</b>	<b>5 069</b>	<b>4164</b>
Perpetuals (including hybrid tier-1 instruments not used in tier-1 capital)	30	30
Revaluation reserve, available-for-sale shares (at 90%)	392	246
Minority interests in revaluation reserve, available-for-sale shares (at 90%)	0	0
IRB provision shortfall (50%) (-) <sup>4</sup>	0	0
IRB provision excess (+) <sup>4</sup>	132	403
Subordinated liabilities	4 730	3 778
Tier-3 capital	182	45
Items to be deducted (-) <sup>3</sup>	-397	-338
<b>Total weighted risks</b>	<b>132 034</b>	<b>126 333</b>
Banking	116 129	110 355
Insurance <sup>5</sup>	15 676	15 791
Holding-company activities	264	286
Elimination of intercompany transactions between banking and holding-company activities	-34	-100
<b>Solvency ratios</b>		
Tier-1 ratio	12.6%	12.2%
Core tier-1 ratio	10.9%	10.6%
CAD ratio	16.5%	15.6%

1 Audited figures.

2 Includes the dividend on ordinary shares and the coupon on non-voting core-capital securities sold to the Belgian State and Flemish Region.

3 Items to be deducted, which are split 50/50 over tier-1 and tier-2 capital, include mainly participations in and subordinated claims against financial institutions in which KBC has between a 10% and 50% share (primarily NLB).

4 Excess/shortfall is defined as the (positive/negative) difference between the actual loan loss impairment recognised and the 'expected loss' calculation.

5 Weighted risks for insurance are calculated by multiplying capital under Solvency I by a factor 12.5 (8% rule similar to the relationship between RWA and capital for banking, i.e. Basel II).

Besides 'Parent shareholders' equity', the major component of the tier-1 capital of the group is non-voting core-capital securities. These originated from the capital-strengthening measures which were taken in 2008 and 2009, whereby non-voting core-capital securities were issued to the Belgian State and the Flemish Regional Government. In addition, a Guarantee Agreement was signed with the Belgian State for the remaining exposure to CDOs (see the 'Additional information' section in the 2011 annual report of KBC Group NV for more details). On 2 January 2012, KBC reimbursed 0.5 billion euros (and paid a 15% penalty) to the Belgian State. This has already been taken into account in the balance sheet and hence also in the solvency calculation at year-end 2011 (0.5 billion euros shifted from equity to liabilities and the penalty deducted from equity by presenting it as a liability).

The tier-1 capital of KBC Group also incorporates hybrid instruments. As these are all issued by KBC Bank, more details are provided under 'Solvency, KBC Bank (consolidated)'.

On 31 December 2010, new rules entered into effect with respect to the characteristics and proportion of hybrid instruments that may be included in pillar I tier-I capital ('CRD II'). The instruments issued by KBC are not yet fully compliant with these new requirements. The European Directive and Belgian regulations allow for a transition period, during which instruments that are no longer compliant may still be included in tier-1 capital. During the first ten years, there would be no additional cap on these grandfathered instruments. However,

implementation of the Basel III regime will affect this grandfathering regime. Non-compliant government-subscribed instruments will be fully grandfathered in an initial phase. As from 2018, they will no longer qualify. The amount of other non-compliant hybrid instruments that can be taken into account will decrease from 90% of the outstanding amount in 2013 to 0% of the outstanding amount in 2022.

The risk-weighted assets for banking at the end of 2011 included the heightened impact of CRD III on the RWA for market risks (roughly 5.7 billion euros).

The *pro forma* tier-1 ratio at 31 December 2011, including the impact of the sale of KBL EPB, Fidea and Warta, amounted to approximately 13.8%.

## Solvency, KBC Bank (consolidated)

The table shows the tier-1 and CAD ratios calculated under Basel II. It should be noted that Basel II rules have been implemented throughout the group since 2008. Basel II IRB Foundation is the primary approach (used for somewhat more than 80% of the weighted credit risks), while the remaining weighted credit risks (almost 20%) are calculated according to the Standardised method.

Solvency, KBC Bank consolidated In millions of EUR	31-12-2010	31-12-2011
	Basel II	Basel II
<b>Total regulatory capital, after profit appropriation</b>	<b>18 552</b>	<b>16 364</b>
<b>Tier-1 capital</b>	<b>13 809</b>	<b>12 346</b>
Parent shareholders' equity	13 193	11 117
Intangible fixed assets (-)	-100	-95
Goodwill on consolidation (-)	-1 611	-1 449
Innovative hybrid tier-1 instruments	414	420
Non-innovative hybrid tier-1 instruments	1 689	1 690
Minority interests	584	606
Equity guarantee (Belgian State)	354	443
Revaluation reserve available-for-sale assets (-)	386	413
Hedging reserve, cashflow hedges (-)	446	612
Valuation diff. in fin. liabilities at fair value - own credit risk (-)	-190	-550
Minority interest in AFS reserve & hedging reserve, cashflow hedges (-)	-5	-5
Dividend payout (-)	-623	-120
IRB provision shortfall (50%) (-)	0	0
Limitation of deferred tax assets	-379	-466
Items to be deducted (-)	-349	-271
<b>Tier-2 and tier-3 capital</b>	<b>4 743</b>	<b>4 019</b>
Perpetuals (including hybrid tier-1 instruments not used in tier-1 capital)	250	250
Revaluation reserve, available-for-sale shares (at 90%)	82	27
Minority interests in revaluation reserve, available-for-sale shares (at 90%)	1	1
IRB provision shortfall (50%) (-)	0	0
IRB provision excess (+)	132	403
Subordinated liabilities	4 445	3 565
Tier-3 capital	182	45
Items to be deducted (-)	-349	-271
<b>Total weighted risks<sup>1</sup></b>	<b>111 711</b>	<b>106 256</b>
Credit risk	97 683	85 786
Market risk	3 279	9 727
Operational risk	10 749	10 744
<b>Solvency ratios</b>		
tier-1 ratio	12.4%	11.6%
of which core tier-1 ratio	10.5%	9.6%
CAD ratio	16.6%	15.4%

<sup>1</sup> Counterparty risk was retroactively shifted from market risk to credit risk.

The regulatory minimum under Basel II for the CAD ratio amounts to 8%. During a transition period, capital requirements will also still be calculated according to Basel I rules, with the intention to limit the decrease in capital requirements between Basel I and Basel II. In 2011, a floor of 80% applied, which means that the capital required under Basel II should not be less than 80% of the capital required under Basel I. If the floor is not respected, the regulator may increase the minimum capital ratio of 8% to cover the capital requirements



below 80%. Currently, the Basel II capital requirements for KBC Bank at consolidated level are slightly above 80% of Basel I.

In Belgium, banks may issue both innovative and non-innovative hybrid capital instruments which qualify for a maximum 35% of tier-1 capital (with additional limits for the innovative hybrid component). To be classified as non-innovative, the instrument must have a number of features, viz. it needs to be subordinated, should not provide for any step-up in dividends, should be perpetual (no general redemption right for investors) and may be converted to ordinary shares subject to certain limits and approvals.

In order to strengthen the solvency ratios of KBC Bank and with a view to optimising the use of hybrid instruments allowed by the regulator, KBC Bank issued so-called non-innovative hybrid tier-1 capital instruments in 2008. Since then, no new hybrid instruments have been issued in view of, *inter alia*, the uncertainty regarding future regulations related to hybrids. The table below gives an overview of the main hybrid tier-1 instruments.

Overview of main hybrid tier-1 instruments

Issuer	Description	Original nominal amount	Nominal amount at 31-12-2011	Start date	First call date
KBC Bank	directly issued perpetual debt securities	525 million GBP (200+175+150)	45 million GBP	December 2003	December 2019
KBC Bank	directly issued perpetual debt securities	1 250 million EUR	1 250 million EUR	May 2008	May 2013
KBC Bank	directly issued perpetual debt securities	700 million EUR	700 million EUR	June 2008	June 2013
KBC Bank Funding Trust II	perpetual non-callable 10-yr preferred securities	280 million EUR	119 million EUR	June 1999	June 2009
KBC Bank Funding Trust III	non-cumulative guaranteed trust preferred securities	600 million USD	169 million USD	November 1999	November 2009
KBC Bank Funding Trust IV	non-cumulative guaranteed trust preferred securities	300 million EUR	121 million EUR	November 1999	November 2009

## Solvency in 2011, significant banking subsidiaries

Solvency information is also disclosed for significant banking subsidiaries. Significance in this respect is defined by KBC in the way set out in the EBA guidelines on co-operation between consolidating supervisors and home supervisors. It therefore takes into account:

- from a KBC group perspective: the contribution to earnings and overall risk of the group, and
- from a local perspective: the importance of the KBC entity to the local banking system as expressed in terms of market share, for instance.

Absolut Bank, CBC Banque, ČSOB (Czech Republic), ČSOB (Slovak Republic), KBC Bank (Ireland), KBL EPB, Kredyt Bank and K&H Bank have been identified as significant banking subsidiaries.

A summary of the solvency information for significant entities is provided in the table below. The reported figures are calculated according to IFRS or Belgian GAAP, and on a consolidated basis (except for CBC). For details on the capital profile of significant banking subsidiaries please refer to the capital disclosures in the annual reports of the relevant entities.

Solvency, significant banking subsidiaries - In millions of EUR

		31-12-2010			31-12-2011		
		Total regulatory capital	Total weighted risks	CAD ratio	Total regulatory capital	Total weighted risks	CAD ratio
Absolut Bank	IFRS	485	2 589	18,7%	566	2 654	21,3%
CBC Banque	Belgian GAAP	544	2 674	20,4%	518	2 784	18,6%
ČSOB (Czech Republic)	IFRS	2 295	12 819	17,9%	2 117	13 577	15,6%
ČSOB (Slovak Republic)	IFRS	593	3 966	14,9%	586	4 107	14,3%
KBL EPB	IFRS	1 092	5 021	21,7%	894	4 132	21,6%
KBC Bank Ireland	IFRS	915	7 234	12,7%	783	7 115	11,0%
Kredyt Bank	IFRS	904	7 030	12,9%	840	6 607	12,7%
K&H Bank	IFRS	720	5 717	12,6%	634	5 696	11,1%

## Solvency, KBC Insurance (consolidated)

At present, KBC Insurance applies Solvency I rules to calculate the solvency ratio, in accordance with the regulator's guidelines. Some specific elements in the calculation are:

- The equalisation reserve – calculated under Belgian GAAP – which is deducted from available capital
- The available capital, which includes:
  - 90% of the *net positive* revaluation reserve for shares and 100% of the *net positive* revaluation reserve for bonds.
  - Unrealised gains on property and equipment, investment property and held-to-maturity instruments.

The combined amount of the above two items cannot exceed a formula-based maximum, equalling the total net amount of unrealised gains/losses in respect of all investments (i.e. the revaluation reserves for AFS investments – including the negative figures – and the unrealised gains/losses on property and equipment, investment property and held-to-maturity instruments).

In millions of EUR	31-12-2010	31-12-2011
Available capital	2 712	2 533
Parent shareholders' equity	3 904	2 850
Dividend payout (-)	-923	-96
Minority interests	57	44
Subordinated liabilities	10	10
Intangible fixed assets (-)	-17	-11
Goodwill on consolidation (-)	-393	-347
Revaluation reserve available-for-sale investments (-)	-482	-337
Equalisation reserve (-)	-128	-139
Equity guarantee (Belgian State)	92	121
Cashflow hedge reserve	-3	-17
90% of positive revaluation reserve, available-for-sale shares	304	193
Latent gains on bonds	210	221
Latent gains on real estate	83	41
Limitation of latent gains on shares and real estate	0	0
Required solvency margin	1 254	1 263
Non-life and industrial accident (legal lines)	315	308
Annuities	9	9
Subtotal, non-life insurance	324	316
Class-21 life insurance	901	915
Class-23 life insurance	15	16
Subtotal, life insurance	916	932
Other	14	15
Solvency ratio and surplus		
Solvency ratio (%)	216%	201%
Solvency surplus (in millions of EUR)	1 458	1 270

The current solvency requirements (Solvency I) are purely volume-based (maximum of a percentage of the premium and a percentage of the claims cost) and do not take into account the asset mix and asset quality. In order to improve the capital regulations, a new EU solvency regime for (re-)insurance companies (Solvency II) will be implemented (target date was intended to be the end of 2012, but has now been postponed until 2014). The Solvency II capital requirements will be based on the real risk exposure of the (re-) insurance company.

## Economic Capital

KBC uses economic capital as a major building block for its Internal Capital Adequacy Assessment Process, where the required Economic Capital (ECap) is set off against the Available Financial Resources (AFR). In addition, ECap provides essential input for risk-adjusted performance measurement and internal valuation models, such as the Market Consistent Embedded Value model.

ECap is an internal risk measure adapted to specific activities and portfolios of KBC Group. KBC's ECap is defined as the amount of capital needed to absorb very severe losses, expressed in terms of the potential reduction in the economic value of the group (= difference between the current economic value and the worst case economic value over a one-year time horizon and measured at a 99.93% confidence level). It represents the minimum amount of capital which has to be available in order to protect the group against economic insolvency.

ECap is calculated for all material risks (credit risk, market risk in trading activities, market risk in non-trading activities, technical insurance risk, operational risk, business risk, and funding cost & bid/offer spread risk) and is modelled on the specific features of the KBC portfolios. By using a common denominator across risk types (the same time horizon and the same confidence interval) it allows for an aggregated view. Since it is extremely unlikely that all risks will materialise at the same time, an allowance is made for diversification benefits when aggregating the individual risks. ECap is reported on a quarterly basis to the Group Executive Committee, the Audit, Risk and Compliance Committee and the Board of Directors.

The breakdown of KBC's ECap per risk type is provided in the table. The difference in the distribution of ECap across the different risk types is partly related to changes in risk exposures, but also to changes being made to the ECap model as, the model – which is the result of an internal assessment – is reviewed on a regular basis.

Economic Capital distribution, KBC group*	2010	2011
Credit risk	69%	68%
Market risk in non-trading activities	12%	12%
Market risk in trading activities	3%	2%
Business risk	6%	8%
Operational risk	5%	6%
Technical insurance risk	3%	3%
Funding cost and bid/offer spread risk	2%	1%
Total	100%	100%

\* All percentages relate to figures at the end of September of the respective year. Excluding entities classified as 'disposal groups' under IFRS 5 and whose contribution to KBC's Economic Capital was around 5% in 2011 (4% in 2010).

## Risk-Adjusted Performance Measurement

In 2011, KBC developed a Risk-Adjusted Performance Measurement (RAPM) policy, whereby risk-adjusted performance metrics were used for allocating capital and setting variable remuneration. The Group Executive Committee approved this policy in March 2011 and the policy was subsequently implemented.

The capital allocation track of this policy is currently fully embedded in the strategic planning process. The new remuneration policy, which includes risk-adjusted features based on RAPM metrics, is currently under discussion with all relevant stakeholders, both internal and external.

The basic idea behind the RAPM metrics used for capital allocation is that neither economic capital nor regulatory capital is enough in itself to determine how capital should be allocated. Regulatory capital has limited coverage in terms of risk types and only partly reflects the specific characteristics of KBC. Although ECap covers a broader scope of risk and reflects KBC's own estimates of the risk profile, it is less granular at present. Given these constraints, it was decided to allocate capital to businesses based on RWA multiples that reflect the aspects of ECap.

## Regulatory environment

### European stress tests

The results of the EU banking stress tests were published on 15 July 2011. These tests were co-ordinated by the European Banking Authority (EBA), in co-operation with the European Central Bank, the European

Commission, the European Systemic Risk Board and the National Bank of Belgium. As regards KBC, the stress test focused on KBC Bank at the consolidated level. The exercise was conducted using the scenarios, methodology and key assumptions provided by CEBS (see the aggregate report published at [www.eba.europa.eu](http://www.eba.europa.eu)).

As a result of the assumed shocks under the adverse scenario, the estimated consolidated tier-1 capital ratio would drop to 10% in 2012 compared with 10.5% at the end of 2010. This result includes the effects of the mandatory restructuring plans as agreed upon by the European Commission before 31 December 2010.

KBC is satisfied that the outcome of the stress test proves that, even under these stress scenarios, the bank adequately meets the legal and market requirements in terms of solvency. More information in this regard is provided in the press release of 15 July 2011, which is available at [www.kbc.com](http://www.kbc.com). The EBA plans to conduct its next full-blown stress test only in 2013, since it is focusing on the capital exercise in 2012.

In 2011, two stress tests were also required by the European Insurance and Occupational Pensions Authority (EIOPA), in co-operation with the European Systemic Risk Board and the National Bank of Belgium. As regards KBC, the stress tests focused on KBC Insurance at the consolidated level.

These tests were based on prospective measures in Solvency II and, therefore, were not a test of the current regulatory requirements (Solvency I). The aim of the stress tests was to assess the group solvency position (with 31 December 2011 as the reference date), focusing on the level of own funds (i.e. available capital) before and after the stress test compared with the Minimum Capital Requirement as a Solvency II measure. The first exercise included insurance-related shock scenarios in order to test the resilience of the sector to catastrophic or severe insurance events for the life and non-life businesses. The second stress test assumed a prolonged period of low interest rates.

The outcome of these stress tests showed that KBC was adequately capitalised and had a satisfactory solvency ratio, which overall was better than the average EU insurer. EIOPA only published its results at the aggregate EU level (see the aggregate report at [www.eiopa.europa.eu](http://www.eiopa.europa.eu)).

## **Basel III**

The Basel III agreement and corresponding draft European CRD IV Directive and Regulation will introduce new, more stringent capital requirements for financial institutions. According to these proposals, the legal minimum tier-1 ratio, which stood at 4% under Basel II, will be increased to 4.5% in 2013, and gradually increase to 6% in 2015 (with a common equity ratio of 4.5%). On top of this, a so-called 'conservation buffer' (0% in 2013, gradually rising to 2.5% in 2019), a 'countercyclical buffer' (of between 0% and 2.5%, to be determined by the national regulatory authority) and an extra charge for global systemic banks will be applied. Certain elements used in the calculation of regulatory capital will be gradually phased out or changed.

Under the current CRD IV draft, the capital injections received from the government (for KBC, the 7 billion euros' worth of core-capital securities sold to the Belgian State and Flemish Region in 2008 and 2009, which now stands at 6.5 billion euros after 0.5 billion euros was reimbursed at the start of 2012) will be classified as common equity tier-1 capital and will be grandfathered until 2018.

Agreed in July 2009, Basel 2.5 enhances the measurement of risks related to securitisation and trading book exposures, and introduces higher capital requirements for this type of exposure. Basel 2.5 came into force at year-end 2011.

## **Solvency II**

Solvency II is the new regulatory solvency regime for all EU insurance and reinsurance companies. Whereas the current insurance solvency requirements (Solvency I) are volume-based, Solvency II pursues a risk-based approach. It aims to implement solvency requirements that better reflect the risks that companies face and to deliver a supervisory system that is consistent across all EU Member States.

Solvency II was intended to come into effect at the end of 2012, but the European authorities have proposed that the date for its full implementation should be postponed until 1 January 2014, because of delays in the development and adoption of the regulatory framework.

In line with the ICAAP in Basel II, Solvency II introduces a Pillar 2 internal view on capital adequacy, namely ORSA (Own Risk and Solvency Assessment). Since the KBC ICAAP is group-overarching (i.e. including insurance activities), KBC plans to align ORSA with the existing ICAAP process.

# Liquidity risk management

Liquidity risk is the risk that an organisation will be unable to meet its liabilities/obligations as they come due, without incurring unacceptable losses.

## Strategy and processes

The principal objective of KBC's liquidity management is to be able to fund the group and to enable the core business activities of the group to continue to generate revenue, even under adverse circumstances. Since the financial crisis, there has been a greater focus on liquidity risk management throughout the industry, and this has been intensified by the minimum liquidity standards defined by the Basel Committee.

KBC is preparing for the Basel III era by gradually incorporating Basel III concepts into its liquidity and funding framework, as well as into its financial planning.

The liquidity management framework and group liquidity limits are set by the Board of Directors. Liquidity management is organised within the Group Treasury function, which is responsible for the overall liquidity and funding management of the KBC group. The Group Treasury function monitors and steers the liquidity profile on a daily basis and sets the policies and steering mechanisms for funding management (intra-group funding, funds transfer pricing). These policies ensure that local management has an incentive to work towards a sound funding profile. The local treasuries in the subsidiaries implement these policies and report to the Group Treasury function, which in turn further centralises collateral management and the acquisition of long-term funding. The local treasuries are directly responsible for liquidity management in their respective entities. However, the liquidity contingency plan requires all significant local liquidity issues to be escalated to group level. The group-wide liquidity risks are also aggregated and monitored centrally on a daily basis and are reported periodically to the GRCOC, Group Executive Committee and ARC Committee.

KBC's liquidity risk management framework is based on the following pillars:

- *Contingency liquidity risk.* This risk is assessed on the basis of liquidity stress tests, which measure how the liquidity buffer of the group's bank entities changes under extreme stressed scenarios. This buffer is based on assumptions regarding liquidity outflows (retail customer behaviour, professional client behaviour, drawing of committed credit lines, etc.) and liquidity inflows resulting from actions to increase liquidity ('repoing' the bond portfolio, reducing unsecured interbank lending, etc.). The liquidity buffer has to be sufficient to cover liquidity needs (net cash and collateral outflows) over (i) a period that is required to restore market confidence in the group following a KBC-specific event, (ii) a period that is required for markets to stabilise after a general market event and (iii) a combined scenario, which takes a KBC-specific event and a general market event into account. The overall aim of the liquidity framework is to remain sufficiently liquid in stress situations, without resorting to liquidity-enhancing actions which would entail significant costs or which would interfere with the core banking business of the group.
- *Structural liquidity risk.* The group's funding structure is managed so as to maintain substantial diversification, to minimise funding concentrations in time buckets, and to limit the level of reliance on short-term wholesale funding. The structural funding position is managed as part of the integrated strategic planning process, where funding – in addition to capital, profits and risks – is one of the key elements. At present, KBC's strategic aim for the next few years is to build up a sufficient buffer in terms of the Basel III LCR and NSFR requirements via a new funding management framework, which sets clear funding targets for the subsidiaries (own funding, reliance on intra-group funding) and provides further incentives via a system of intra-group pricing to the extent subsidiaries run a funding mismatch.

The table below illustrates structural liquidity risk by grouping the assets and liabilities according to the remaining term to maturity (contractual maturity date). The difference between the cash inflows and outflows is referred to as the 'net liquidity gap'. At year-end 2011, KBC had attracted 43 billion euros' worth of funding from the professional interbank and repo markets. Please note that USD funding obtained from these markets amounted to approximately 7 billion euros on the position at year-end (total USD funding of 13 billion euros).

- *Operational liquidity risk.* Operational liquidity management is conducted in the treasury departments, based on estimated funding requirements. Group-wide trends in funding liquidity and funding needs are monitored on a daily basis by the Group Treasury function, ensuring that a sufficient buffer is available at all times to deal with extreme liquidity events in which no wholesale funding can be rolled over.

## Scope of liquidity risk management

This liquidity risk report covers most material entities of the KBC group that carry out banking activities, i.e. KBC Bank NV, CBC Banque SA, Centea (2010), KBC Lease, Antwerp Diamond Bank, KBC Financial Products, ČSOB Czech Republic, ČSOB Slovakia, KBC Ireland, K&H, Kredyt Bank, CIBank, KBC Credit

Investments, KBC Bank Deutschland, KBC Finance Ireland, Absolut Bank and KBC Banka. KBC Insurance entities are not included, since they are generally liquidity providers and not liquidity users.

## Structural liquidity risk

The table below illustrates structural liquidity risk by grouping the assets and liabilities according to the remaining term to maturity (contractual maturity date). The difference between the cash inflows and outflows is referred to as the 'net liquidity gap'.

Liquidity risk at year-end (excluding intercompany deals) <sup>1,2</sup> (in billions of EUR)	<= 1 month	1-3 months	3-12 months	1-5 years	5-10 years	> 10 years	not defined	Total
<b>31-12-2010</b>								
Total inflows	49	12	23	64	44	46	37	276
Total outflows	65	16	14	31	6	2	141	276
Professional funding <sup>3</sup>	36	5	1	1	0	0	0	44
Customer funding	17	8	8	13	3	2	99	149
Debt certificates	8	4	5	17	3	0	0	36
Other	4	0	0	0	0	0	43	47
Liquidity gap (excl. undrawn commitments)	-16	-4	9	34	38	44	-105	0
Undrawn commitments	-	-	-	-	-	-	-34	-
Financial guarantees	-	-	-	-	-	-	-12	-
Net liquidity gap (incl. undrawn commitments)	-16	-4	9	34	38	44	-151	-46
<b>31-12-2011</b>								
Total inflows	32	11	17	55	40	36	50	241
Total outflows	51	17	12	36	5	2	118	241
Professional funding <sup>3</sup>	28	10	1	4	0	0	0	43
Customer funding	17	6	8	11	3	1	77	123
Debt certificates	3	2	3	20	2	1	1	31
Other	3	0	0	0	0	0	40	43
Liquidity gap (excl. undrawn commitments)	-20	-6	5	19	36	34	-68	0
Undrawn commitments	-	-	-	-	-	-	-34	-
Financial guarantees	-	-	-	-	-	-	-12	-
Net liquidity gap (incl. undrawn commitments)	-20	-6	5	19	36	34	-114	-46

1. Cashflows exclude interest rate flows consistent with internal and regulatory liquidity reporting. Inflows/outflows that arise from margin calls posted/received for MtM positions in derivatives are reported in the 'not defined' bucket.

2. Entities classified as 'disposal groups' under IFRS 5 have also been excluded (balance sheet total for KBL EPB: 12.6 billion euros).

3. 'Professional funding' includes all deposits from credit institutions and investment firms, as well as all repos.

Typical for a banking group, funding sources generally have a shorter maturity than the assets that are funded, leading to a negative net liquidity gap in the shorter time buckets and positive net liquidity gap in the longer term buckets. This creates liquidity risk if KBC would be unable to renew maturing short-term funding. The KBC liquidity framework imposes a funding strategy to ensure that the liquidity risk remains within the group's risk appetite.

Despite the challenging market conditions regarding liquidity, KBC still has a solid liquidity position. Historically, KBC has always had a substantial amount of liquid assets. At year-end 2011, KBC Bank (at the consolidated level) had 48 billion euros' worth of central bank eligible assets, 34 billion euros of which in the form of liquid government bonds. Some 15 billion euros were used as collateral for attracting repo funding.

The loan-to-deposit ratio of KBC Bank amounted to 94% at the end of 2011, compared to 81% at the end of 2010. The increase is the result of an outflow of some volatile short-term corporate and institutional deposits – mainly outside our core markets – due to the short-term rating of KBC Bank being lowered by S&P's (from A1 to A2 in December 2011) and to risk aversion towards the European market in general. The corporate and retail deposit base in the core markets remained stable.

During 2011, KBC Bank used its EMTN programme to raise 4.3 billion euros in long-term funding. Due to the success of this programme and the robust issuance of long-term funding in the retail network (KBC Bank and CBC Banque: 6.7 billion euros for 2011), sufficient long-term funding is available to cover the repayment of



long-term funding that will mature in the course of 2012. In addition, new regulations allowing the issuance of covered bonds in Belgium is likely to increase the ability to attract long-term funding on the wholesale market.

KBC participated in the ECB's long-term refinancing operations (LTRO) of December 2011 and February 2012, borrowing a total of 8.67 billion euros.

# Credit risk management

Credit risk is the potential negative deviation from the expected value of a financial instrument consequent on non-payment or non-performance by a contractual party (for instance, a borrower, guarantor, insurer or reinsurer, counterparty in a professional transaction or issuer of a debt instrument), due to that party's insolvency or lack of willingness to pay or perform, or to events or measures taken by the political or monetary authorities of a particular country (country risk). Credit risk thus encompasses default risk and country risk, but also includes migration risk which is the risk for adverse variances in transitions between credit ratings.

Credit risk is confined mainly to the banking entities of the KBC group, but also arises at its insurance entities. Most of this stems from the investment portfolios, which – for instance – includes investments in debt securities. Furthermore, credit risk also ensues from insurance and reinsurance contracts concluded by KBC Insurance.

Credit risk, including counterparty credit risk, arising at the banking entities is dealt with under the Basel II (regulatory capital) requirements directive and presented as such in this risk report.

Credit risk exposure related to KBC Insurance is reported separately at the end of this section (see 'Credit risk related to KBC Insurance'). This means that, up to and including the 'Internal modelling' section, all disclosures deal with credit risk at KBC's banking entities.

## Strategy and processes

Credit risk is managed at both transactional and portfolio level. Managing credit risk at the transactional level means that there are sound procedures, processes and applications in place to identify and measure the risks before and after accepting individual credit exposures. Limits and delegations (based on parameters such as internal risk class, type of counterparty) are set to determine the maximum credit exposure allowed and the level at which acceptance decisions are taken. Managing the risk at portfolio level encompasses *inter alia* periodic measuring of and reporting on risk embedded in the consolidated loan and investment portfolios, monitoring limit discipline, conducting stress tests under different scenarios, taking risk mitigating measures and optimising the overall credit risk profile.

### Credit risk management at transactional level

Sound acceptance policies and procedures are in place for all kinds of credit risk exposure. The description here is limited to exposures related to traditional loans to businesses and to lending to individuals, as these account for the largest part of the group's credit risk exposure.

Lending to individuals (e.g., mortgages) is subject to a standardised process, during which the output of scoring models plays an important role in the acceptance procedure. Lending to businesses is subject to a more integrated acceptance process in which relationship management, credit acceptance committees (cf. delegations) and model-generated output are taken into account.

For most types of credit risk exposure, monitoring is determined primarily by the *risk class*, with a distinction being made based on the Probability of Default (PD) and the Loss Given Default (LGD). The latter reflects the estimated loss that would be incurred if an obligor defaults, the likelihood of which is estimated as the PD.

In order to determine the risk class, KBC has developed various rating models for measuring how creditworthy borrowers are and to estimate the expected loss of various types of transactions. A number of uniform models are used throughout the group (models for governments, banks, large companies, etc.), while others have been designed for specific geographic markets (SMEs, private individuals, etc.). The same internal rating scale is used throughout the group.

The output generated by these models is used to split the normal loan portfolio into internal rating classes ranging from 1 (lowest risk) to 9 (highest risk) for the PD. A defaulted obligor is assigned an internal rating ranging from PD 10 to PD 12. PD class 12 is assigned when either one of the obligor's credit facilities is terminated by the bank, or when a court order is passed instructing repossession of the collateral. Class 11 groups obligors that are more than 90 days past due (in arrears or overdrawn), but that do not meet PD 12 criteria. PD class 10 is assigned to obligors for which there is reason to believe that they are unlikely to pay (on time), yet are still performing and do not meet the criteria for classification as PD 11 or PD 12. For the larger loans, an overview of all obligors in default is submitted to the Group Executive Committee every quarter.

Loans to large corporations are reviewed at least once a year, with the internal rating being updated, as a minimum. If ratings are not updated in time, a penalty is incurred. Reviews of loans to small and medium-sized enterprises are based primarily on risk signals (such as a significant change in the risk class). Loans to individuals are screened periodically at aggregate level for review purposes.

For credit linked to defaulted borrowers in PD classes 10, 11 and 12 (impaired loans), KBC records impairment losses based on an estimate of the net present value of the recoverable amount. This is done on a case-by-case basis (and on a statistical basis for smaller credit facilities). In addition, for non-defaulted credits in PD classes 1 to 9, impairment losses are recorded on a 'portfolio basis', using a formula based on the IRB Advanced models used internally (or an alternative method if an IRB Advanced model is not yet available).

In order to avoid a situation where an obligor facing financial difficulties ends up defaulting, a decision can be taken to renegotiate its loans. Renegotiation may involve changing the contractual repayment schedule, lowering or postponing interest or fee payments, or some other appropriate measure. At the end of 2011, loans that were renegotiated to avoid impairment accounted for some 2.6% of the total loan portfolio (amount outstanding), as opposed to 2.5% at the end of 2010.

Renegotiated loans avoiding impairment (as a % of the total portfolio of renegotiated loans)*	31-12-2010	31-12-2011
Belgium Business Unit	16%	20%
CEE Business Unit	19%	19%
Czech Republic	4%	5%
Slovakia	2%	1%
Hungary	10%	11%
Bulgaria	3%	2%
Merchant Banking Business Unit	61%	57%
Group Centre (including planned divestments)	4%	4%
<b>Total</b>	<b>100%</b>	<b>100%</b>
In billions of EUR	4.0	4.0

\* At year-end 2011, the amount for KBL EPB had become negligible within the total portfolio of renegotiated loans.

## Credit risk management at portfolio level

Monitoring is also conducted on a portfolio basis, *inter alia* by means of quarterly reports on the consolidated credit portfolio in order to ensure that lending policy and limits are being respected. In addition, the largest risk concentrations are monitored via periodic and *ad hoc* reports. Limits are in place at borrower/guarantor, issuer or counterparty level, at sector level and for specific activities or geographic areas. Moreover, stress tests are performed on certain types of credit (for instance, mortgages), as well as on the full scope of credit risk.

Whereas some limits are still in notional terms, concepts such as 'expected loss' and 'loss given default' are being used as well. Together with the 'probability of default' and 'exposure at default', these concepts form the building blocks for calculating the regulatory capital requirements for credit risk, as KBC has opted to use the Basel II Internal Rating Based (IRB) approach. Consequently, the main group entities now adopt an IRB Foundation approach and are scheduled to shift to the IRB Advanced approach. Other entities are still preparing for the IRB Foundation and Advanced approaches, while 'non-material entities' will continue to adopt the Basel II Standardised approach.

## Scope of credit risk disclosures

The scope of the disclosures for credit risk is based on the implementation of Basel II at KBC, and can be inferred from the roll-out plan below.

With regard to the timing of and approach to implementing Basel II, KBC has opted for a phased roll-out of the IRB approach at all its material entities. A material entity in this respect is defined as any subsidiary that accounts for more than 1% of the risk-weighted assets for credit risk at KBC Group NV. Compliance with this criterion is checked at least yearly. The first set of material entities started adopting the IRB Foundation approach at the beginning of 2007. The internal target dates for the other material entities to adopt this approach are shown in the table below. Any switchover is of course subject to regulatory approval.

Material entities that had not yet adopted the IRB Foundation approach in 2011 are following the Basel II Standardised approach for the time being. This approach will also be adhered to until further notice by the other (non-material) entities of the KBC group.

For its material entities, KBC envisages a phased roll-out of the IRB Advanced approach. For a first set of entities, the switch from the IRB Foundation approach to the IRB Advanced approach is planned to start in 2012. Other entities will follow from 2013 on.

The scope is limited to these material entities, which accounted for more than 95% of the total credit risk weighted assets of KBC group in 2011.

Because of this limitation in scope, and also because another definition of exposure<sup>1</sup> is used in the accounting figures, a one-to-one comparison cannot be made with similar disclosures in KBC Bank's 2011 annual report.

Roll-out of Basel II pillar 1 approach	2011	2012	2013
IRB Advanced approach		KBC Bank CBC Banque ČSOB Czech Republic KBC Credit Investments KBC Finance Ireland KBC Real Estate <sup>1</sup> KBC Lease Belgium	KBC Bank CBC Banque ČSOB Czech Republic KBC Credit Investments KBC Finance Ireland KBC Real Estate <sup>1</sup> KBC Lease Belgium K&H Bank Kredyt Bank <sup>3</sup>
IRB Foundation approach	KBC Bank CBC Banque ČSOB Czech Republic KBC Bank Ireland KBC Credit Investments KBC Financial Products KBC Finance Ireland KBC Bank Deutschland <sup>3</sup> KBC Real Estate <sup>1</sup> KBC Lease Belgium Antwerp Diamond Bank <sup>3</sup> K&H Bank	KBC Bank Ireland KBC Financial Products KBC Bank Deutschland <sup>3</sup> Antwerp Diamond Bank <sup>3</sup> Kredyt Bank <sup>3</sup> K&H Bank	KBC Bank Ireland KBC Financial Products KBC Bank Deutschland <sup>3</sup> Antwerp Diamond Bank <sup>3</sup> CSOB Slovak Republic Absolut Bank <sup>3</sup>
Standardised approach	Kredyt Bank <sup>3</sup> Centea <sup>2</sup> KBL EPB <sup>3</sup> ČSOB Slovak Republic Absolut Bank <sup>3</sup> Non-material entities	ČSOB Slovak Republic Absolut Bank <sup>3</sup> Non-material entities	Non-material entities

<sup>1</sup> Although KBC Real Estate is not a material entity according to KBC's definition above, it also uses the IRB approach as it operates on a shared IT platform.

<sup>2</sup> Centea was sold during 2011 and, therefore, is no longer included in the 2011 figures of this report.

<sup>3</sup> Kredyt Bank, Antwerp Diamond Bank, KBC Bank Deutschland, KBL EPB and Absolut Bank have been targeted for divestment under the KBC strategic plan approved by the EU.

<sup>1</sup> In this report, credit exposure – where possible – is expressed as EAD (Exposure At Default), while it is expressed as an amount granted or an amount outstanding in the annual report. EAD is a typical measure for exposure within the context of Basel II, pillar I.

## Exposure to credit risk

The tables in this section provide an overview of the overall credit risk expressed in terms of Exposure At Default (EAD) and are based on the figures for the end of December 2011. Exposure to securities in the trading book and to structured credit products is excluded. Information on securities in the trading book is reported in the credit risk section of KBC's annual report and the related risks are taken up in the trading market risk VAR. For structured credit exposure, reference is made to the detailed information in the 'Structured credit products' section in this document.

Detailed information is given separately in the following sections: (i) a general aggregate overview of the total credit risk in scope, (ii) a general (IRB Foundation and Standardised) overview of the lending portfolio, (iii) overviews of concentration in the lending portfolio (including a quality analysis), (iv) overviews of impaired credit in the lending portfolio, (v) breakdowns of the counterparty credit risk, (vi) credit risk mitigation and exposure to repo-like transactions and (vii) information on internal modelling.

In the lending portfolio, EAD is the amount that KBC expects to be outstanding if and when an obligor were to default. For lending exposure treated under the IRB approach, EAD is composed of the amount outstanding at the time of the calculation (without taking provisions into account), plus a weighted part of the off-balance-sheet portion of the exposure. For non-retail exposures, this weight is determined on a regulatory basis according to the IRB Foundation approach. For retail exposures, the weight is determined via internal models, in line with the IRB Advanced approach for this asset class. For lending exposures treated under the Standardised approach, EAD is not defined as such, but can be regarded as the amount outstanding at the time of the calculation minus the provisions set aside plus a weighted part of the off-balance-sheet portion of the exposure. EAD can be stated with or without application of eligible collateral, i.e. net or gross.

For the portfolio of derivatives, EAD (actually, pre-settlement counterparty credit risk) is calculated as the sum of the (positive) current replacement value (marked-to-market) of a transaction and the potential risk as captured by the applicable add-on (= current exposure method). Credit Default Swaps (CDS) in the banking book (protection bought or sold) are an exception to this calculation, since they are considered guarantees (obtained or given) and treated as such in this report.

For the portfolio of repo-like instruments, the EAD is determined based on the lending leg in the transaction, which means that for reverse-repos, including tri-party repos, this is based on the nominal amount of the cash that was provided by KBC, and that for repos it is based on the market value of the securities sold.

The EAD is used as a basis to determine the Risk-Weighted Assets (RWA), which in turn are used to calculate the capital required for the exposure. RWA can be regarded as an exposure weighted according to its 'riskiness'. This 'riskiness' depends on such factors as the amount of collateral or guarantees, the maturity of the exposure and the probability of default (PD) of the obligor.

## Total and average aggregate exposure to credit risk

In the table below, exposures are broken down according to types of credit exposure. These types are equal for exposures subject to the Standardised or the IRB Foundation approach.

- *On-balance-sheet assets (On-balance)*: this category contains assets, including equities in the banking book, whose contract is booked on the balance sheet of the entities in scope excluding securities in the trading book, repo-like instruments and – in the case of this publication – securitisation-related assets. On-balance-sheet assets are dealt with in the ‘lending portfolio’ sections.

*Off-balance-sheet assets (Off-balance)*: this category contains assets whose contract is not booked on the balance sheet of the entities in scope. The category excludes most derivative instruments, repo-like instruments and – in the case of this publication – securitisation-related assets. Derivative instruments related to selling credit protection, i.e. CDS that have been sold are included as off-balance-sheet assets when they do not relate to trading activity. Off-balance-sheet assets are dealt with in the ‘lending portfolio’ sections.

- *Derivatives*: this category contains all credit exposure arising from derivative transactions, such as Interest Rate Swaps (IRS), Forex deals, etc. (excluding CDS in banking book, which are treated as an Off-balance instrument). Derivatives are dealt with in the section on ‘Counterparty credit risk’ and not in the ‘lending portfolio’ sections.
- *Repo-like transactions (Repo-like)*: this category contains all credit exposure arising from repo-, reverse repo and tri-party repo transactions in scope. More details on these transactions can be found in the section on ‘Credit risk mitigation’.

Average exposure is determined by aggregating the total exposure at the end of every quarter and dividing the sum by four. The gross EAD is the Exposure At Default after application of the credit conversion factor and substitution due to guarantees, but before the application of eligible collateral. The net EAD is the gross EAD after application of all eligible collateral.

In billions of EUR – 31-12-2010\*

Exposure [EAD]	On-balance	Off-balance	Derivatives	Repo-like	Total
Gross total	226	20	11	36	292
Gross average	220	20	14	41	296
Net total	218	19	9	5	251
Net average	212	19	11	6	248
Total RWA	70	10	4	0	83

In billions of EUR – 31-12-2011\*

Exposure [EAD]	On-balance	Off-balance	Derivatives	Repo-like	Total
Gross total	192	18	10	16	237
Gross average	201	19	10	16	246
Net total	185	17	9	6	217
Net average	194	18	9	6	227
Total RWA	65	9	4	0	77

\* KBL EPB has been excluded from the 2010 and 2011 figures. At year-end 2010, KBL EPB's gross exposure totalled 13 billion euros (6.5 billion euros of which for on-balance-sheet assets and 5.5 billion euros for repo-like transactions), net exposure totalled 8 billion euros and RWA amounted to 3 billion euros. At year-end 2011, its gross exposure totalled 13 billion euros (6.5 billion euros of which for on-balance-sheet assets and 5.0 billion euros for repo-like transactions), net exposure totalled 8 billion euros and RWA amounted to 3 billion euros.

As regards the group-wide framework for dealing with model uncertainty – as referred to in the section on ‘Internal modelling’ later in this report – KBC has taken into account (and has reported under pillar 1) additional RWA for known deficiencies and avoidable uncertainties regarding its PD models, since mid 2010. At year-end 2011, this additional RWA amounted to 0.7 billion euros.



## Credit risk in the lending portfolio

The lending portfolio excludes all derivatives (except for CDS in banking book) and any repo-like exposure as these are dealt with in the 'Counterparty credit risk' and 'Credit risk mitigation' sections. As mentioned above, exposure to securities in the trading book is also excluded. The securities in trading book carry issuer risk, and totalled 0.3 billion euros at year-end 2011. In light of the capital calculations this risk is included in trading market risk.

In millions of EUR – 31-12-2010

Lending portfolio [EAD]	Gross EAD of main categories	'Other' <sup>1</sup>	Total Gross EAD
Subject to IRB approach	178 080	24 603	202 683
Subject to Standardised approach <sup>2</sup>	41 391	1 277	42 668
<b>Total</b>	<b>219 471</b>	<b>25 880</b>	<b>245 351</b>

In millions of EUR – 31-12-2011

Lending portfolio [EAD]	Gross EAD of main categories	'Other' <sup>1</sup>	Total Gross EAD
Subject to IRB approach	157 781	4 252	162 032
Subject to Standardised approach <sup>2</sup>	46 541	1 099	47 640
<b>Total</b>	<b>204 322</b>	<b>5 351</b>	<b>209 673</b>

<sup>1</sup> Exposure to 'Other' is given separately and is not included in the disclosures on concentrations and impaired exposure, since the data required to create the breakdowns is often missing. This category contains mostly 'other assets' (e.g., property and equipment, non-assignable accruals). The significant year-to-year decrease related mainly to cash balances with central banks: these balances have been reduced, on the one hand, and been shifted to 'Standardised approach – main categories' (more specific sovereign exposure), on the other.

<sup>2</sup> As mentioned, KBL EPB has been excluded from the 2010 and 2011 figures (for the Standardised approach). At year-end 2010, KBL EPB's 'gross EAD of main categories' amounted to 6 778 million euros, while 'other assets' amounted to 439 million euros. At year-end 2011, its 'gross EAD of main categories' amounted to 7 146 million euros, while 'other assets' amounted to 399 million euros.

Overall information on the lending portfolio is divided into two tables below. One for a total overview of the exposure subject to the IRB approach and one for the overview of the exposure treated via the Standardised approach. This is because each approach has its own (regulatory) breakdown by type of exposure/asset class. In the tables relating to concentrations, both are aggregated to provide a total overview of concentrations in the lending portfolio. This is done at the expense of best-efforts mapping into the mainstream asset classes. As regards the quality analysis, however, both the IRB and Standardised approaches are presented separately again, since the manner for indicating quality is not equal.

### Credit exposure subject to the IRB approach

The table below shows the total exposure calculated via the IRB approach broken down per asset class. The asset classes are those defined for the purpose of regulatory reporting according to the IRB approach, viz.:

- **Sovereign:** this category includes claims on public sector entities, regional governments and local authorities as long as they are categorised as 'Sovereign' by the local regulator. Multilateral development banks attracting a 0% risk weighting are included.
- **Institutions:** this category relates mainly to bank exposure. Claims on public sector entities, regional governments and local authorities that do not qualify as 'Sovereign' are also included in this category.
- **Corporates:** besides ordinary corporate exposure, this category includes specialised lending exposure (project finance and commercial real estate).
- **SME (treated as) Corporates:** these are exposures fulfilling the necessary conditions (total annual sales of under 50 million euros) for determining the minimum capital requirements according to the capital weighting formula for corporate SMEs.
- **Retail:** this includes all types of retail exposure, such as mortgage loans, personal loans and commercial credit to retail SMEs, for which the total exposure of the counterparty (or related group of the counterparty) does not exceed a threshold of one million euros. It should be noted that the IRB Foundation approach for retail exposure no longer exists and that IRB Advanced is the only approach for this asset class.
- **Other:** besides 'other assets', this category includes the residual value of leasing transactions.

In millions of EUR - 31-12-2010

IRB exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail <sup>1</sup>	(sub)Total <sup>3</sup>	Other	Total
Gross Exposure	47 739	6 549	42 547	16 076	65 169	178 080	24 603	202 683
Net Exposure	47 646	6 534	39 020	11 897	65 168	170 265	24 603	194 868
RWA	1 245	1 865	29 568	11 012	10 189	53 879	3 960	57 839

In millions of EUR - 31-12-2011

IRB exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail <sup>2</sup>	(sub)Total <sup>3</sup>	Other	Total
Gross Exposure	21 876	5 985	42 152	17 897	69 870	157 781	4 252	162 032
Net Exposure	21 833	5 972	38 735	13 606	69 869	150 015	2 982	152 997
RWA	3 027	1 896	28 475	11 650	11 228	56 276	4 218	60 494

1 In 2010, the gross EAD of the retail class consisted of 48 221 million euros in mortgages and 16 948 million euros in other retail. The related RWA amounts to 7 243 million euros and 2 946 million euros respectively.

2 In 2011, the gross EAD of the retail class consisted of 53 093 million euros in mortgages and 16 777 million euros in other retail. The related RWA amounts to 8 225 million euros and 3 004 million euros respectively.

3 The (sub)Total is accounted for in the section on concentrations in the lending portfolio.

The material reduction in 'Sovereign' exposure is explained by scaling back exposure due to the debt crisis, on the one hand, and by applying a specific carve-out to the Standardised approach, on the other. The latter means that home country sovereign exposure in the books of KBC's IRB entities in Belgium, the Czech Republic and Hungary has been carved out from the IRB approach and been treated under the Standardised approach.

Furthermore, the table demonstrates KBC's strategic focus, i.e. increased exposure in the SME and retail (mortgages) business.

### Credit exposure subject to the Standardised approach

The table below shows the exposure calculated via the Standardised approach broken down per exposure type. The exposure types are those defined for the purpose of regulatory reporting according to the Standardised approach, viz.:

- *Sovereign*: claims on central authorities and governments.
- *RGLA*: claims on Regional Governments and Local Authorities independently if these qualify as 'Sovereign' under the IRB approach.
- *PSE*: claims on Public Sector Entities.
- *MDB*: claims on Multilateral Development Banks independently if these qualify as 'Sovereign' under the IRB approach.
- *International Org.*: claims on a specific list of organisations (e.g., International Monetary Fund, European Central Bank).
- *Institutions*: claims on banks.
- *Corporates*: claims on all corporate exposure, including small and medium-sized enterprises that are treated as corporate clients.
- *Retail*: claims on retail clients (including SMEs not qualifying for treatment as corporate clients). Most of these claims are related to mortgages and categorised under 'secured by real estate'.
- *Secured by real estate*: claims that are (fully) covered by real estate collateral via mortgages and including real estate leasing. These are extracted from the above categories (mostly retail or corporate).
- *Past Due*: all exposure which is past due, meaning that it is more than 90 days in arrears. All past due exposure is extracted from all the other categories.
- *CIU*: claims on Collective Investment Undertakings.
- *High Risk*: exposure that is not collateralised and/or not rated, attracting a risk-weighting equal to or higher than 150% and therefore considered 'high risk'. Past due and equity exposure are excluded.
- *Covered bonds*: exposure for which the credit risk is mitigated by risk positions on very highly rated governments, authorities or institutions. Past due, equity and high-risk claims are excluded.
- *Short term*: exposure (to institutions or to corporates) which is rated and has a maturity of less than three months. Past due, equity and high-risk claims are excluded. This exposure has been assigned to its respective exposure type, namely 'Institutions' or 'Corporates'.
- *Other*: all other claims (e.g., other assets).

In millions of EUR – 31-12-2010 <sup>2</sup>

Standardised exposure [EAD]	gross Exposure	net Exposure	RWA
Sovereign	12 397	12 397	170
RGLA	511	510	460
PSE	35	34	27
MDB	13	13	1
International Organisations	0	0	0
Institutions	921	921	388
Corporates	7 302	7 139	7 133
Retail	7 696	7 677	5 758
Secured by real estate	11 747	11 257	5 654
Past due	755	726	658
CIU	14	14	14
(sub)Total <sup>1</sup>	41 391	40 688	20 265
High risk	14	14	22
Covered bonds	0	0	0
Short term	28	28	6
Other	1 235	1 235	887
Total	42 668	41 965	21 180

In millions of EUR – 31-12-2011 <sup>2</sup>

Standardised exposure [EAD]	gross Exposure	net Exposure	RWA
Sovereign	31 032	31 032	143
RGLA	169	169	74
PSE	84	84	21
MDB	13	13	1
International Organisations	0	0	0
Institutions	781	781	404
Corporates	4 636	4 632	4 633
Retail	5 175	5 174	3 881
Secured by real estate	4 423	4 423	2 790
Past due	227	227	245
CIU	0	0	0
(sub)Total <sup>1</sup>	46 541	46 537	12 195
High risk	5	5	7
Covered bonds	0	0	0
Short term	17	17	3
Other	1 077	1 077	442
Total	47 640	47 636	12 647

<sup>1</sup> Accounted for in the section on concentrations in the lending portfolio.

<sup>2</sup> The 2010 portfolio of KBL EPB is mostly concentrated in sovereign (2 278 million euros), institutions (1 539 million euros) and corporate exposure (1 402 million euros). The 2011 portfolio of KBL EPB is mostly concentrated in sovereign (3 167 million euros), institutions (1 000 million euros) and corporate exposure (1 365 million euros).

The material increase in 'Sovereign' exposure is the result of the above-mentioned application of a specific carve-out to the Standardised approach. This means that home country sovereign exposure in the books of KBC's IRB entities in Belgium, the Czech Republic and Hungary has been carved out from the IRB approach and been treated under the Standardised approach.

The substantial reduction in the 'Secured by real estate' exposure type was accounted for by the sale of Centea in 2011. This is also the main reason for the decline in the 'Corporates' and 'Retail' exposure types.

## Concentrations to credit risk in the lending portfolio

In order to portray an overall picture of the lending portfolio, the exposure calculated according to the Standardised approach and the IRB approach is aggregated based on the most material asset classes from the IRB approach. KBC believes this leads to a more transparent and uniform presentation of the concentrations to credit risk in the lending portfolio.

The exposure types under the Standardised approach are therefore mapped to the most applicable types/asset classes under IRB Foundation, viz.:

- *Secured by real estate*: this type of exposure is mapped according to the asset class of the underlying client from which the exposure originated, mostly retail, corporate or SME corporates.
- *Corporates*: this type of exposure is mapped to 'corporates' or 'SME corporates' depending on the internally used segmentation.
- *Past due*: this type of exposure is mapped according to the asset class of the underlying client from which the exposure originated.
- *RGLA, PSE, International organisations and MDB*: these exposure types are mapped mostly to the 'Institutions' asset class, or when distinguishable as eligible sovereign exposure to the 'Sovereigns' asset class.
- *CIU*: this exposure is mapped to the 'Institutions' asset class.

The Standardised exposure types of 'High risk', 'Covered bonds' and 'Short term' are all mapped to the 'Other' asset class, due to their immateriality. The other mapping exercises are rather straightforward.

For reasons of relevancy/materiality/data availability, the 'Other' category is not included in the following tables.

Unless otherwise stated, all the results presented in this section are stated gross (i.e. without collateral benefits), and exposure is attributed to the asset class after PD substitution. This implies that if PD substitution is applied to a certain exposure to a borrower guaranteed by another party, the exposure will shift to the region, sector and exposure class of the guaranteeing party in the breakdowns below. For example, when a corporate entity is guaranteed by a bank and PD substitution is applied, this exposure will be incorporated under 'Institutions' in the breakdowns provided.

### Total credit exposure in the lending portfolio per geographic region

In millions of EUR – 31-12-2010\*

Gross exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
Africa	11	164	137	1	1	314
Asia	382	1 364	1 529	84	0	3 360
Central and Eastern Europe & Russia	18 719	1 633	9 289	6 777	21 696	58 114
Latin America	72	163	161	0	0	397
Middle East	0	514	455	6	0	976
North America	2 072	610	5 051	83	2	7 817
Oceania	0	77	799	1	0	877
Western Europe	39 382	3 000	30 608	12 535	62 091	147 616
<b>Total</b>	<b>60 637</b>	<b>7 527</b>	<b>48 029</b>	<b>19 487</b>	<b>83 791</b>	<b>219 471</b>

In millions of EUR – 31-12-2011\*

Gross exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
Africa	10	168	144	2	1	325
Asia	299	1 139	1 161	102	0	2 702
Central and Eastern Europe & Russia	15 243	1 713	9 408	6 759	21 896	55 019
Latin America	0	59	114	0	0	173
Middle East	0	622	474	4	0	1 101
North America	2 597	395	3 087	118	1	6 197
Oceania	0	47	634	1	0	682
Western Europe	34 831	2 684	30 937	12 926	56 745	138 124
<b>Total</b>	<b>52 980</b>	<b>6 828</b>	<b>45 958</b>	<b>19 912</b>	<b>78 644</b>	<b>204 322</b>

\* KBL EPB, which is not included in the table, mainly focuses on Western Europe.

The geographic regions in the above table are those where each borrower (or guarantor) is situated. The predominance of Western Europe reflects KBC's focus on its Belgian home market, along with its sizeable exposures to Ireland and – to a lesser extent – the UK, France and Germany. The drop in 'Retail' relates to the sale of Centea. Furthermore, the importance of the second home market, Central and Eastern Europe, also stands out.

### Total credit exposure in the lending portfolio per sector

In millions of EUR – 31-12-2010<sup>2</sup>

Gross exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
Agriculture, Farming & Fishing	0	0	494	970	2 289	3 753
Authorities	60 397	38	338	0	0	60 773
Automotive	0	0	1 598	884	582	3 064
Building & Construction	0	0	3 307	1 209	1 460	5 976
Chemicals	0	0	2 328	602	60	2 990
Commercial Real Estate	0	0	8 135	2 616	926	11 677
Distribution	0	0	4 366	4 009	2 891	11 265
Electricity	0	0	2 637	161	4	2 803
Finance & Insurance	239	7 404	4 764	135	361	12 903
Food Producers	0	0	1 741	484	220	2 445
Metals	0	0	1 726	580	271	2 577
Oil, Gas & Other Fuels	0	0	1 784	91	5	1 880
Private Persons	0	0	26	86	69 484	69 595
Services	0	15	6 141	4 028	3 572	13 757
Other <sup>1</sup>	0	70	8 645	3 630	1 668	14 013
<b>Total</b>	<b>60 637</b>	<b>7 527</b>	<b>48 029</b>	<b>19 487</b>	<b>83 791</b>	<b>219 471</b>

In millions of EUR – 31-12-2011<sup>2</sup>

Gross exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
Agriculture, Farming & Fishing	0	0	534	1 031	2 107	3 672
Authorities	52 917	30	502	0	0	53 449
Automotive	0	0	1 389	725	510	2 624
Building & Construction	0	0	3 525	1 316	1 310	6 150
Chemicals	0	0	1 740	443	56	2 240
Commercial Real Estate	0	0	8 056	2 502	856	11 414
Distribution	0	0	5 212	4 006	2 674	11 892
Electricity	0	0	2 917	271	5	3 193
Finance & Insurance	64	6 787	3 379	152	373	10 755
Food Producers	0	0	1 565	464	202	2 231
Metals	0	0	1 425	515	232	2 171
Private Persons	0	0	81	94	62 528	62 703
Services	0	10	6 040	4 759	3 408	14 217
Shipping	0	0	1 234	366	88	1 688
Other <sup>1</sup>	0	0	8 359	3 268	4 295	15 922
<b>Total</b>	<b>52 980</b>	<b>6 828</b>	<b>45 958</b>	<b>19 912</b>	<b>78 644</b>	<b>204 322</b>

<sup>1</sup> All sectors with a concentration of less than 0.75% of the total EAD are aggregated into this category.

<sup>2</sup> The largest part of the exposure attributed to KBL EPB (for both 2010 and 2011) is situated in the 'Authorities' and 'Finance & Insurance' sectors.

In view of KBC's substantial retail activities in most markets, 'Private Persons' represent a large share of this sector distribution, even after the sale of Centea. The decline in 'Authorities' illustrates the above-mentioned reduction in sovereign exposure due to the debt crisis.

## Maturity analysis of the total credit exposure in the lending portfolio

In millions of EUR – 31-12-2010<sup>2</sup>

Residual maturity	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
<1 year	7 174	3 476	19 777	6 733	3 572	40 732
=>1 to <5 years	30 011	2 763	13 952	3 640	8 101	58 467
=>5 to <10 years	11 017	811	4 775	2 807	31 713	51 122
=>10 years	11 566	396	8 559	5 679	39 328	65 527
Until Further Notice <sup>1</sup>	870	82	966	628	1 078	3 624
<b>Total</b>	<b>60 637</b>	<b>7 527</b>	<b>48 029</b>	<b>19 487</b>	<b>83 791</b>	<b>219 471</b>

In millions of EUR – 31-12-2011<sup>2</sup>

Residual maturity	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
<1 year	11 972	3 537	20 173	7 281	3 869	46 833
=>1 to <5 years	23 774	2 315	12 197	4 101	7 184	49 572
=>5 to <10 years	8 397	530	4 729	2 956	31 186	47 798
=>10 years	8 590	303	4 864	4 205	33 827	51 789
Until Further Notice <sup>1</sup>	247	142	3 996	1 368	2 577	8 330
<b>Total</b>	<b>52 980</b>	<b>6 828</b>	<b>45 958</b>	<b>19 912</b>	<b>78 644</b>	<b>204 322</b>

<sup>1</sup> Exposure without a concrete end-date is assigned to the 'Until Further Notice' category.

<sup>2</sup> At KBL EPB, which is not included in the table, 78% of the exposure will mature within five years (74% in 2010).

About 47% of the lending portfolio will mature within five years. The longest maturities are mainly found in the retail asset class and relate primarily to mortgage loans to private persons.

## Total credit exposure in the lending portfolio per product type

In millions of EUR – 31-12-2010\*

Gross exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
Guarantee	817	325	3 957	960	283	6 342
Debt instrument	50 461	2 742	1 580	3	0	54 786
Equity	0	10	160	14	0	185
Leasing	10	5	1 770	857	1 405	4 046
Mortgage loans	0	0	0	38	62 606	62 644
Other lending	9 349	4 444	40 562	17 614	19 498	91 467
<b>Total</b>	<b>60 637</b>	<b>7 527</b>	<b>48 029</b>	<b>19 486</b>	<b>83 791</b>	<b>219 471</b>

In millions of EUR – 31-12-2011\*

Gross exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
Guarantee	1 015	453	3 399	937	273	6 077
Debt instrument	36 185	2 244	1 136	3	0	39 569
Equity	0	7	68	1	0	76
Leasing	40	7	1 507	887	1 647	4 088
Mortgage loans	0	0	1	27	58 798	58 825
Other lending	15 739	4 116	39 848	18 057	17 926	95 696
<b>Total</b>	<b>52 980</b>	<b>6 828</b>	<b>45 958</b>	<b>19 912</b>	<b>78 644</b>	<b>204 322</b>

\* KBL EPB (figures not included in 2010 and 2011) is mainly active in the 'debt instruments' and 'other lending' categories.

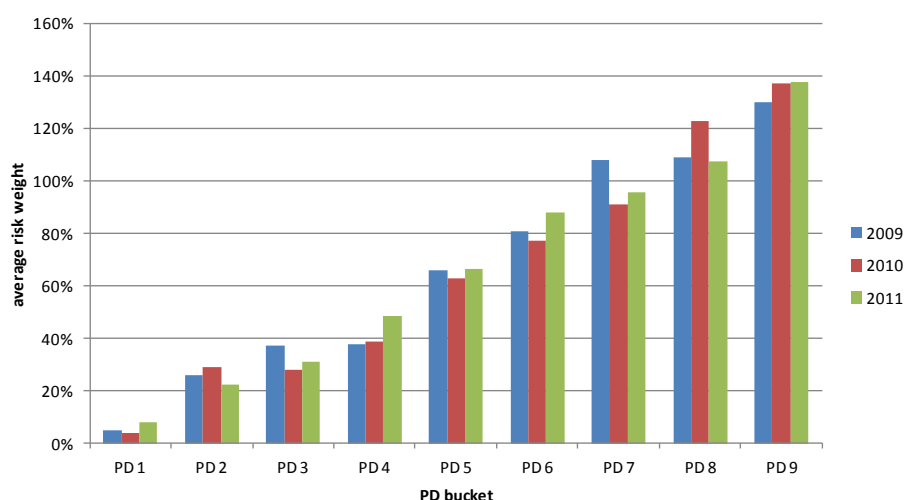
The increase in 'Other lending' to sovereigns relates solely to cash balances with central banks, which was not included in the 2010 figures (see explanation in footnote 1 of the first table in the section entitled 'Credit risk in the lending portfolio').

## Quality analysis of the total credit exposure in the lending portfolio – IRB

The graph and table below show credit risk exposure per Probability of Default (PD) class in terms of average risk weight or EAD at year-end. Only the lending exposure subject to the IRB approach is captured in this table. A similar overview of the exposure subject to the Standardised approach appears in a subsequent table. The exposure (EAD) is presented together with the relevant RWA per PD rating.

Unlike the previous tables, the table below shows exposure before the application of guarantees. This means that there is no shift in asset class due to PD substitution. The RWA for the exposure, however, is presented after all collateral and guarantees have been applied. This allows an indication to be given of the mean residual RWA for a certain original exposure. The latter is also reflected in the 'weighted average' percentage.

### IRB exposure - credit quality analysis



Generally, the average weighting percentage increases as PD ratings worsen, which is in line with the principle that higher risks attract higher capital.

The PD scale presented is KBC's Master Scale for Probability of Default. For more information in this regard, please refer to the 'Internal modelling' section.



In millions of EUR – 31-12-2010

PD Master scale	gross Exposure [EAD] RWA Average in %	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
01 [0.00% - 0.10%]	Sum of EAD	43 985	4 186	6 910	617	21 641	77 338
	Sum of RWA	625	685	1 433	141	405	3 290
	weighted average	1%	16%	21%	23%	2%	4%
02 [0.10% - 0.20%]	Sum of EAD	310	775	6 133	1 216	2 418	10 852
	Sum of RWA	81	188	2 304	424	169	3 166
	weighted average	26%	24%	38%	35%	7%	29%
03 [0.20% - 0.40%]	Sum of EAD	136	656	6 898	2 583	11 502	21 775
	Sum of RWA	72	294	3 603	1 244	949	6 162
	weighted average	53%	45%	52%	48%	8%	28%
04 [0.40% - 0.80%]	Sum of EAD	457	114	6 483	2 769	11 816	21 639
	Sum of RWA	357	57	4 601	1 772	1 729	8 515
	weighted average	78%	50%	71%	64%	15%	39%
05 [0.80% - 1.60%]	Sum of EAD	44	640	6 223	2 868	5 394	15 170
	Sum of RWA	3	394	5 658	2 277	1 283	9 614
	weighted average	7%	61%	91%	79%	24%	63%
06 [1.60% - 3.20%]	Sum of EAD	115	60	3 678	1 871	3 672	9 395
	Sum of RWA	11	33	4 118	1 743	1 303	7 208
	weighted average	10%	55%	112%	93%	35%	77%
07 <sup>1</sup> [3.20% - 6.40%]	Sum of EAD	58	51	2 473	1 394	3 089	7 064
	Sum of RWA	4	37	3 481	1 523	1 415	6 460
	weighted average	7%	73%	141%	109%	46%	91%
08 [6.40% - 12.80%]	Sum of EAD	25	19	908	566	700	2 219
	Sum of RWA	42	13	1 559	775	336	2 725
	weighted average	167%	69%	172%	137%	48%	123%
09 [12.80% - 100.00%]	Sum of EAD	0	10	1 371	656	2 738	4 775
	Sum of RWA	0	22	2 973	1 137	2 415	6 547
	weighted average	0%	230%	217%	173%	88%	137%
Total gross exposure		45 130	6 511	41 077	14 539	62 970	170 227
Total risk-weighted assets		1 196	1 722	29 728	11 036	10 005	53 687
Total weighted average		3%	26%	72%	76%	16%	32%

1 Unrated exposure is assigned a PD% of 4.53% and allocated to PD bucket 7.

In millions of EUR – 31-12-2011

PD Master scale	gross Exposure [EAD] RWA Average in %	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
01 [0.00% - 0.10%]	Sum of EAD	18 679	3 483	6 656	591	24 369	53 777
	Sum of RWA	1 772	597	1 536	130	415	4 450
	weighted average	9%	17%	23%	22%	2%	8%
02 [0.10% - 0.20%]	Sum of EAD	393	690	5 861	1 520	8 344	16 808
	Sum of RWA	260	178	2 332	543	471	3 783
	weighted average	66%	26%	40%	36%	6%	23%
03 [0.20% - 0.40%]	Sum of EAD	592	602	6 308	3 013	11 110	21 623
	Sum of RWA	433	277	3 441	1 496	1 084	6 731
	weighted average	73%	46%	55%	50%	10%	31%
04 [0.40% - 0.80%]	Sum of EAD	94	66	7 600	3 360	7 731	18 851
	Sum of RWA	86	32	5 733	2 107	1 185	9 143
	weighted average	91%	49%	75%	63%	15%	49%
05 [0.80% - 1.60%]	Sum of EAD	90	694	5 859	3 161	5 647	15 451
	Sum of RWA	109	494	5 664	2 459	1 531	10 256
	weighted average	121%	71%	97%	78%	27%	66%
06 [1.60% - 3.20%]	Sum of EAD	65	59	3 776	2 162	2 357	8 418
	Sum of RWA	93	63	4 277	2 017	945	7 395
	weighted average	143%	107%	113%	93%	40%	88%
07 <sup>1</sup> [3.20% - 6.40%]	Sum of EAD	35	82	1 902	1 148	2 329	5 497
	Sum of RWA	54	103	2 720	1 210	1 174	5 260
	weighted average	155%	125%	143%	105%	50%	96%
08 [6.40% - 12.80%]	Sum of EAD	18	10	782	451	1 573	2 835
	Sum of RWA	33	13	1 386	625	990	3 047
	weighted average	183%	126%	177%	139%	63%	107%
09 [12.80% - 100.00%]	Sum of EAD	6	1	735	647	2 934	4 323
	Sum of RWA	17	2	1 645	1 098	3 176	5 937
	weighted average	0%	256%	224%	170%	108%	137%
Total gross exposure		19 972	5 687	39 479	16 052	66 394	147 583
Total risk-weighted assets		2 856	1 758	28 733	11 686	10 970	56 004
Total weighted average		14%	31%	73%	73%	17%	38%

1 Unrated exposure is assigned a PD% of 4.53% and allocated to PD bucket PD 7.

The average risk weighting for sovereigns has increased substantially for two reasons:

- Internal downgrades leading to higher probability of default;
- An adjustment to KBC's master scale leading to higher probabilities of default for top-rated countries.

With reference to the retail exposure, which is treated according to the IRB Advanced approach, key data are shown in the table below (i.e., EAD, the outstanding amount, the undrawn amount, the EAD-weighted mean Credit Conversion Factor (CCF %) applicable to the undrawn amount and the EAD-weighted mean LGD percentages).

Further detailed quality information on retail exposure  
In millions of EUR – 31-12-2010

PD	1	2	3	4	5	6	7	8	9	Total
EAD	21 641	2 418	11 502	11 816	5 394	3 672	3 089	700	2 738	62 970
Outstanding amount	20 998	2 070	11 070	11 439	5 101	3 438	2 823	666	2 710	60 315
Undrawn amount	1 087	650	732	612	501	339	333	59	45	4 359
Average CCF %	59.2%	53.5%	59.3%	61.7%	58.6%	68.9%	79.8%	57.6%	62.2%	60.9%
LGD %	14.4%	20.9%	15.3%	16.6%	19.1%	20.1%	17.4%	21.4%	17.1%	16.3%

In millions of EUR – 31-12-2011

PD	1	2	3	4	5	6	7	8	9	Total
EAD	24 369	8 344	11 110	7 731	5 647	2 357	2 329	1 573	2 934	66 394
Outstanding amount	23 757	7 979	10 845	7 436	5 164	2 197	2 264	1 551	2 902	64 094
Undrawn amount	862	891	699	641	698	282	139	49	48	4 310
Average CCF %	71.0%	40.9%	38.0%	46.0%	69.2%	56.7%	47.5%	43.9%	67.4%	53.4%
LGD %	13.5%	16.6%	16.9%	17.6%	20.8%	23.0%	19.2%	18.7%	20.8%	16.5%

Strictly pursuant to Basel II pillar 3 rules, KBC should disclose a comparison of 'expected losses' with 'actual losses' over a longer period in time and broken down by asset class. KBC believes that this disclosure is less relevant for a portfolio that is largely made up of exposure subject to the IRB Foundation approach, since only one underlying parameter of the EL, namely PD, is subject to own estimates/models.

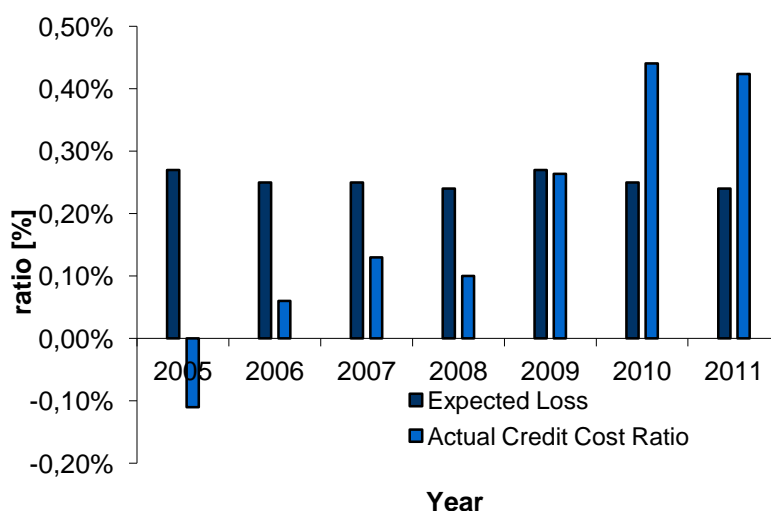
Therefore, KBC has chosen to disclose this comparison only for the retail portfolio which is subject to the IRB Advanced approach (see first graph below). As regards the exposure subject to the IRB Foundation approach, KBC discloses what it believes to be a valid alternative (see second graph below).

The first graph compares KBC's EL ratio (EL related to the outstanding amount) with the actual average credit cost percentage. Note that EL expresses the modelled expectations with a one-year time horizon and thus there is a time lag compared to the credit cost ratio.

Only the normal (i.e. non-default) portfolio is taken into account.

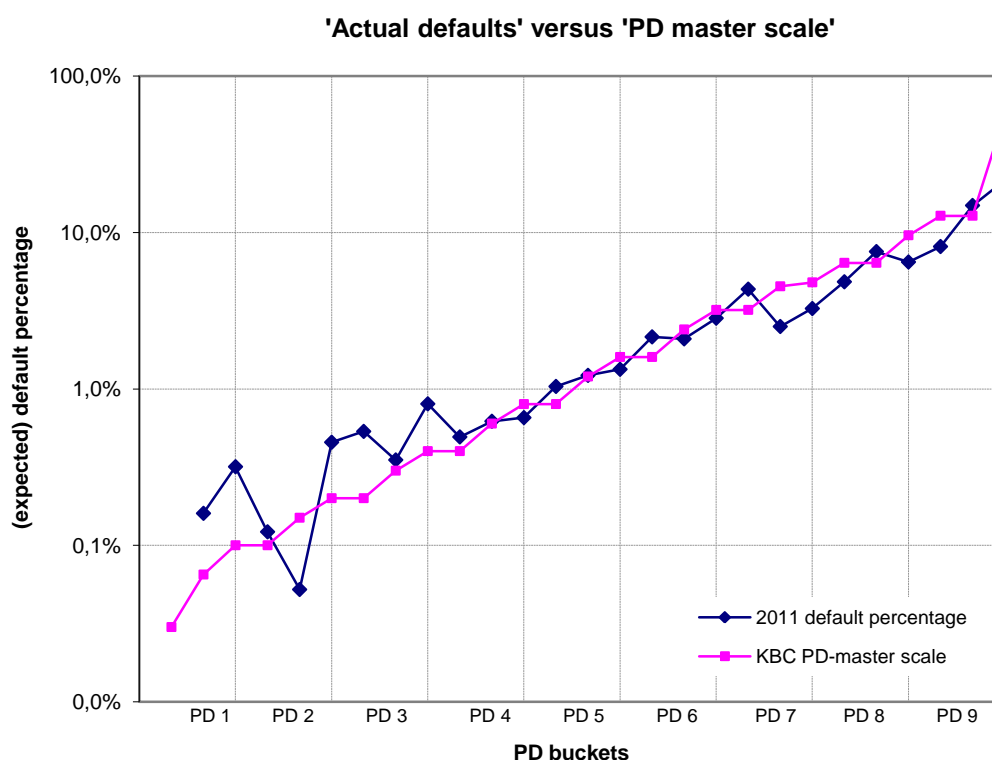
KBC Homeloans only switched from the Standardised to the IRB approach halfway through 2008 and was thus only incorporated into the graph below as of 2009. The retail portfolios of ČSOB Czech Republic and K&H, which are also subject to the IRB Advanced approach, are not included in the scope of this graph.

**Comparison of historical credit cost and expected loss ratio  
Exposure subject to IRB Advanced (i.e. pooled retail)**



The economic downturn of recent years, especially in Ireland, is responsible for an increased number of defaults and higher losses, and is thus reflected in the fact that the credit cost ratio shown in the graph was higher than the EL ratio in 2010 and 2011.

With reference to the portfolio subject to the IRB Foundation approach (i.e. non-retail), the predictive aspect of KBC's models is presented in the table below by means of a comparison between the percentage of defaults expected at year-end 2010, according to KBC's PD master scale, and the actual outcome (measured in observed defaults over the past year divided by the number of non-defaults at the beginning of the year). It should be noted that every bucket of the PD scale from PD 1 to PD 9 is further subdivided into three intervals resulting in a total of 27 data points. The IRB Foundation portfolios of ČSOB Czech Republic, K&H and KBC Financial Products are not included in the scope of the graph below.



Overall, the actual default percentage closely follows the predicted one according to the master scale. The seemingly higher deviation from the master scale for PD 1 to 3, is explained by the logarithmic scale of the graph, and by the fact that there are far fewer observed defaults for these better ratings compared to the number of non-defaulted clients with these PDs (which automatically creates a larger statistical deviation from the modelled master scale). For example, for the first data point in the graph (0.03% PD on the master scale), there were no observed defaults during 2011 (0% default percentage, so not indicated on the graph).

## Quality analysis of the total credit exposure in the lending portfolio – Standardised

As mentioned above, only the lending exposure subject to the Standardised approach is dealt with in this section.

KBC uses the regulatory defined risk buckets to assess the quality and linked risk weight for all exposure calculated according to the Standardised approach. It uses external ratings from S&P, Fitch and Moody's to define the risk bucket of exposures. If there are three external ratings with different risk weights attached to them, the risk weight corresponding with the second best external rating is applied.

The table below shows credit risk exposure calculated according to the Standardised approach broken down by type of exposure and risk bucket. Unlike previous indications, the gross exposure appearing in this table is not only before the application of eligible collateral, but also before the application of guarantees, which means that substitution effects are not taken into account.

Much of the exposure is assigned to the unrated bucket. This includes the 'secured by real estate' exposure, which does not require a rating. Obviously, the retail exposure is assigned to the unrated bucket.

In millions of EUR – 31-12-2010\*

Standardised exposure [EAD]		Quality steps							Unrated	Total
		1	2	3	4	5	6			
Sovereign	gross	3 553	2 539	4 356	0	0	0	0	1 947	12 396
	net	3 553	2 539	4 356	0	0	0	0	1 947	12 396
RGLA	gross	0	38	6	0	0	0	0	467	511
	net	0	38	6	0	0	0	0	467	511
PSE	gross	0	34	0	0	0	0	0	1	35
	net	0	34	0	0	0	0	0	1	34
MDB	gross	12	0	1	0	0	0	0	0	13
	net	12	0	1	0	0	0	0	0	13
International Org.	gross	0	0	0	0	0	0	0	0	0
	net	0	0	0	0	0	0	0	0	0
Institutions	gross	205	319	144	26	50	3	173		921
	net	205	319	144	26	50	3	173		921
Corporates	gross	0	24	25	24	0	0	7 228		7 300
	net	0	26	25	24	0	0	7 063		7 137
Retail	gross	0	0	0	0	0	0	7 719		7 719
	net	0	0	0	0	0	0	7 700		7 700
Secured by real estate	gross	0	2	0	0	0	0	11 745		11 747
	net	0	2	0	0	0	0	11 254		11 256
Past due	gross	0	0	0	0	0	0	716		716
	net	0	0	0	0	0	0	686		686
High risk	gross	0	0	0	0	0	0	34		34
	net	0	0	0	0	0	0	34		34
Covered bonds	gross	0	0	0	0	0	0	0		0
	net	0	0	0	0	0	0	0		0
CIU	gross	0	0	0	14	0	0	0		14
	net	0	0	0	14	0	0	0		14
Short term	gross	28	0	0	0	0	0	0		28
	net	28	0	0	0	0	0	0		28
Other	gross	1	0	0	0	0	0	1 234		1 235
	net	1	0	0	0	0	0	1 234		1 235
Total	gross	3 800	2 955	4 533	63	50	3	31 264		42 668
	net	3 800	2 957	4 533	63	50	3	30 559		41 965

\* KBL EPB: 35% of its gross EAD is top-rated (quality step 1), 47% is unrated.

In millions of EUR – 31-12-2011\*

Standardised exposure [EAD]		Quality steps							Unrated	Total
		1	2	3	4	5	6			
Sovereign	gross	23 021	2 103	3 134	38	202	0	1 429	29 927	
	net	23 270	2 103	3 125	0	0	0	1 429	29 927	
RGLA	gross	0	35	0	0	0	0	135	169	
	net	0	35	0	0	0	0	135	169	
PSE	gross	0	26	0	0	0	0	100	125	
	net	41	26	0	0	0	0	59	125	
MDB	gross	12	0	1	0	0	0	0	13	
	net	12	0	1	0	0	0	0	13	
International Org.	gross	0	0	0	0	0	0	0	0	
	net	0	0	0	0	0	0	0	0	
Institutions	gross	107	232	276	78	30	8	222	954	
	net	282	231	276	23	22	0	119	954	
Corporates	gross	0	125	4	26	0	0	5 373	5 528	
	net	890	25	1	26	0	0	4 582	5 524	
Retail	gross	0	0	0	0	0	0	5 175	5 175	
	net	0	0	0	0	0	0	5 174	5 174	
Secured by real estate	gross	0	1	0	0	0	0	4 422	4 423	
	net	0	1	0	0	0	0	4 422	4 423	
Past due	gross	0	0	0	0	0	0	227	227	
	net	0	0	0	0	0	0	227	227	
High risk	gross	0	0	0	0	0	0	5	5	
	net	0	0	0	0	0	0	5	2	
Covered bonds	gross	0	0	0	0	0	0	0	0	
	net	0	0	0	0	0	0	0	0	
CIU	gross	0	0	0	0	0	0	0	0	
	net	0	0	0	0	0	0	0	0	
Short term	gross	17	0	0	0	0	0	0	17	
	net	17	0	0	0	0	0	0	17	
Other	gross	1	0	0	0	0	0	1 076	1 077	
	net	1	0	0	0	0	0	1 076	1 077	
Total	gross	23 158	2 521	3 416	142	232	8	18 163	47 640	
	net	24 513	2 421	3 403	49	22	0	17 228	47 636	

\* KBL EPB: 64% of its gross EAD is top-rated (quality step 1), 22% is unrated.

The substantial increase in Quality step 1 for 'Sovereign' exposure is the result of the above-mentioned application of a specific carve-out to the Standardised approach.

## Impaired credit exposure in the lending portfolio

The tables show impaired credit risk exposure per geographic region and per sector.

The tables include all exposure in the lending portfolio, independently of the regulatory approach or the assigned exposure type or asset class. If exposure is treated according to the IRB approach, impairment is determined in the same way as for accounting purposes, i.e. the PD assigned to the obligor of the exposure is PD 10, 11 or 12. If exposure is treated according to the Standardised approach, impairment is determined by the fact that provisions were set for the exposure and/or as 'past due' in this section. It is worth mentioning that the EAD reported here and originated via the Standardised approach, already takes provisions for the exposure into account. For exposure calculated according to the IRB approach, this is not the case.

In millions of EUR

Impaired gross exposure per geographic region [EAD]	31-12-2010*	31-12-2011*
Africa	0	10
Asia	138	116
Central and Eastern Europe & Russia	2 618	2 196
Latin America	30	4
Middle East	15	17
North America	285	240
Oceania	41	44
Western Europe	6 456	8 171
<b>Total</b>	<b>9 582</b>	<b>10 800</b>

\* In 2010, KBL EPB's impaired gross exposure amounted to 43 million euros, mainly situated in Western Europe. In 2011, KBL EPB's impaired gross exposure amounted to 50 million euros, mainly situated in Western Europe.

In millions of EUR

Impaired gross exposure per sector [EAD]	31-12-2010	31-12-2011
Agriculture, Farming & Fishing	182	133
Automotive	268	215
Building & Construction	571	559
Chemicals	205	148
Commercial Real Estate	2 048	2 412
Distribution	1 065	1 004
Electrotechnics	99	72
Finance & Insurance	134	154
Horeca	281	350
IT	130	131
Machinery & Heavy Equipment	129	90
Metals	200	228
Private Persons	2 252	2 414
Services	691	783
Shipping	176	192
Textile & Apparel	196	201
Other*	957	1 714
<b>Total</b>	<b>9 582</b>	<b>10 800</b>

\* All sectors with a concentration of less than 1% of the total EAD are aggregated into the 'Other' category.

For all data on impairment, provisions and value adjustments, reference is made to the consolidated annual accounts section of KBC's annual report for 2011 (Notes 14 and 21).

## Counterparty credit risk

KBC defines counterparty credit risk as the credit risk resulting from over-the-counter transactions (i.e. where there is no formal Exchange), which are in the main Credit Default Swaps (CDS), interest-related transactions (e.g., Interest Rate Swaps), currency-related transactions (e.g., FX swap), equity-related transactions or commodity transactions. In principle, it includes repo-like transactions, which are measured in-house and managed like other over-the-counter transactions. However, in this report, repo-like transactions are not covered here, but instead are dealt with in the section on 'Credit risk mitigation' below.

No distinction is made between counterparty credit risk arising from exposures subject to the IRB approach or to the Standardised approach, nor from the banking or trading book.

The tables show the counterparty credit risk for the entities referred to in the scope description of credit risk disclosures.

Counterparty limits are set for each individual counterparty, taking into account the general rules and procedures set out in a group-wide policy. Sub-limits can be put in place for each product type. The risk is monitored by a real-time limit control system, allowing dealers to check limit availability at any time. A pre-deal check occurs before the conclusion of each transaction using 'heavy' add-ons which are higher than the regulatory add-ons.

Close-out netting and collateral techniques are used wherever possible (subject to legal certainty about applicability). These techniques are discussed in the next section. The netting benefits and risk mitigation through collateral for OTC-derivative transactions are however already shown in the bottom part of the table below.

In millions of EUR – 31-12-2010

Transaction type	Marked-to-market	Add-on	Gross counterparty risk [EaD]	Notional value of contracts	Regulatory capital <sup>1</sup>
CDS bought - Trading	1 079	2 207	3 308	27 020	138
CDS sold - Trading	78	469	665	31 099	6
Other	0	1	2	15	0
<b>Total credit derivatives</b>	<b>1 158</b>	<b>2 677</b>	<b>3 974</b>	<b>58 134</b>	<b>143</b>
Interest Rate Swaps (IRS)	5 821	1 504	7 342	321 232	114
Caps/Floors	773	268	1 041	28 566	12
Other	303	331	634	38 617	9
<b>Total interest-related transactions</b>	<b>6 898</b>	<b>2 103</b>	<b>9 017</b>	<b>388 415</b>	<b>135</b>
FX forward	261	271	533	21 354	7
FX swap	830	769	1 599	73 207	6
Cross Currency IRS	1 274	1 081	2 355	65 723	18
Other	188	175	363	13 085	3
<b>Total currency-related transactions</b>	<b>2 553</b>	<b>2 296</b>	<b>4 849</b>	<b>173 369</b>	<b>35</b>
Equity swaps	2 402	2 044	4 445	60 380	17
Equity options	491	351	869	7 161	5
<b>Total equity-related transactions</b>	<b>2 893</b>	<b>2 395</b>	<b>5 315</b>	<b>67 541</b>	<b>22</b>
<b>Total commodity transactions</b>	<b>46</b>	<b>55</b>	<b>101</b>	<b>491</b>	<b>0</b>
<b>Gross counterparty risk</b>	<b>13 548</b>	<b>9 525</b>	<b>23 257</b>	<b>687 950</b>	
- Netting benefit			-12 390		
<b>Total counterparty risk after netting</b>			<b>10 867</b>		
- Collateral benefit			-1 407		
<b>Total net Counterparty risk<sup>2</sup></b>			<b>9 460</b>		<b>335</b>

<sup>1</sup> Based on the net counterparty risk of the transaction type.

<sup>2</sup> KBL EPB's net counterparty credit risk (EAD) amounted to 186 million euros at the end of 2010.



In millions of EUR – 31-12-2011

Transaction type	Marked-to-market	Add-on	Gross counterparty risk [EaD]	Notional value of contracts	Regulatory capital <sup>1</sup>
CDS bought -Trading	1 112	1 708	2 820	21 322	102
CDS sold - Trading	21	357	378	25 289	4
Other	0	2	2	15	0
<b>Total credit derivatives</b>	<b>1 133</b>	<b>2 067</b>	<b>3 199</b>	<b>46 627</b>	<b>106</b>
Interest Rate Swaps (IRS)	6 900	1 315	8 215	262 496	142
Caps/Floors	722	278	999	31 203	9
Other	412	350	762	45 056	8
<b>Total interest related transactions</b>	<b>8 034</b>	<b>1 943</b>	<b>9 976</b>	<b>338 755</b>	<b>159</b>
FX forward	352	229	581	17 066	11
FX swap	998	665	1 663	60 958	8
Cross Currency IRS	1 079	798	1 878	51 406	18
Other	168	131	299	9 951	2
<b>Total currency-related transactions</b>	<b>2 598</b>	<b>1 823</b>	<b>4 421</b>	<b>139 382</b>	<b>40</b>
Equity swaps	2 367	1 776	4 142	53 825	16
Equity options	459	219	678	4 411	3
<b>Total equity related transactions</b>	<b>2 826</b>	<b>1 994</b>	<b>4 820</b>	<b>58 236</b>	<b>19</b>
<b>Total commodity transactions</b>	<b>27</b>	<b>40</b>	<b>67</b>	<b>379</b>	<b>1</b>
<b>Gross counterparty risk</b>	<b>14 617</b>	<b>7 866</b>	<b>22 483</b>	<b>583 378</b>	
- Netting benefit			-12 056		
<b>Total counterparty risk after netting</b>			<b>10 427</b>		
- Collateral benefit			-1 525		
<b>Total net Counterparty risk <sup>2</sup></b>			<b>8 902</b>		<b>324</b>

1 Based on the net counterparty risk of the transaction type.

2 KBL EPB's net counterparty credit risk (EAD) amounted to 298 million euros at the end of 2011.

A breakdown of the net counterparty risk is provided below, both by geographic region (i.e. where the counterparty is located) and by rating band (based on external ratings). This reveals that around 80% of the total counterparty credit risk is exposure to investment-grade counterparties.

In millions of EUR

Net derivative exposure per geographic region [EAD] <sup>1</sup>	31-12-2010	31-12-2011
Africa	4	1
Asia	216	195
Central and Eastern Europe & Russia	779	654
Latin America	2	0
Middle East	81	62
North America	1 170	833
Oceania	46	70
Western Europe	7 161	7 086
<b>Total</b>	<b>9 460</b>	<b>8 902</b>
Net derivative exposure per rating band <sup>2</sup> [EAD] <sup>1</sup>	31-12-2010	31-12-2011
AAA	650	636
AA	2 911	2 093
A	3 370	3 540
BBB	838	1 044
BB	1 080	1 155
B and below	396	316
No rating	215	117
<b>Total</b>	<b>9 460</b>	<b>8 902</b>

<sup>1</sup> After collateral and netting benefits have been taken into consideration.

<sup>2</sup> For instance, rating band AA incorporates ratings AA+, AA and AA-. If multiple ratings are available, the second best is used.

As mentioned earlier, the EAD is calculated as the sum of the (positive) current replacement value (marked-to-market) of a transaction and the applicable add-on (= current exposure method).

It is worthwhile mentioning that a PFE methodology (Potential Future Exposure) is also used in-house at KBC Financial Products. This is a simulation-based methodology that takes the effect of collateral agreements in the counterparty exposure fully into account. Counterparty exposure is estimated conservatively via scenarios drawn from the historical distribution of the underlying risk factors, the possible risk of exposure during an extended margin period of risk of either 10 or 20 days depending on the complexity and liquidity of reference assets. KBC Financial Products uses a PFE percentile of 99% as the internal risk measure to check limit utilisation.

## Credit risk mitigation

Credit risk mitigation entails the use of techniques to lower credit risk and hence capital needs, e.g., regulatory capital.

### Netting

To date, KBC has not engaged in on-balance-sheet-netting (i.e. the offsetting of balance-sheet products such as loans and deposits).

Close-out netting, on the other hand, is applied in order to manage the counterparty risk arising from derivative transactions. For netting to apply, such transactions need to be documented under ISDA-92 or ISDA-2002 Master Agreements. In addition, 'suitable for netting' rules have been established for all relevant jurisdictions and all relevant products, based on legal opinions published by the ISDA. Accordingly, close-out netting is only applied if legal effectiveness and enforceability is assured.

Based on figures for the end of December 2011, the netting impact on derivative exposure amounted to 12.1 billion euros. Intra-group netting is not included in this figure.

### Collateral in repo transactions

KBC engages in the following types of repo transaction:

- Reverse repos and 'buy and sell-back' transactions:** These transactions are considered deposits made by KBC, with KBC lending cash against securities, until the cash is repaid. The difference between reverse repos and buy and sell-backs is technical and relates to the way coupon payments are handled during the transaction.

The securities underlying the reverse repo transactions are almost solely government securities (99% of the 2.5 billion euros), with the underlying issuers of the remaining securities being mainly banks and corporate entities. In order to conclude such transactions, a standard General Master Repurchase Agreement (GMRA) needs to be concluded with the counterparty, and legal certainty must exist for all relevant jurisdictions. Transactions also need to be compliant with KBC's repo policies for all relevant entities.
- Repos and 'sell and buy-back' transactions:** These transactions are considered funding, as KBC receives cash in exchange for securities provided as collateral until the cash is repaid. Here too, the difference between repos and sell and buy-backs is a technical one.
- Tri-party repo transactions:** These transactions are a specific type of reverse repo, where KBC would lend cash and would receive securities as collateral but, unlike regular reverse repos, the collateral is managed by a third party and more types of collateral can be used as stipulated in the tri-party repo contracts. Exposure to these at both reporting dates was zero.

In millions of EUR – 31-12-2010<sup>4</sup>

	Exposure [EAD]	Covered exposure [EaD]	Covered exposure [%]
Reverse repos/buy and sell-back <sup>1</sup>	12 233	8 040	66% <sup>3</sup>
Repos/sell and buy-back <sup>2</sup>	23 274	23 110	99%
Total	35 507	31 150	88%

In millions of EUR – 31-12-2011<sup>4</sup>

	Exposure [EAD]	Covered exposure [EaD]	Covered exposure [%]
Reverse repos/buy and sell-back <sup>1</sup>	8 600	2 469	29% <sup>3</sup>
Repos/sell and buy-back <sup>2</sup>	7 862	7 743	98%
Total	16 461	10 212	62%

1. The covered exposure is lower than the exposure, as the security amount is corrected for regulatory haircuts and mismatches.

2. The exposure of repo transactions, which is based on the market value of the securities in the transaction, is higher than the coverage by cash (covered exposure), which is also due to the notion of haircuts. These haircuts are added to the securities leg of the transaction.

3. This low percentage is mainly due to transactions at ČSOB Czech Republic, where the reverse repo counterparty and the counterparty of securities is the same entity, namely the Czech National Bank. Therefore, the collateral is not eligible for capital purposes and thus not included in the coverage percentage. At year-end 2011, ČSOB Czech Republic accounted for 65% of the reverse repo exposure [EAD].

4. In 2010, KBL EPB's gross exposure to repo-like transactions amounted to 5.5 billion euros, 3 billion euros of which for reverse repos and 2.5 billion euros for repos; the covered exposure amounted to 5.3 billion euros. In 2011, its gross exposure to repo-like transactions amounted to 5.0 billion euros, 3.7 billion euros of which for reverse repos and 1.3 billion euros for repos; the covered exposure amounted to 4.8 billion euros.

## Other collateral

This section covers credit risk mitigation by means of collateral provided to cover the counterparty risk arising from derivative transactions and the lending portfolio. The tables show the EAD covered, broken down into different portfolios and different types of credit risk mitigation.

### *Counterparty risk arising from derivative transactions (excluding repo-like transactions)*

With regard to collateral for counterparty risk arising from derivative transactions (other than repos which are covered above), a collateral management policy is in place. Financial collateral is only taken into account if the assets concerned are considered eligible risk-mitigants for regulatory capital calculations. This implies, among other things, that legal comfort must have been obtained regarding the ownership of the collateral for all relevant jurisdictions.

Of the total counterparty risk exposure after netting and before collateral, 14.6% (1 525 million out of 10 427 million euros) was classified as collateralised at the end of 2011. A breakdown of covered exposure values by exposure classes and type of collateral is provided in the table below. Both debt securities and cash collateral were taken into account for credit risk mitigation of counterparty risk exposure. In this respect, it is noted that according to the applicable policy, equity collateral is not eligible.

In millions of EUR – 31-12-2010<sup>3</sup>

Covered exposure <sup>1,2</sup> [EaD]	LGD % applied under IRB				SME Corporates	Total
	Foundation	Sovereigns	Institutions	Corporates		
Cash	0%	0	924	440	0	1 364
Debt securities	0%	0	43	0	0	43
<b>Total</b>		<b>0</b>	<b>967</b>	<b>440</b>	<b>0</b>	<b>1 407</b>

In millions of EUR – 31-12-2011<sup>3</sup>

Covered exposure <sup>1,2</sup> [EaD]	LGD % applied under IRB				SME Corporates	Total
	Foundation	Sovereigns	Institutions	Corporates		
Cash	0%	0	944	491	0	1 435
Debt securities	0%	0	90	0	0	90
<b>Total</b>		<b>0</b>	<b>1034</b>	<b>491</b>	<b>0</b>	<b>1 525</b>

1. Covered EAD is the EAD amount (after netting) on which a reduced LGD percentage is applied due to collateralisation.

2. The exposure only relates to the covered counterparty risk arising from derivative transactions.

3. Impact of KBL EPB is immaterial.

### *Lending portfolio*

The retail segment is not included in the exposure classes in the table below, as it is irrelevant in a collateral context of exposure subject to the IRB approach, because retail is handled through the IRB Advanced approach and collateral is included in LGD modelling (See 'IRB Quality analysis').

Collateral applying to lending exposure subject to the Standardised approach have a direct effect by lowering the EAD, which in turn has a direct effect on RWA and on capital. Since LGD is irrelevant for these exposures, the collateral is not included in the table.

Of the non-retail lending EAD (subject to the IRB approach), 8.9% (7.8 billion euros of 87.9 billion euros) was classified as collateralised at the end of 2011 implying that a lower LGD percentage is applied to this portion of exposure in the capital calculations. The impacted exposure is to be interpreted as the total collateralised<sup>2</sup> EAD to which an LGD percentage of 0%, 30%, 35% or 40% has been applied in the capital requirement calculations (compared to an LGD of 45% as used for un-collateralised amounts). The exact percentages depend on the type of collateral concerned as indicated in the table below.

It is clear that credit risk mitigation is only applied when the necessary policies and procedures are in place. Only the collateral meeting the eligibility criteria and minimum requirements (as imposed by the CRD) to qualify for credit risk mitigation has been included in the figures. Hence, bearing in mind that the figures refer to collateralised EAD as described in the previous paragraph, the effective amount of collateral obtained in KBC is much higher than the figure taken into account for risk mitigation purposes. Real estate collateral obtained for KBC's commercial real estate financing activities is not taken into account for credit risk mitigation purposes, for instance. It does not meet the conditions for credit risk mitigation, since the impact is already partially reflected in the PD rating under the IRB approach.

<sup>2</sup> After the application of haircuts, mismatch corrections and collateralisation floors.

The table below gives the total EAD covered by eligible financial and physical collateral for each exposure class.

In millions of EUR – 31-12-2010<sup>4</sup>

Covered IRB lending exposure [EAD] <sup>1</sup>	LGD applied under IRB Foundation <sup>2</sup>	Sovereign	Institutions	Corporates	SME Corporates	Total
Cash	0%	1	6	322	164	493
Debt securities	0%	0	0	58	22	80
Equity collateral	0%	1	0	154	79	234
Total financial collateral		2	6	534	265	807
Real estate <sup>3</sup>	30%	17	9	1 987	3 151	5 164
Receivables	35%	0	0	587	287	874
Lease collateral	35%	0	0	0	0	0
Other physical collateral	40%	74	1	418	476	970
Total physical collateral		91	10	2 992	3 914	7 008
General total		93	16	3 526	4 179	7 815

In millions of EUR – 31-12-2011<sup>4</sup>

Covered IRB lending exposure [EAD] <sup>1</sup>	LGD applied under IRB Foundation <sup>2</sup>	Sovereign	Institutions	Corporates	SME Corporates	Total
Cash	0%	2	3	328	235	568
Debt securities	0%	0	0	56	21	77
Equity collateral	0%	0	0	132	76	208
Total financial collateral		3	3	515	332	853
Real estate <sup>3</sup>	30%	40	9	1 961	3 191	5 202
Receivables	35%	0	0	539	283	822
Lease collateral	35%	0	0	104	154	259
Other physical collateral	40%	0	1	298	330	629
Total physical collateral		40	10	2 902	3 959	6 911
General total		43	14	3 417	4 291	7 765

1 Covered EAD is the EAD amount subject to a reduced LGD percentage due to collateralisation.

2 The LGD percentages are those applied in accordance with Belgian regulations.

3 Including real estate leasing.

4 Impact of KBL EPB is immaterial.

The table shows that the bulk of the collateralised amounts relates to physical collateral (6.9 billion euros or 7.9% of the non-retail lending EAD subject to the IRB approach, i.e. 87.9 billion euros), while financial collateral, which has a bigger impact on capital as it attracts a LGD of 0%, is limited to 0.9 billion (1.0% of the non-retail lending EAD subject to the IRB approach). Furthermore, as financial collateral is predominantly cash collateral and non-cash financial collateral is amply diversified, issuer concentration risk in respect of financial collateral is negligible.

Where physical collateral is concerned, the concentrations shown in the table are in line with expectations, as most collateral is held for the 'Corporates' and 'SME Corporates' asset classes (and not 'Sovereign' and 'Institutions'). The focus on real estate collateral in these asset classes reflects the preference for this type of asset when collateral is called for.

### Unfunded credit protection

Unfunded credit protection is provided mainly through guarantees and – to a much lesser extent – credit derivatives entered into for hedging purposes. For guarantees, the impacted exposure (i.e. amounts receiving a better rating through PD substitution, resulting in lower capital requirements) amounted to 6.7 billion euros at the end of 2011, or 5.3% of total non-retail lending EAD (i.e. 125.7 billion euros for both the Standardised and IRB approach). For credit derivatives, this impact is negligible.

In millions of EUR – 31-12-2010<sup>4</sup>

Covered exposure [EAD] <sup>1,2,3</sup>	Sovereign	Institutions	Corporates	SME Corporates	Total
Credit derivatives	0	0	43	0	43
Guarantees	2 029	727	3 349	268	6 373
<b>Total</b>	<b>2 029</b>	<b>727</b>	<b>3 391</b>	<b>268</b>	<b>6 416</b>

In millions of EUR – 31-12-2011<sup>4</sup>

Covered exposure [EAD] <sup>1,2,3</sup>	Sovereign	Institutions	Corporates	SME Corporates	Total
Credit derivatives	0	0	2	0	2
Guarantees	2 315	501	3 386	494	6 697
<b>Total</b>	<b>2 315</b>	<b>501</b>	<b>3 389</b>	<b>494</b>	<b>6 699</b>

1 Covered exposure is the EAD amount after netting covered by guarantees or credit derivatives and thus subject to substitution.

2 The breakdown refers to the exposure classes before substitution is applied.

3 The scope of the table includes the Standardised and IRB approaches.

4 Impact of KBL EPB is immaterial.

The main types of guarantors and providers of protection through credit derivatives are government entities and large financial institutions such as banks, investment banks and insurance companies.

## Internal modelling

The credit risk models developed by KBC over the years to support decisions in the credit process include Probability of Default models (PD), Loss Given Default models (LGD) and Exposure At Default models (EAD) models, plus application and behavioural scorecards for specific portfolios (retail and SME).

These models are used in the credit process for:

- defining the delegation level for credit approval (e.g., PD models);
- accepting credit transactions (e.g., application scorecards);
- setting limits (e.g., EL limits);
- pricing credit transactions (predominantly through the use of the RAROC concept);
- monitoring the risk of a (client) portfolio (Risk Signals Databases);
- calculating the internal economic capital;
- calculating the regulatory capital;
- input for other credit risk models (e.g., behavioural scores as pooling criteria for the retail portfolio).

### Probability of Default models

Probability of Default (PD) is the likelihood that an obligor will default on its obligations within a one-year time horizon, with default being defined in accordance with Basel II rules. The PD is calculated for each client or for a portfolio of transactions with similar attributes (pools in retail portfolios).

There are several approaches to estimating PDs (from purely objective to more subjective methods); however, all have four steps in common:

Step 1: The segment for which a model will be built is defined (segmentation of the portfolio). It is important that a good balance be struck between the homogeneity of the segment, the exposure, the number of clients and the number of default events. Having too many models will lead to additional operational risks in the credit process, smaller and less reliable data samples and high maintenance costs. On the other hand, the predictability of the models will go down if the segments are less homogeneous. Once the segment has been defined, the data sample on which the model development will be based can be created. This usually requires some 'cleansing' of the available data (for instance, handling missing values and outliers). KBC has built its rating models mainly on internal data.

Step 2: This entails ranking the clients in the targeted segment according to their creditworthiness. Depending on the amount of data available and its characteristics (subjective or objective), specific techniques are used in order to create a ranking model.

- Statistical default/non-default models based on objective inputs: Rankings are derived purely mechanically with no subjective input, using regression techniques. At KBC, this method is only used in the retail segment where objective data is plentiful (e.g., behavioural information).
- Statistical default/non-default models based on objective and subjective input: These are very similar to the purely objective models, but also use subjective input entered by a credit adviser (for instance management quality). At KBC, this method is used to rank large Western European corporate customers, for example.
- Statistical expert-based models: Rankings are based on quantitative and qualitative input, but due to the small number of observed default events, regression is applied to predict expert assessments of the creditworthiness of the clients, rather than their default/non-default behaviour. At KBC, this method is used to rank borrowers in the 'Commercial real estate and site financing' segment, for example.
- Generic flexible rating tool: This is a template that is used by 'graders' to justify and document the given rating class. In this template, the most relevant risk indicators are given a score and ranked in order of importance as a basis for a final rating.

Step 3: The ranking score is calibrated to a probability of default.

Step 4: The probability of default is mapped to a rating class. There is a unique rating scale at KBC for all segments, the so-called KBC Master Scale.

Once all the steps have been taken and the model built and implemented, the quality of the PD models developed is measured by:

- Statistical analysis: variable distributions (means, standard deviations), rating distributions, statistical powers of variables and (sub)models.
- The number of overrulings: if users frequently overrule the output of a model, this indicates that the model might be improved.
- The soundness of model implementation and policies, more specifically as regards system access, system security, integrity of data input, etc.
- The available documentation (user manual, technical reports, etc.).

### Loss Given Default models

Loss Given Default (LGD) is a measure of the loss that a bank would suffer if an obligor defaults. It can be expressed as an amount or as a percentage of the expected amount outstanding at the time of default (EAD).

In general, there are many ways of modelling the LGD, such as:

- Market LGD: this is observed from market prices of defaulted bonds or marketable loans soon after the actual default event.
- Workout LGD: this is determined by the sum of cashflows resulting from the workout and/or collections process, discounted to the time of default and expressed as a percentage of the estimated exposure at default.

The LGD models currently used at KBC are all workout LGDs. The models developed are (methodologically) based on historical recovery rates and cure rates<sup>3</sup> per collateral type or per pool (segmentation-based approach).

A major challenge posed by the Basel II regulations is the 'downturn requirement'. The underlying principle is that the LGD is correlated to the PD, and loss rates will be higher in a year with many defaults. This effect has been demonstrated in a number of studies. However, as these studies almost exclusively used market LGD, they are not necessarily relevant for workout LGD.

One explanation for the difference in cyclicity between market LGD and workout LGD is the fact that workout LGD is based on a recovery process that can take several years. In most cases, the workout period will thus include periods of both upturn and downturn economic conditions. Market LGD is based entirely on information one month after default. In downturn economic conditions, the market will be hit by a large supply of defaulted bonds, depressing prices. The classic market mechanism based on supply and demand may prove to be a stronger driver for the 'downturn' recovery rates than the macroeconomic conditions that led to the higher number of defaults.

Data collected from the current credit crisis will help KBC Group to model downturn LGD based on its own portfolios and workout processes.

### Exposure At Default (EAD) models

KBC uses historical information that is available on exposures of defaulted counterparties to model EAD. The EAD model is used to estimate the amount that is expected to be outstanding when a counterparty defaults in the course of the next year.

Measuring EAD tends to be less complicated and generally boils down to clearly defining certain components (discount rate, moment of default and moment of reference) and gathering the appropriate data. In most cases, EAD equals the nominal amount of the facility, but for certain facilities (e.g., those with undrawn commitments) it includes an estimate of future drawings prior to default.

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<sup>3</sup> The cure rate is the percentage of defaulted clients returning to a non-default state.



## Pooling models

A pool is a set of exposures that share the same attributes (characteristics).

Pooling can be based on continuous estimates of PD, LGD and EAD or on other relevant characteristics.

- If pooling is based on continuous estimates of PD, LGD and EAD the pooling merely consists of aggregating the continuous estimates into PD, LGD and EAD bands. The added value of pooling is that exposure can be processed on an aggregate basis, which enhances calculation performance.
- If pooling is based on (other) criteria, loans are aggregated into pools based on these criteria. Since criteria need not be continuous (for example, whether or not there is a current account, which only has two categories) the resulting PD, LGD and EAD estimates are not necessarily on a continuous scale.

## Group-wide framework for dealing with model uncertainty

While KBC makes extensive use of modelling to steer its business processes, it aims to do so in a cautious manner. In particular, it recognises that no value or risk model provides a perfect prediction of future outcomes. Explicit measures for dealing with model risk are therefore imposed. The potential shortcomings of credit risk models are grouped into three categories, each of which is evaluated using a fixed group-wide assessment.

- Known deficiencies are shortcomings for which the size of the error is known in some way. An example is a model implementation where the average model PD differs from the calibration target. For known deficiencies, a correction is applied to the outcome of the model in order to arrive at a best estimate.
- Avoidable uncertainties concern measurements that are known to be uncertain and rectifiable, but for which the size and even the sign of the error is not known. Examples are an uncertainty triggered by a late model review or not timely reassessed PDs. For avoidable uncertainties, capital penalties are imposed as incentives for corrective actions.
- Unavoidable uncertainties are similar to avoidable uncertainties, except that here the uncertainty is inherent and hence not rectifiable. An example is a new credit portfolio for which no relevant historical data can be found. To raise awareness, estimates of potential errors are made for unavoidable uncertainties.

The estimated overall level of uncertainty (avoidable + unavoidable) is clearly communicated to any stakeholder that uses the model outputs.

This framework was adopted from the second quarter of 2010 on, in replacement of a similar one that was in place from the beginning of 2009 on.

## Overview of credit risk models

The table shows information on some of the most relevant PD models used for capital calculations under the IRB Foundation approach. The scope of the tables excludes all pooled retail exposure.

PD models used under the IRB Foundation approach <sup>1</sup>	Exposure granted [gross EAD] In billions of EUR	Central Tendency <sup>2</sup>	Historical default rate <sup>3</sup>	Average Model PD (excl. overrulings) <sup>4</sup>
<b>PD models for government and public sector segments</b>				
(Worldwide) model for central governments	43.1	0.70%	0.00%	0.36%
Czech Municipalities	0.4	0.30%	0.17%	0.30%
Hungarian municipalities	0.4	1.04%	0.83%	0.92%
<b>PD models for corporate and institutional segments</b>				
Asia-Pacific corporates	0.9	1.55%	1.98%	1.60%
US corporates	1.3	1.60%	1.64%	1.60%
Western-European corporates	18.9	1.51%	1.54%	1.88%
Czech corporates and large SMEs	6.5	2.10%	1.73%	1.25%
Hungarian corporates	2.2	3.54%	3.65%	2.41%
(Worldwide) model for banks of which Developed	29.56	0.19%	0.14%	0.32%
of which Others	3.4	1.13%	1.13%	1.59%
(Worldwide) model for project finance	3.0	1.54%	1.81%	1.59%
(Worldwide) model for management buy outs	1.4	2.70%	3.10%	2.68%
<b>PD models for SME segments</b>				
models for Belgian professionals of which liberal professions	0.3	0.58%	0.52%	0.55%
of which self-employed professionals of which private persons	1.3	1.47%	1.52%	1.50%
Belgian farmers	0.5	1.29%	1.29%	1.34%
Belgian SMEs – small businesses	1.2	1.80%	1.61%	1.73%
Czech SMEs	13.4	1.73%	1.73%	1.67%
Hungarian upper SMEs	0.4	2.30%	3.53%	1.39%
	0.2	4.46%	3.83%	4.00%

<sup>1</sup> Non-exhaustive list of models used under the IRB Foundation approach, and excluding all (pooling) models used in the IRB advanced approach.

<sup>2</sup> The central tendency is the average through-the-cycle default probability of a portfolio.

<sup>3</sup> The default rate is the observed number of defaulted obligors during a certain time period as a percentage of total non-defaulted obligors at the beginning of the period (this result is scaled to a one-year period).

<sup>4</sup> The average model PD is the mean PD of all obligors rated according to the model. The value at the time of the latest review is shown.

## **Credit risk related to KBC Insurance**

Notwithstanding the fact that KBC Insurance is not subject to Basel II capital requirements, it holds financial instruments that attract a credit risk. This risk stems primarily from the investment portfolio (i.e. issuers of debt instruments).

Credit risk also arises due to insurance or reinsurance contracts concluded mainly by KBC Insurance. In some cases, however, other entities are also involved.

### **Credit risk in the investment portfolio of KBC Insurance**

Where the insurance activities are concerned, credit exposure exists primarily in the investment portfolio (towards issuers of debt instruments) and towards reinsurance companies. Guidelines for the purpose of controlling credit risk within the investment portfolio are in place with regard to, for instance, portfolio composition and ratings. The table below provides an overview of the total investment portfolio of the group's insurance entities.

Investment portfolio of KBC group insurance entities  
(in millions of EUR, market value)<sup>1</sup>

Per balance sheet item	31-12-2010 <sup>5</sup>	31-12-2011 <sup>5</sup>
Securities	22 677	18 447
Bonds and other fixed-income securities	21 139	17 490
Held to maturity	3 483	3 518
Available for sale	17 448	13 912
At fair value through profit or loss and held for trading	136	49
As loans and receivables	72	9
Shares and other variable-yield securities	1 534	948
Available for sale	1 531	946
At fair value through profit or loss and held for trading	3	2
Other	4	8
Loans and advances to banks	87	20
Property and equipment and investment property	566	381
Investment contracts, unit-linked <sup>2</sup>	7 329	7 652
Other	298	326
<b>Total</b>	<b>30 957</b>	<b>26 824</b>
<b>Details for bonds and other fixed-income securities</b>		
By rating <sup>3,4</sup>		
Investment grade	97%	98%
Non-investment grade	0%	1%
Unrated	3%	1%
Total	100%	100%
By sector <sup>3</sup>		
Governments	66%	66%
Financial	18%	23%
Other	16%	11%
Total	100%	100%
By currency <sup>3</sup>		
Euro	92%	94%
Other European currencies	8%	5%
US dollar	0%	0%
Total	100%	100%
By remaining tenor <sup>3</sup>		
Not more than 1 year	7%	8%
Between 1 and 3 years	22%	22%
Between 3 and 5 years	20%	14%
Between 5 and 10 years	34%	34%
More than 10 years	16%	21%
Total	100%	100%

1 The total carrying value amounted to 26 613 million euros at December 2011 (excl. VITIS Life, Fidea and WARTA) and to 30 732 million euros at December 2010 (excl. VITIS Life).

2 Representing the assets side of unit-linked (class 23) products and completely balanced on the liabilities side. No credit risk involved for KBC Insurance.

3 Excluding investments for unit-linked life insurance. In certain cases, based on extrapolations and estimates.

4 External rating scale.

5 Excluding entities classified as 'disposal groups' under IFRS 5. In 2011, their investment portfolios amounted to 6.5 billion euros (2.2 billion euros at VITIS Life, 3.1 billion euros at Fidea and 1.2 billion euros at Warta), compared with 2.3 billion euros in 2010 (relates solely to VITIS Life's investment portfolio). The scope has changed since the annual report for 2010 and, therefore, the amounts for 2010 have been duly adjusted (intercompanies with both banking and insurance entities have been filtered out in 2011, whereas only insurance intercompanies were eliminated in 2010).

## Credit risk due to insurance or reinsurance contracts

KBC is also exposed to a credit risk in respect of (re)insurance companies, since they could default on their commitments under (re)insurance contracts concluded with KBC. This particular type of credit risk is measured by means of a nominal approach (the maximum loss) and expected loss, among other techniques. Name concentration limits apply. PD – and by extension – expected loss is calculated using internal or external ratings. The exposure at default is determined by adding up the net loss reserves and the premiums, and the loss given default percentage is fixed at 50%.

Credit exposure to (re)insurance companies by risk class <sup>1</sup> : Exposure at Default (EAD) and Expected Loss (EL) <sup>2</sup> (in millions of EUR)	EAD 2010	EL 2010	EAD 2011	EL 2011
AAA up to and including A-	423	0.07	309	0.06
BBB+ up to and including BB-	137	0.13	150	0.17
Below BB-	0	0.00	0	0
Unrated	15	0.34	5	0.10
<b>Total</b>	<b>576</b>	<b>0.54</b>	<b>463</b>	<b>0.33</b>

<sup>1</sup> Based on internal ratings when available, external ratings otherwise

<sup>2</sup> EAD: audited figures; EL: unaudited figures

# Structured credit products

This section deals with KBC's structured credit activities at year-end 2011. These activities relate to Asset-Backed Securities (ABS) and Collateralised Debt Obligations (CDOs), which are defined as follows:

- *ABS* are bonds or notes backed by loans or accounts receivables originated by providers of credit, such as banks and credit card companies. Typically, the originator of the loans or accounts receivables transfers the credit risk to a trust, which pools these assets and repackages them as securities. These securities are then underwritten by brokerage firms, which offer them to the public.
- *CDOs* are a type of asset-backed security and a structured finance product in which a distinct legal entity, a Special Purpose Vehicle (SPV), issues bonds or notes against an investment in an underlying asset pool. Pools may differ with regard to the nature of their underlying assets and can be collateralised either by a portfolio of bonds, loans and other debt obligations, or be backed by synthetic credit exposures through use of credit derivatives and credit-linked notes.

The claims issued against the collateral pool of assets are prioritised in order of seniority by creating different tranches of debt securities, including one or more investment grade classes and an equity/first loss tranche. Senior claims are insulated from default risk to the extent that the more junior tranches absorb credit losses first. As a result, each tranche has a different priority of payment of interest and/or principal and may thus have a different rating.

KBC was active in the field of structured credits both as an originator and an investor. Since mid-2007, KBC has tightened its strategy in this regard (see 'Strategy and processes' below). As an originator, KBC also takes on other roles such as sponsor, when it provides liquidity support to the related SPVs. KBC also invested in structured credit products. These investments appear on KBC's balance sheet.

Apart from briefly describing the procedures and defining the scope, this disclosure provides more insight into:

- structured credit programmes where KBC acts as the originator;
- KBC's investments in structured credit products at year-end 2011, together with information on the credit quality of the securities, an amortisation schedule of the investments, a view on the quality of the underlying collateral, a discussion on valuation and accounting principles, a view on the results of stress tests;
- the capital charges corresponding to the structured credit exposures.

## Strategy and processes

KBC has tightened its strategy during the last five years and has implemented a moratorium on investments in ABS/CDOs and on new originations thereof by KBC Financial Products (a 100% subsidiary of KBC Bank). Over the last year, the risk management of structured credits has been further enhanced by processes centred around KBC's continuing de-risking strategy for structured credit exposures. This is reflected in a number of de-risking trades. More details in this regard can be found in this report and in Note 48 of the 'Consolidated financial statements' section of the 2011 Annual Report of KBC Group NV.

Due to this internal reorganisation, a dedicated risk department was created that focuses exclusively on structured credit positions for the entire KBC group. This department serves as a direct counterpart to the de-risking focused managers of the structured credit positions. It analyses, identifies and advises – from a risk and capital perspective – on proposals from these position managers to reduce the exposure to structured credit positions in the KBC group. It is also responsible for producing consolidated reports on both securitised and re-securitised positions and for submitting them to senior management of KBC and the regulators. In producing these reports, there is no specific or different approach between securitisation and re-securitisation positions, though members of the dedicated risk department have in-depth knowledge about the specific risk drivers. This dedicated team not only reports on positions, but also monitors overall governance to ensure that appropriate decision authorities and business processes are in place at all levels of the organisation.

## Scope of structured credit activities

All KBC group banking (incl. KBL EPB) and insurance entities that engage in structured credit activities are covered in this disclosure.

Over 2011, the number of CDOs and ABS in scope decreased, as some CDOs matured or were terminated and a set of ABS matured and others were sold. More details in this regard are given in the relevant sections below.

## Structured credit programmes for which KBC acts as originator

The structured credit transactions in which KBC entities have an originating role are summarised under this heading. These structured credit operations can be broken down into the following categories:

- structured credit whose underlying assets arise directly from KBC's credit-granting activities
- structured credit involving third-party assets with no sponsoring role for KBC

### Structured credit whose underlying assets arise directly from KBC's credit-granting activities

The main objective of such structured credit is to optimise the balance sheet and to provide additional sources of bank funding. The following structured credit transactions fall under this heading:

Structured credit transactions whose underlying assets arise directly from KBC's credit-granting activities

In millions of EUR – 31-12-2011

Programme	Role	Type of underlying exposure	Nominal amount of the underlying
Home Loan Invest 2007	Originator	Mortgage loans	3 874
Home Loan Invest 2008	Originator	Mortgage loans	2 942
Home Loan Invest 2009	Originator	Mortgage loans	4 700
Home Loan Invest 2011	Originator	Mortgage loans	3 905
Phoenix 2 Funding 2008	Originator	Mortgage loans	6 598
Phoenix 3 Funding 2008	Originator	Mortgage loans	2 798
Phoenix 4 Funding 2009	Originator	Mortgage loans	745

#### Home Loan Invest 2007

Home Loan Invest 2007 is a 'Residential Mortgage-Backed Securities' (RMBS) issue where KBC Bank acts as the originator. An SPV acquired a pool of Belgian residential mortgages granted by KBC and raised funds through the issuance of notes (Class A and Class B Notes, rated 'AAA' and 'Aaa' by Fitch and Moody's, respectively) and KBC's subscription to a subordinated loan of 376 million euros. The notes are eligible as collateral for the European Central Bank (ECB), and thus provide KBC Bank with a liquidity buffer. The portfolio of mortgages is a revolving facility where the number of loans and total amount can vary. At year-end 2011, the portfolio comprised 88 003 loans totalling 3 874 million euros. Since KBC holds the first loss piece in the form of the subordinated loan, the Basel II securitisation framework does not apply to this structured credit programme, as an insufficient amount of the risk incurred has been transferred. Assets are held as regular assets on the balance sheet of KBC Bank and treated accordingly for capital adequacy calculation purposes.

#### Home Loan Invest 2008

Home Loan Invest 2008, which is similar to Home Loan Invest 2007, was set up in November 2008. In January 2011, the vehicle underwent some changes to allow the addition of a Fitch rating for the transaction. A portfolio of 2 942 million euros' worth of Belgian mortgage loans has been securitised. KBC Bank holds the subordinated loan of 442 million euros and notes worth 1 871 million euros, which implies that the Basel II securitisation framework does not apply, as here too an insufficient amount of the risk incurred has been transferred. These notes are also eligible as collateral for the ECB, and thus provide KBC Bank with a liquidity buffer.



### Home Loan Invest 2009

In April 2009 KBC Bank set up its third securitisation transaction. Home Loan Invest 2009 securitised a portfolio of 6 667 million euros' worth of Belgian mortgage loans and set aside a reserve of 60 million euros on account. In January 2011, this deal was restructured to allow the addition of a Fitch rating. KBC Bank holds the subordinated loan of 727 million euros. The SPV issued notes in the amount of 6 000 million euros. At issuance, approximately 350 million euros' worth of notes was placed with external investors, while the rest was retained by KBC Bank. The notes are eligible as collateral for the ECB and thus provide an added liquidity buffer for KBC Bank. The Basel II securitisation framework does not apply, as here too an insufficient amount of the risk incurred has been transferred. Unlike the previous Home Loan Invest transactions, this issue amortises over the tenor of the transaction. At 31 December 2011, the outstanding notes amounted to 4 249 million euros, with notional amounts as shown in the above table. The subordinated loan amount remained unchanged.

### Home Loan Invest 2011

In October 2011 KBC Bank set up its fourth securitisation transaction. Home Loan Invest 2011 securitised a portfolio of 4 351 million euros' worth of Belgian mortgage loans and set aside a reserve of 50 million euros on account. The SPV issued notes in the amount of 3 500 million euros. At issuance, approximately 175 million euros' worth of notes was placed with external investors, while the rest was retained by KBC Bank. The notes are eligible as collateral for the ECB and thus provide an added liquidity buffer for KBC Bank. The Basel II securitisation framework does not apply, as here too an insufficient amount of the risk incurred has been transferred. This issue amortises over the tenor of the transaction. At 31 December 2011, the outstanding notes amounted to 3 413 million euros, with notional amounts as shown in the above table. The subordinated loan amount remained unchanged.

### Phoenix Funding 2

On 16 June 2008, a programme called Phoenix Funding 2 was set up as a source of contingent funding. The SPV has a remaining underlying pool of residential mortgages originated by KBC Bank Ireland<sup>4</sup> (a fully owned subsidiary of KBC Bank), amounting to 6 598 million euros. KBC Bank Ireland has retained all of the notes, which implies that the Basel II securitisation framework does not apply, as an insufficient amount of the risk incurred has been transferred. The notes are divided into two classes, i.e. 86.1% in class A (Moody's 'A1' rating) and 13.9% in class B (Moody's 'A1' rating), maturing in 2050. Following a change in ECB requirements, a second rating was provided for the class A notes with effect from February 2011, viz. an 'A+' rating by Fitch. The Class A notes are eligible for placement with the ECB, thus providing KBC Bank Ireland with a liquidity buffer.

### Phoenix Funding 3

Phoenix Funding 3, which is similar to Phoenix Funding 2, was set up in November 2008. The SPV has a remaining underlying pool of residential mortgages originated by KBC Bank Ireland worth 2 798 million euros. KBC Bank Ireland has retained all of the notes, which implies that the Basel II securitisation framework does not apply, as an insufficient amount of the risk incurred has been transferred. The notes are split into two classes, i.e. 88.6% in class A (Moody's 'A1' rating) and 11.4% in class B (the class B notes are not rated), maturing in 2050. Following a change in ECB requirements a second rating was provided for the class A notes with effect from February 2011, viz an 'A+' rating by Fitch. The class A notes are eligible for placement with the ECB, thus providing KBC Bank Ireland with a liquidity buffer.

### Phoenix Funding 4

Phoenix Funding 4 was set up on 4 August 2009. The SPV has a remaining underlying pool of residential mortgages originated by KBC Bank Ireland plc worth 745 million euros. KBC Bank Ireland plc has retained all of the notes. The notes are split into two classes, i.e. 88% in class A (Moody's 'A1' rating) and 12% in class B (the class B notes are not rated), maturing in 2046. Following a change in ECB requirements, a second rating was provided for the class A notes with effect from February 2011, viz. an 'A+'-rating by Fitch. The class A notes of Phoenix Funding 4 are eligible for placement with the ECB.

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<sup>4</sup> In 2009, KBC Homeloans merged with KBC Bank Ireland.

## Structured credit involving third-party assets with no sponsoring role for KBC

The purpose of this business line was to generate fee income for KBC as an originator of structured credit. The credit risk related to the underlying assets is transferred to investors. The following existing structured credit programmes fall under this heading:

Structured credit programmes involving third-party assets with no sponsoring role for KBC

In millions of EUR – 31-12-2011

Programme	Roles	Type of underlying exposure	Nominal amount of the underlying
KBC FP CDO deals with ABS	Originator	Corporate reference names and/or ABS	18 543
KBC FP CDO deals without ABS	Originator	Corporate reference names	1 200

KBC Financial Products has structured synthetic Collateralised Debt Obligation (CDO) deals. These CDOs relate to a pool of reference entities that are selected and monitored by KBC Financial Products. The underlying pools generally consist of either corporate reference names (on average 86%) and ABS (on average 14%, part of which entails exposure to subprime loans), or are made up entirely of corporate reference names.

The CDOs structured by KBC Financial Products are managed CDOs, whereby the manager has the option to conclude substitutions in the underlying asset portfolios of the CDOs. There were no such substitutions in 2011.

The capital structure of a CDO deal comprises several tranches, each representing a certain credit risk profile. These tranches are, in increasing order of seniority:

- the equity pieces, which are always held on the books of KBC and are fully provisioned as of origination date;
- a number of classes of (credit-linked) notes which have obtained external ratings;
- the super senior portion of the CDO deal structure, which is partly hedged and partly unhedged (further information below).

## KBC's structured credit position (where KBC acts as investor)

Under this heading, information is provided on KBC group structured credit investments booked in both the banking and trading portfolios and covering hedged and unhedged CDOs, and other ABS exposure. Firstly, an overview is given of the overall exposure, including more details on the hedge counterparties, followed by an overview of the credit quality of the securities, an amortisation schedule and details on the credit quality of the underlying assets of the securities. Lastly, the valuation principles, accounting principles and stress tests are examined.

### Overall exposure

In millions of EUR – 31-12-2011	31-12-2010	31-12-2011
KBC investments in structured credit products (CDOs and other ABS)		
Total nominal amount	27 215	20 447
<i>of which hedged CDO exposure</i>	14 857	10 855
<i>of which unhedged CDO exposure</i>	7 679	6 448
<i>of which other ABS exposure</i>	4 678	3 144
Cumulative value markdowns (mid 2007 to date)	-6 345	-5 494
<i>of which value markdowns</i>	-5 163	-4 540
<i>for unhedged CDO exposure</i>	-4 185	-4 101
<i>for other ABS exposure</i>	- 978	- 440
<i>of which Credit Value Adjustment (CVA) on MBIA cover</i>	-1 182	-954

In 2011, the total nominal amount decreased by -6.8 billion euros, due to the:

- Chiswell CDO reaching maturity (-1.4 billion euros hedged CDO exposure and -0.2 billion euros of unhedged exposure).
- Sale of the Avebury CDO (-0.5 billion euros unhedged CDO exposure).
- Lancaster CDO being unwound (-0.4 billion euros of hedged CDO exposure and -0.1 billion euros of unhedged exposure).

- Early termination of the Fulham Road CDO (-1.7 billion euros of hedged CDO exposure and -0.3 billion euros of unhedged CDO exposure).
- Sale of KBC's exposure in the Wadsworth CDO (-0.5 billion euros of hedged CDO exposure).
- Sale of the underlying ABS-assets for the expired Aldersgate and Chiswell CDO's (-0.3 billion euros).
- Sale of impaired assets on KBC Bank's balance sheet, along with some minor sales, amortisations and prepayments (-1.4 billion euros of other ABS exposure and CDO exposure).

## Overview: remaining exposure of KBC Group CDOs

As mentioned in the 'Additional Information' section of the 2011 Annual Report of KBC Group NV, the notional amount at risk has been lowered due to the Guarantee Agreement (PPA – Portfolio Protection Agreement). In order to provide an overview of this and to show which parts of the KBC portfolio are affected, the table below indicates the adjusted notional amount and the remaining exposure for all CDO positions held by KBC Group. Please note that this exposure is the amount if all the underlying assets default and there is zero recovery (please refer to the tables below showing the credit quality of underlying collateral) and, in addition, the counterparty of the hedged exposure (MBIA) also defaults with zero recovery, which is not a realistic scenario.

Since the inception, KBC-owned positions arising from CDOs issued by KBC Financial Products have experienced net effective losses caused by claimed credit events until 9 January 2012 in the lower tranches of the CDO structure totalling -2.1 billion euros (recorded under 'not covered by PPA' in the table below). Of these, -1.8 billion euros' worth of events have been settled. These have had no further impact on P/L, because complete markdowns for these tranches had already been absorbed in P/L in the past.

In millions of EUR – 31-12-2011			
	Notional amount	Notional amount (allowing for PPA)	Remaining exposure for KBC Group (allowing for markdowns and PPA)
Hedged CDO exposure	10 855	3 143	2 189
Unhedged CDO exposure	6 448	4 855	634
<i>Of which covered by PPA</i>	3 046	1 453	372
<i>Of which not covered by PPA</i>	3 402	3 402	262

## Hedged CDO exposure

Details of the hedged CDO exposure (insurance for CDO-linked risks received from MBIA)  
In millions of EUR

31-12-2010 31-12-2011

Total insured amount (notional amount of super senior swaps) <sup>1</sup>	14 416	10 855
Details for MBIA insurance coverage		
- Fair value of insurance coverage received (modelled replacement value, after taking the Guarantee Agreement into account)	1 688	1 362
- CVA for counterparty risk, MBIA	-1 182	-954
(as a % of fair value of insurance coverage received)	70%	70%

<sup>1</sup> The amount insured by MBIA is included in the Guarantee Agreement with the Belgian State (14 May 2009).

The super senior portions of CDOs originated by KBC Financial Products are mostly hedged via swap contracts with MBIA, a US monoline insurer.

In February 2009, MBIA announced a restructuring plan, which included a spin-off of valuable assets, provoking a steep decline in its creditworthiness. The increase of the market value of the underlying swap in combination with the increased counterparty risk, resulted in significant additional negative value adjustments at KBC. KBC and other institutions filed court cases after MBIA announced its restructuring plan. After reaching an out of court settlement with MBIA, KBC dropped out of the litigation on 6 September 2011. However, this has no impact on the protection bought from MBIA for the still outstanding CDOs. Moreover, the remaining risk related to MBIA's insurance coverage is to a large extent mitigated, as it is included in the scope of the Guarantee Agreement that was agreed with the Belgian State on 14 May 2009 (see the 'Additional information' section in the 2011 Annual Report of KBC Group NV (see [www.kbc.com](http://www.kbc.com))).

KBC has not granted any straightforward credit facilities to the above credit insurer, but is exposed to (i) reinsurance cover received for CDOs and (ii) credit enhancement received for liquidity facilities granted by KBC to public finance and healthcare sector counterparties. The underlying public finance counterparties of the liquidity facilities carry high ratings.

In addition, there is also indirect corporate credit exposure to credit insurers within the collateral pool of the CDOs held, which is reflected in the overall valuation of the CDO exposure (fair value approach, as described below).

### Unhedged KBC group investment in structured credit (31-12-2011)

This heading relates to the CDOs which KBC bought as investments and which are not 'insured' by credit protection from MBIA or any other external credit insurer (i.e. the 'unhedged CDO exposure') and other ABS in portfolio.

The total nominal amount outstanding in the unhedged portfolio fell by 2.8 billion euros, due to the maturing of 'Chiswell', the unwinding of 'Lancaster', the early termination of 'Fulham', the sale of various assets, along with prepayments and amortisations (for an exhaustive list, please see the 'KBC's structured credit position' section above).

Please note that a portion of the risk attached to unhedged KBC group investments in CDOs is mitigated, due to the fact that the unhedged super senior CDO tranches are fully included in the Asset Protection Plan concluded with the Belgian State (see the 'Additional information' section in the 2011 Annual Report of KBC Group NV (see [www.kbc.com](http://www.kbc.com))).

In 2011, KBC also concluded several out-of-court settlement agreements with clients in Belgium, Slovakia and Hungary, who had invested in CDOs issued by KBC Financial Products.

### Credit quality of securities held (31-12-2011)

An overview of the quality of the notes and super senior swaps held at year-end 2011 is shown in the table below.

Credit quality of securities held – based on Moody's ratings

Amounts at nominal value - in millions of EUR – 31-12-2011

	Super Senior (SS)	Aaa	Aa	A	Baa	<Baa3	Unrated	Total
Hedged CDO exposure	10 855 <sup>1</sup>	-	-	-	-	-	-	10 855
Unhedged CDOs <sup>2</sup>	2 998	-	62	-	7	92	1 400	4 559 <sup>5</sup>
Other ABS	-	1 291	927	412	184	307	23	3 144
Total for 2011 <sup>4</sup>	13 853	1 291	989	412	191	399	1 423	18 558
Total for 2010 <sup>3</sup>	18 450	2 682	776	259	115	3 334	73	25 688

<sup>1</sup> Positions hedged by MBIA.

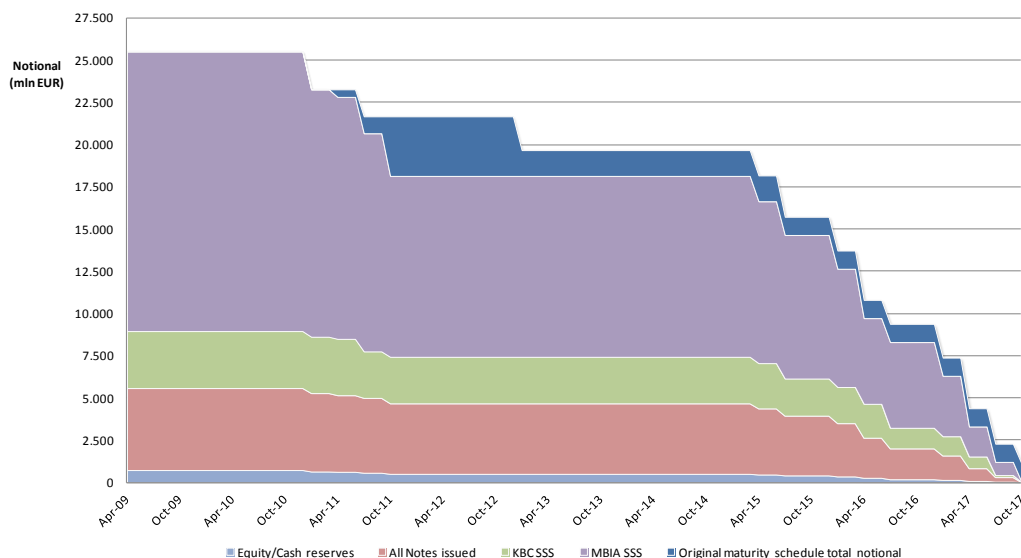
<sup>2</sup> All unhedged positions in the scope of the Guarantee Agreement signed with the Belgian State (see the 'Additional information' section in the 2011 Annual Report of KBC Group NV (see [www.kbc.com](http://www.kbc.com))).

<sup>3</sup> Figures are net of equity and junior CDO pieces, settled credit events, prepayments and retained ABS hedges for Aldersgate.

<sup>4</sup> Figures are net of equity and junior CDO pieces, settled credit events, prepayments.

<sup>5</sup> Settled defaulted names and paydowns (1.9 billion euros) not taken into account.

## Maturity schedule for CDO positions issued by KBC Financial Products



The above graph shows how the CDOs originated by KBC Financial Products amortise over the next number of years (this schedule excludes the impact of the de-risking that took place in January 2012). It should be noted that KBC is continuing to look at reducing ABS and CDO exposure and thus further de-risking would affect the maturity schedule. The first drop in the maturity schedule is when the Clifton CDO matures (in April 2015). By year-end 2017, all CDOs issued by KBC Financial Products are expected to have matured.

## Overview of the underlying collateral of the securities held (31-12-2011)

The next tables provide a breakdown of the underlying collateral of the CDO portfolio (both hedged and unhedged) and the other ABS portfolio. They contain more detailed information on KBC's subprime exposure, on the quality of the underlying collateral and on the breakdown of corporate reference names according to sector and region. The figures are net of provisions for equity and junior CDO pieces, settled credit events, prepayments and retained ABS hedges.

## Hedged Portfolio

Credit quality of underlying collateral of CDO held – based on Moody's ratings  
in millions of EUR - 31-12-2011

		Aaa	Aa	A	Baa	Ba	B	Caa	<Caa3	NR	Total
<b>Corporates</b>		<b>3</b>	<b>249</b>	<b>1 513</b>	<b>4 202</b>	<b>1 857</b>	<b>904</b>	<b>462</b>	<b>797</b>	<b>297</b>	<b>10 283</b>
<b>Sector</b>	Buildings & Real Estate	-	-	50	968	290	190	35	50	71	1 653
	Banking	-	33	490	284	82	29	-	283	4	1 205
	Insurance	-	161	173	386	3	67	133	175	1	1 099
	Finance	-	50	165	117	253	147	47	139	11	928
	Mining, Steel, Iron & Nonprecious Metal	-	-	101	332	41	39	-	-	7	520
	Printing & Publishing	-	-	-	70	276	85	60	-	11	502
	Retail Stores	-	-	40	142	162	65	47	-	2	458
	Automobile	-	-	37	178	148	16	-	-	3	382
	Telecommunications	-	2	126	162	15	10	46	-	12	374
	Oil & Gas	3	-	30	247	79	-	-	-	7	366
	Utilities	-	3	62	254	20	1	3	-	17	359
	Electronics	-	-	25	67	119	5	5	59	19	299
	Other	-	1	213	994	371	251	85	92	130	2 137
<b>Region</b>	US	3	219	485	2 471	1 226	570	435	446	-	5 855
	EU	-	26	371	1 105	382	258	28	154	-	2 323
	ASIA	-	4	445	384	272	54	-	170	-	1 329
	LATIN AMERICA	-	4	52	87	9	-	-	31	-	182
	OTHER	-	3	205	298	33	50	4	-	-	594
<b>CMBS</b>		-	<b>1</b>	-	-	-	-	<b>2</b>	-	-	<b>3</b>
<b>RMBS</b>		-	-	-	-	-	<b>10</b>	<b>10</b>	<b>375</b>	-	<b>396</b>
<b>Origin</b>	PRIME	-	-	-	-	-	-	-	-	-	-
	ALT-A	-	-	-	-	-	1	-	77	-	78
	Alt-A (<2005 vintage)	-	-	-	-	-	1	-	2	-	3
	Alt-A (2005-2008 vintage)	-	-	-	-	-	-	-	75	-	75
<b>SUBPRIME</b>		-	-	-	-	-	9	10	298	-	318
	Subprime (<2005 vintage)	-	-	-	-	-	-	7	39	-	47
	Subprime (2005-2008 vintage)	-	-	-	-	-	9	3	259	-	272
<b>region</b>	US	-	-	-	-	-	10	10	375	-	396
<b>OTHER ABS</b>		<b>4</b>	<b>14</b>	<b>19</b>	<b>18</b>	<b>11</b>	-	-	-	<b>33</b>	<b>97</b>
<b>CDO</b>		<b>7</b>	<b>2</b>	-	-	<b>13</b>	<b>8</b>	<b>5</b>	<b>36</b>	<b>4</b>	<b>76</b>
<b>Total</b>		<b>14</b>	<b>265</b>	<b>1 530</b>	<b>4 219</b>	<b>1 882</b>	<b>922</b>	<b>480</b>	<b>1 208</b>	<b>334</b>	<b>10 855</b>

'Full look through approach', which means that the subordination of the notes held is not taken into account.

## Unhedged Portfolio

Credit quality of underlying collateral of CDO held – based on Moody's ratings  
in million of EUR - 31-12-2011

		Aaa	Aa	A	Baa	Ba	B	Caa	<Caa3	NR	Total
<b>Corporates</b>		<b>1</b>	<b>105</b>	<b>636</b>	<b>1 765</b>	<b>780</b>	<b>380</b>	<b>194</b>	<b>335</b>	<b>125</b>	<b>4 319</b>
<b>Sector</b>	Buildings & Real Estate	-	-	21	407	122	80	15	21	30	694
	Banking	-	14	206	119	34	12	-	119	2	506
	Insurance	-	67	73	162	1	28	56	73	-	462
	Finance	-	21	69	49	106	62	20	58	4	390
	Mining, Steel, Iron & Nonprecious Metal	-	-	42	139	17	16	-	-	3	218
	Printing & Publishing	-	-	-	29	116	36	25	-	5	211
	Retail Stores	-	-	17	60	68	27	20	-	1	192
	Automobile	-	-	16	75	62	7	-	-	1	161
	Telecommunications	-	1	53	68	6	4	19	-	5	157
	Oil & Gas	1	-	13	104	33	-	-	-	3	154
	Utilities	-	1	26	107	8	-	1	-	7	151
	Electronics	-	-	11	28	50	2	2	25	8	126
	Other	-	-	90	418	156	105	36	39	55	898
<b>Region</b>	US	1	92	204	1 038	515	240	183	187	-	2 459
	EU	-	11	156	464	160	109	12	65	-	976
	ASIA	-	2	187	161	114	23	-	71	-	558
	LATIN AMERICA	-	2	22	36	4	-	-	13	-	76
	OTHER	-	1	86	125	14	21	2	-	-	249
<b>CMBS</b>		-	-	-	-	-	-	<b>1</b>	-	-	<b>1</b>
<b>RMBS</b>		-	-	-	-	-	<b>4</b>	<b>4</b>	<b>158</b>	-	<b>166</b>
<b>Origin</b>	PRIME	-	-	-	-	-	-	-	-	-	-
	ALT-A	-	-	-	-	-	-	-	32	-	33
	Alt-A (<2005 vintage)	-	-	-	-	-	-	-	1	-	1
	Alt-A (2005-2008 vintage)	-	-	-	-	-	-	-	31	-	31
	SUBPRIME	-	-	-	-	-	4	4	125	-	134
	Subprime (<2005 vintage)	-	-	-	-	-	-	3	16	-	20
	Subprime (2005-2008 vintage)	-	-	-	-	-	4	1	109	-	114
<b>Region</b>	US	-	-	-	-	-	4	4	158	-	166
<b>OTHER ABS</b>		<b>2</b>	<b>6</b>	<b>7</b>	<b>7</b>	<b>5</b>	-	-	-	<b>14</b>	<b>41</b>
<b>CDO</b>		<b>3</b>	<b>1</b>	-	-	<b>6</b>	<b>3</b>	<b>2</b>	<b>15</b>	<b>2</b>	<b>32</b>
<b>Total</b>		<b>6</b>	<b>111</b>	<b>642</b>	<b>1 772</b>	<b>790</b>	<b>387</b>	<b>202</b>	<b>508</b>	<b>140</b>	<b>4 559</b>

'Full look through approach', which means that the subordination of the notes held is not taken into account.

'Settled defaulted names and paydowns (1.9 billion euros) not taken into account'.

## Other ABS exposure: breakdown by type and quality

### Rating and type breakdown of ABS held

Moody's ratings - amounts at nominal value - in millions of EUR - 31-12-2011

		Aaa	Aa	A	Baa	Ba	B	Caa	<=Caa3	NR	Total
<b>CMBS</b>		<b>6</b>	<b>18</b>	<b>37</b>	<b>21</b>	<b>17</b>	-	-	-	-	<b>99</b>
<b>RMBS</b>		<b>1 039</b>	<b>596</b>	<b>346</b>	<b>149</b>	<b>72</b>	<b>54</b>	<b>75</b>	<b>86</b>	<b>23</b>	<b>2 439</b>
<b>Origin</b>	PRIME	1 018	586	340	148	58	28	-	-	-	2 178
	Prime (<2005 vintage)	610	420	227	118	40	20	-	-	-	1 435
	Prime (2005-2008 vintage)	408	166	114	31	18	8	-	-	-	743
	ALT-A	-	-	6	-	-	6	75	-	-	87
	Alt-A (<2005 vintage)	-	-	6	-	-	-	-	-	-	6
	Alt-A (2005-2008 vintage)	-	-	-	-	-	6	75	-	-	81
	SUBPRIME	21	10	-	-	14	20	-	86	23	174
	Subprime (<2005 vintage)	11	10	-	-	3	1	-	-	-	25
	Subprime (2005-2008 vintage)	10	-	-	-	11	19	-	86	23	149
<b>Region</b>	US	21	263	6	1	15	26	75	109	-	515
	ES	369	237	120	24	24	-	-	-	-	774
	PT	-	-	205	109	-	-	-	-	-	314
	IT	314	28	8	-	-	-	-	-	-	350
	NL	302	20	-	-	-	-	-	-	-	322
	UK	20	45	-	-	-	-	-	-	-	65
	OTHER	14	3	7	14	34	27	-	-	-	99
	GR	-	-	-	-	34	27	-	-	-	61
	BE	5	2	3	-	-	-	-	-	-	10
	AU	4	2	1	-	-	-	-	-	-	7
	GE	-	-	-	-	-	-	-	-	-	-
	IR	-	-	-	14	-	-	-	-	-	14
	KOR	4	-	-	-	-	-	-	-	-	4
	FR	-	-	-	-	-	-	-	-	-	-
	West Eur	-	-	3	-	-	-	-	-	-	3
<b>OTHER ABS</b>		<b>246</b>	<b>312</b>	<b>19</b>	<b>14</b>	-	-	<b>4</b>	-	-	<b>606</b>
<b>Type</b>	CLO	116	281	-	-	-	-	-	-	-	397
	Leases	19	28	-	6	-	-	-	-	-	52
	SME loans	18	4	27	5	-	-	-	-	-	55
	Consumer Loans	4	-	1	-	-	-	-	-	-	5
	Auto Loans/Leases	22	-	-	2	-	-	-	-	-	24
	other	67	-	2	1	-	-	4	-	-	74
<b>Total</b>		<b>1 291</b>	<b>927</b>	<b>412</b>	<b>184</b>	<b>89</b>	<b>54</b>	<b>78</b>	<b>86</b>	<b>23</b>	<b>3 144</b>



## Valuation and accounting principles

Multiple valuation techniques are used to determine the market value of the CDO/ABS portfolio.

For CDOs, KBC applies a level-3 valuation technique. The Gaussian Copula model models the distribution of default times of the underlying corporate and ABS names in the reference portfolios of the CDO transactions. The asset default trigger in the model is derived from the credit default swap spreads in the market. The correlation between the default times is modelled through Gaussian Copulas<sup>5</sup> and can as such be simulated. By discounting the cashflows resulting from the default time curves on the underlying assets, a value for a specific CDO tranche is determined. The model also ensures that the inner tranches are valued in line with the market, through the calibration with CDX and iTraxx credit spread indices.

For the valuation of the non-super senior positions, the fundamental value (see below) of the positions is also taken into account.

It should be noted that value adjustments to KBC's CDOs are accounted for via profit and loss (instead of directly via shareholders' equity), since the group's CDOs are mostly of a synthetic nature (meaning that the underlying assets are derivative products such as credit default swaps on corporate names). Their synthetic nature is also the reason why KBC's CDOs are not eligible for accounting reclassification under IFRS in order to neutralise their impact.

Securitisation activities are accounted for under IFRS according to the guidelines provided by 'IAS 39 Financial Instruments: Recognition and Measurement' and 'SIC 12 Consolidation – Special Purpose Entities.

The derecognition rules of IAS 39 determine when the securitised assets may be derecognised from the balance sheet. This is the case when the contractual rights to receive the cash flows of the financial asset are transferred or retained but 'passed through' and substantially all the risk and rewards of ownership of the asset are transferred.

In many cases Special Purpose Entities are set-up for securitisation activities. SIC 12 determines that a company should consolidate this entity if

- (i) it is undertaking activities on its behalf and its benefits;
- (ii) it effectively controls the SPE;
- (iii) it has the majority of the residual or ownership risks of the SPE, or;
- (iv) it receives the majority of the benefits of the SPE.

## Stress-test results for KBC group investments in structured credits (31-12-2011)

Two sorts of stress tests have been conducted on the (hedged and unhedged) portfolio of investments in CDOs originated by KBC Financial Products, namely (i) stress tests with an effect on credit default and (ii) stress tests with an impact on P/L. The first type of test determines the (credit) loss in the case of defaults and losses in the assets underlying the CDOs. The second type shows the (market) loss when the main parameters in the valuation of the CDOs originated by KBC Financial Products are stressed.

### *Stress tests with an effect on credit default*

Since mid-2008, KBC has used the concept of 'fundamental value' for the CDOs issued by KBC Financial Products. This aims to estimate how (expected) credit events – when claimed, verified and settled – would affect the principal amounts of the CDO tranches, according to the waterfall structure (reversed seniority). It serves as a reasonable prediction of the redemption value of the CDOs originated by KBC Financial Products at or around the respective expected maturity dates. The calculation of the fundamental value (referred to as the *fundamental value scenario* in the table below) is based on ABS credit events actually claimed and expected losses on ABS, and a 16% loss in the underlying corporate portfolio (which also includes credit events actually claimed and expected cumulative losses).

In addition, a further stressed fundamental analysis was performed under the following test assumptions:

*Stress scenario 1:* ABS credit events actually claimed and expected losses on ABS, and a 19% loss in the underlying corporate portfolio (which also includes credit events actually claimed and expected cumulative losses).

*Stress scenario 2:* ABS credit events actually claimed and expected losses on ABS, and a 29% loss in the underlying corporate portfolio (which also includes credit events actually claimed and expected cumulative losses).

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<sup>5</sup> A Gaussian Copula is a dependency structure, which in this case indicates how default events are inter-related.

The results of these scenarios are summarised in the table<sup>1,2</sup>

Stress-test results on credit default			
In millions of EUR - 31-12-2011			
	Notional	Estimated loss	Estimated loss as % of notional
Fundamental value scenario			
Unhedged portfolio	5 657	3 169	56.0 %
Hedged portfolio	10 855	217	2.0 %
Stress scenario 1			
Unhedged Portfolio	5 657	3 355	59.3 %
Hedged portfolio	10 855	549	5.1 %
Stress scenario 2			
Unhedged Scenario	5 657	3 769	66.6 %
Hedged Scenario	10 855	1 704	15.7 %

1 Account taken of the Guarantee Agreement with the Belgian State.

2 Nominal value unhedged portfolio (excl. equity and junior pieces).

#### Stress tests with effect on P/L

KBC has calculated the impact of two stress test scenarios in terms of changes in credit spreads (an increase or decrease by 10%, 20% and 50%, respectively) on the hedged and unhedged portfolio of CDOs originated by KBC Financial Products (nominal value in scope of 17.1 billion euros, > 90% of total investments in CDOs).

The calculations take into account the impact of the Guarantee Agreement signed with the Belgian State, which reduces the volatility of the super senior positions in scope on P/L. The provisioning rate of 70% for MBIA has also been taken into account.

#### Stress test result on the market sensitivity of CDOs

In millions of EUR – 31-12-2011 (pre-tax)

	Market valuation sensitivity	Stress test result
Test assumptions	Credit spreads in December x 1.10	-117
	Credit spreads in December x 1.20	-224
	Credit spreads in December x 1.50	-505
Test assumptions	Credit spreads in December x 0.90	128
	Credit spreads in December x 0.80	267
	Credit spreads in December x 0.50	782

## Structured credit exposure – capital charges

Regulatory capital requirements for structured credit positions are held against credit and market risks related to such products and positions. Market risk (trading) regulatory capital requirements are determined through the new CRD III requirements. Under Basel II, there are different approaches available to determine the required capital for credit risk. The treatment used for the different structured credit programmes is described throughout this report. The investment positions are dealt with under the Rating-Based Approach (RBA), with the exception of KBC Asset Management, ČSOB SR and KBL EPB, which report under the Basel II Standardised Approach.

As regards the investments in structured credit products, the risk weightings applied for regulatory capital calculations are linked directly to the rating of the structured credit products invested in. A further distinction is made depending on their classification as securitisation or re-securitisation (see CRD III, implemented at year-end 2011) and whether they are senior or non-senior positions. Since these risk weightings rise sharply when ratings fall, downgrades of the structured credit invested in have a serious impact on the capital charge. The exposure amount to which the risk weights are applied, depends on the IFRS classification.

Regulatory capital only has to be held by banking entities. Insurance entities are not required to hold this capital, but this situation will change when the Solvency II regulations are implemented.

31-12-2011 in mln EUR	Securitisation	Re- securitisation	Total nominal amount	Total EAD for CRD III	of which 6 - 18%	of which 20 - 850%	of which 850% - 1250%	RWA 31-12-11
<b>Banking entities</b>								
<b>Trading book</b>	<b>247</b>	<b>12.412</b>	<b>12.659</b>	<b>374</b>	<b>-</b>	<b>297</b>	<b>77</b>	<b>1.196</b>
Hedged CDO exposure	-	10.855	10.855	-	-	-	-	-
<i>of which senior positions</i>	-	10.855	10.855	-	-	-	-	-
<i>of which non-senior positions</i>	-	-	-	-	-	-	-	-
Unhedged CDO exposure	-	1.557	1.557	121	-	44	77	1.145
<i>of which senior positions</i>	-	914	914	119	-	44	75	1.118
<i>of which non-senior positions</i>	-	643	643	2	-	-	2	27
Other ABS exposure	247	-	247	253	-	253	-	51
<i>of which senior positions</i>	247	-	247	253	-	253	-	51
<i>of which non-senior positions</i>								
<b>Banking book</b>	<b>2.970</b>	<b>2.485</b>	<b>5.454</b>	<b>2.962</b>	<b>1.978</b>	<b>668</b>	<b>316</b>	<b>4.673</b>
Hedged CDO exposure	-	-	-	-	-	-	-	-
<i>of which senior positions</i>	-	-	-	-	-	-	-	-
<i>of which non-senior positions</i>	-	-	-	-	-	-	-	-
Unhedged CDO exposure	107	2.475	2.581	187	-	109	78	1.324
<i>of which senior positions</i>	107	10	117	111	-	98	13	494
<i>of which non-senior positions</i>	-	2.465	2.465	76	-	11	65	831
Other ABS exposure	2.863	10	2.873	2.775	1.978	559	237	3.348
<i>of which senior positions</i>	2.762	10	2.772	2.674	1.902	534	237	3.331
<i>of which non-senior positions</i>	102	-	102	101	76	25	-	17
<b>Total banking entities</b>	<b>3.217</b>	<b>14.897</b>	<b>18.114</b>	<b>3.336</b>	<b>1.978</b>	<b>965</b>	<b>393</b>	<b>5.868</b>
<b>Insurance entities</b>								
Unhedged CDO exposure	45	2.264	2.309					
Other ABS exposure	24		24					
<b>Total insurance entities</b>	<b>69</b>	<b>2.264</b>	<b>2.333</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Total nominal amount KBC Group</b>	<b>3.286</b>	<b>17.161</b>	<b>20.447</b>					
Client credit facility <sup>1</sup>	N/A	N/A	337	N/A	N/A	N/A	N/A	32
ABS Protection at KBC FP <sup>2</sup>	463	112	575	120	21	42	58	758
<b>Total capital charge</b>				<b>3.456</b>	<b>1.999</b>	<b>1.007</b>	<b>451</b>	<b>6.658</b>

1. For historical reasons, this credit facility, with receivables as collateral, is provided to a single client in the form of commercial paper, all of which is held by KBC Group. It is therefore subject to the Supervisory Formula Approach for the purpose of capital adequacy calculations. It therefore can't be broken down according to the Rating Based Approach but is included in this table for completeness.

2. This ABS protection is retained at KBC FP to facilitate the de-risking process, but does attract Regulatory Capital.

# Market risk management (non- trading)

The process of managing KBC's structural exposure to market risks (including interest rate risk, equity risk, real estate risk, foreign exchange risk and inflation risk) is also known as Asset/Liability Management (ALM).

'Structural exposure' encompasses all exposure inherent in the commercial activity of KBC or the long-term positions held by the group (banking and insurance). Trading activities are consequently not included. Structural exposure can also be described as a combination of:

- mismatches in the banking activities linked to the branch network's acquisition of working funds and the use of those funds (via lending, among other things);
- mismatches in the insurance activities between liabilities in the non-life and life businesses and the cover for these liabilities present in the investment portfolios held for this purpose;
- the risks associated with holding an investment portfolio for the purpose of reinvesting shareholders' equity;
- the structural currency exposure stemming from the activities abroad (investments in foreign currency, results posted at branches or subsidiaries abroad, exchange risk linked to the currency mismatch between the insurer's liabilities and its investments).

## Strategy and processes

Market risk in non-trading activities is managed by the ALCO, supported by the Group Treasury function, which is the first line of defence with regard to this activity. The second line of defence, i.e. risk control, is the responsibility of a team in the Group Value and Risk Management Directorate. This team supports the GRCOC and Group Executive Committee by providing advice and drawing up reports. Similar teams exist at the different business units.

The Group Treasury function develops and implements the ALM strategies which have been approved by the ALCO, within the boundaries of the ALM Risk Management Framework developed by the Group Value and Risk Management Directorate.

The main building blocks of KBC's ALM Risk Management Framework are:

- a focus on 'economic value' as the cornerstone of ALM policy, with attention also being paid to criteria such as income, solvency and liquidity.
- the use of a uniform ALM measurement methodology for banking and insurance activities based on 'fair value models' that forecast the value of a product group under different market scenarios and that are translated into replicating portfolios (combinations of market instruments that allow the relevant product groups to be hedged with the lowest risk).
- the use of a Value-at-Risk (VAR) measurement method for the various categories of risk throughout the group for risk budgeting and limit-setting purposes. This VAR measures the maximum loss that might be sustained over a one-year time horizon with a certain confidence level, as a result of movements in interest rates and other fluctuations in market risk factors.
- the definition of an ALM VAR limit at group level and the breakdown of this limit into various types of risk and entities.
- the use of VAR, which is calculated using fair value models for non-maturing products, taking into account different embedded options and guarantees in the portfolio.
- the use of other risk measurement methods, such as Basis-Point-Value (BPV), notional amounts, etc., to supplement VAR.

KBC group non-trading market risk, by risk category (VAR 99%, 1-year time horizon, marginal contribution of various risk types to VAR) - (in billions of EUR) <sup>1</sup>	31-12-2010	31-12-2011
Interest rate risk	0.90	0.67
Equity risk	0.57	0.19
Real estate risk	0.10	0.06
Other risks <sup>2</sup>	0.11	0.05
<b>Total diversified VAR (group)</b>	<b>1.68</b>	<b>0.96</b>

<sup>1</sup> Excluding a number of small group companies. The VAR in this table does not yet capture the following (material) risks: corporate credit spread, sovereign credit spread and cyclical prepayment options embedded in mortgage loans. Excluding entities classified as 'disposal groups' under IFRS 5. Their impact on the group's ALM VAR was 90 million euros at year-end 2010 and 89 million euros at year-end 2011.

<sup>2</sup> Foreign exchange risk and inflation risk.

## Scope of non-trading market risk disclosures

The ALM framework is applicable to all material KBC group entities that are subject to non-trading market risks. In practice, this means all entities of the KBC group with the exception of entities that only conduct trading activities. In banking entities with both trading and other activities, the balance sheet is split into a trading book and a banking book, with ALM only dealing with the risks incurred in the banking book.

Equity risk and interest rate risk account for the lion's share of the total risk and will thus be discussed in more detail. However, real estate risk, inflation risk and foreign exchange risk are also briefly addressed below.

## Interest rate risk

### Interest rate risk for the banking activities

All the commercial production activity of the bank (credit, deposits, etc.) is actively managed in a risk-neutral way. There is no active interest rate risk-taking in funding or investing client-driven production. Active interest rate risk-taking is organised in separate positions for which a separate profit/loss account is kept that can be set off against the economic capital required for the ALM risks taken.

KBC Bank's non-trading interest rate positions are managed via a system of market-oriented internal pricing for products with a fixed maturity date (dated products) and via a replicating portfolio technique for products without a fixed maturity date (undated products: e.g., current and savings accounts). For the latter, a benchmark maturity mix and a core amount are established and reviewed on a dynamic basis in order to incorporate them into the internal risk-measurement system. The fair value model for saving accounts is based on a volume formula and a tariff formula. The volume formula is used to calculate the outstanding volume of the non-maturing instruments based on market-drivers (current volume, current interest rate and spread between market rate and tariff rate). The tariff formula is used to calculate the tariff rate given the outstanding volume.

The bank's capital and reserves are invested in fixed assets, strategic shareholdings and government bonds. The bank may also take interest rate positions with a view to acquiring interest income.

Two main techniques are used to measure interest rate risks: 10 BPV and VAR (see above). The 10 BPV measures the extent to which the value of the portfolio would change if interest rates were to go up by ten basis points across the entire curve (negative figures indicate a decrease in the value of the portfolio). 10 BPV limits are set in such a way that interest rate positions combined with the other structural exposures (equity, real estate, etc.) remain within the overall VAR limits. Other techniques such as gap analysis, the duration approach, scenario analysis and stress testing (both from an economic value perspective and from an income perspective) are also used.

The table below shows how the bank's exposure to interest rate risk developed over the course of 2010 and 2011.

BPV of the ALM book, banking activities* (in millions of EUR)	2010	2011
Average for 1Q	-63	-61
Average for 2Q	-68	-62
Average for 3Q	-69	-58
Average for 4Q	-62	-45
As at 31 December	-55	-40
Maximum in year	-69	-65
Minimum in year	-55	-40

\* Excluding entities classified 'as disposal groups' under IFRS 5 (including these entities would lead to an overall BPV for the banking activities of -57 million euros at year-end 2010 and -34 million euros at year-end 2011).

In line with the Basel II guidelines, a 2% stress test is carried out at regular intervals. It sets off the total interest rate risk in the banking book (given a 2% parallel shift in interest rates) against total capital and reserves. For the banking book at KBC group level (excluding KBL EPB), this risk came to 11% of total capital and reserves at year-end 2011 (well below the 20% threshold, where a bank is considered an 'outlier bank' and which can lead to a higher regulatory capital charge).

The following table shows the interest sensitivity gap of the ALM banking book. In order to determine the sensitivity gap, the carrying value of assets (positive amount) and liabilities (negative amount) is broken down according to either the contractual repricing date or the maturity date, whichever is earlier, so as to obtain the length of time for which interest rates are fixed. Derivative financial instruments, which are used mainly to reduce exposure to interest rate movements, are included on the basis of their notional amount and repricing date.

The interest sensitivity gap shows the overall long position of the KBC group in interest rate risk. Overall, assets reprice on a longer term than liabilities, which means that KBC's net interest income benefits from a normal yield curve. The economic value of the KBC group is predominantly sensitive to movements at the long-term end of the yield curve.

Interest sensitivity gap of the ALM book (including derivatives), banking activities\*  
(in millions of EUR)

	≤ 1 month	1–3 months	3–12 months	1–5 years	5–10 years	> 10 years	Non-interest-bearing	Total
31-12-2010	-5 116	-558	626	1 513	5 226	3 852	-5 542	0
31-12-2011	-8 138	3 220	2 563	7 107	2 822	2 900	-10 474	0

\* Entities classified as 'disposal groups' under IFRS 5 have also been excluded (figures for these entities are given below). Excluding a number of small group companies.

31-12-2010	-140	55	88	528	140	18	-689	0
31-12-2011	-114	43	125	580	129	15	-777	0

## Interest rate risk for the insurance activities

Where the group's insurance activities are concerned, the fixed-income investments for the non-life reserves are invested with the aim of matching the projected pay-out patterns for claims, based on extensive actuarial analysis.

The non-unit-linked life activities (class 21) combine a guaranteed interest rate with a discretionary participation feature (DPF) fixed by the insurer. The main risks to which the insurer is exposed as a result of such activities are a low-interest-rate risk (the risk that return on investments will drop below the guaranteed level) and a risk that the investment return will not be sufficient to give customers a competitive profit-sharing rate. The risk of low interest rates is managed via a cashflow-matching policy, which is applied to that portion of the life insurance portfolios covered by fixed-income securities.

Unit-linked life insurance investments (class 23) are not dealt with here, since this activity does not entail any market risk for KBC.

The table summarises the exposure to interest rate risk in KBC's life insurance activities. The life insurance assets and liabilities relating to business offering guaranteed rates are grouped according to the expected timing of cashflows.

Expected cashflows (not discounted), life insurance activities\*  
(in millions of EUR)

	0–5 years	5–10 years	10–15 years	15–20 years	> 20 years	Total
31-12-2010						
Fixed-income assets backing liabilities, guaranteed component	12 353	7 245	2 250	1 504	1 074	24 425
Liabilities, guaranteed component	9 814	6 287	2 140	1 723	2 560	22 524
Difference in expected cashflows	2 539	958	109	-219	-1 487	1 901
Mean duration of assets						5.40 years
Mean duration of liabilities						6.36 years
31-12-2011						
Fixed-income assets backing liabilities, guaranteed component	12 408	6 197	1 842	1 333	753	22 534
Liabilities, guaranteed component	10 020	4 330	1 751	1 341	1 945	19 387
Difference in expected cashflows	2 388	1 867	91	-7	-1 192	3 147
Mean duration of assets						5.44 years
Mean duration of liabilities						6.03 years

\* Entities classified as 'disposal groups' under IFRS 5 have also been excluded (they accounted for 3 552 million euros in fixed-income assets backing 3 643 million euros worth of guaranteed liabilities at year-end 2011 (573 and 508 million euros, respectively, at year-end 2010)). Excluding a number of small group companies.

As mentioned above, the main interest rate risk for the insurer is a downside one. KBC adopts a liability driven ALM approach focused on mitigating the interest rate risk in accordance with KBC's risk appetite. For the remaining interest rate risk, KBC adheres to a policy that takes into account the possible negative consequences of a sustained decline in interest rates, and has built up adequate supplementary reserves.

Breakdown of the reserves for non-unit-linked life insurance by guaranteed interest rate, insurance activities <sup>1</sup>	31-12-2010	31-12-2011
5.00% and higher <sup>2</sup>	3%	3%
More than 4.25% up to and including 4.99%	11%	6%
More than 3.50% up to and including 4.25%	7%	11%
More than 3.00% up to and including 3.50%	33%	33%
More than 2.50% up to and including 3.00%	22%	24%
2.50% and lower	19%	22%
0.00%	5%	2%
<b>Total</b>	<b>100%</b>	<b>100%</b>

<sup>1</sup> Excluding a number of small group companies. VITIS Life, Warta & Fidea, which accounted for 15.2% of total nominal exposure (19.4% of their exposure is in the 'More than 2.50% up to and including 3.00%' category) at year-end 2011, have also been excluded.

<sup>2</sup> Contracts in Central and Eastern Europe.

## Aggregate interest rate risk for the KBC Group

The figures below show the impact on the KBC group of a 10-basis-point parallel upward shift of yield curves by the end of 2011, broken down by currency.

### Interest Rate Risk - BPV in thousands of EUR – 31-12-2010<sup>1</sup>

	Overall	EUR	CHF	USD	GBP	CZK	HUF	PLN	Other
Bank	-54.801	-38.046	55	1.209	43	-12.174	-1.365	-1.723	-2.800
Insurance	-5.498	-4.058	0	-9	2	227	-90	-1.344	-226
<b>KBC Group<sup>2</sup></b>	<b>-53.979</b>	<b>-35.784</b>	<b>55</b>	<b>1.200</b>	<b>45</b>	<b>-11.947</b>	<b>-1.455</b>	<b>-3.067</b>	<b>-3.026</b>

### Interest Rate Risk - BPV in thousands of EUR – 31-12-2011<sup>1</sup>

	Overall	EUR	CHF	USD	GBP	CZK	HUF	PLN	Other
Bank	-40.154	-27.138	-213	1.957	307	-8.651	-656	-1.990	-3.770
Insurance	5.468	5.634	0	-433	-69	610	32	-16	-290
<b>KBC Group<sup>2</sup></b>	<b>-26.288</b>	<b>-13.107</b>	<b>-213</b>	<b>1.524</b>	<b>238</b>	<b>-8.041</b>	<b>-623</b>	<b>-2.006</b>	<b>-4.060</b>

<sup>1</sup> KBL EPB, VITIS Life, Fidea & WARTA have been excluded from the KBC Group figures at year-end 2011. Their total +10BPV was 3.2 million euros. KBL and VITIS Life were excluded from the year-end 2010 figures; they reported a total +10BPV of -2.34 million euros.

<sup>2</sup> KBC Pension Fund has been added to the KBC group figure.

The group-wide sensitivity of IFRS-based net profit to interest rate movements is reported on a regular basis and at the same time for both the banking and the insurance activities. The table illustrates the impact on net profit of a 1% increase and a 1% decrease in the yield curve, given the positions at the reporting date.

Impact on net profit (IFRS) of an increase/decrease in the yield curve for the KBC group<sup>1</sup>

In millions of EUR

	Increase by 1% <sup>3</sup>		Decrease by 1% <sup>2,3</sup>	
	2010	2011	2010	2011
Insurance	-5	-8	5	2
Banking	-56	-27	89	44
<b>Total for the KBC Group</b>	<b>-61</b>	<b>-35</b>	<b>95</b>	<b>46</b>

<sup>1</sup> Excluding a number of small group companies.

<sup>2</sup> Full market value, regardless of accounting classification or impairment rules.

<sup>3</sup> Entities classified 'as disposal groups' under IFRS 5 have been excluded. A 1% increase/decrease in the yield curve would have a very limited impact on the net profit of these divested entities (-1.3 million euros and +1.35 million euros, respectively).

## Equity risk

The main exposure to equity is within the insurance business, where the ALM strategies are based on a risk-return evaluation, account taken of the market risk attached to open equity positions. Please note that a large part of the equity portfolio is held for the DPF of insurance liabilities (especially profit-sharing in the Belgian market). Apart from the insurance entities, smaller equity portfolios are also held by other group entities (e.g., KBC Bank, KBL EPB, KBC Asset Management and KBC Private Equity). The tables below present more information on total non-trading equity exposures at KBC.



The tables below present more information on total non-trading equity exposures at KBC. The first part of the table provides an overview of concentration according to sector, while the second part breaks down the total equity exposure into listed and unlisted components.

Equity portfolio of the KBC group <sup>1,2,3</sup> (breakdown by sector, in %)	Banking activities		Insurance activities		Group	
	31-12-2010	31-12-2011	31-12-2010	31-12-2011	31-12-2010	31-12-2011
Financial	46%	32%	21%	19%	32%	21%
Consumer non-cyclical	15%	9%	8%	14%	11%	11%
Communication	2%	2%	6%	3%	4%	3%
Energy	5%	0%	8%	10%	7%	8%
Industrial	5%	28%	10%	18%	8%	18%
Utilities	4%	3%	5%	3%	4%	4%
Consumer cyclical	7%	3%	20%	8%	15%	7%
Basic materials	8%	13%	9%	8%	8%	8%
Other and not specified	8%	10%	13%	15%	11%	21%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
In billions of EUR	1.1	0.2	1.4	0.9	2.6	1.6
of which unlisted	0.5	0.1	0.1	0.03	0.6	0.2

1. Excluding a number of small group companies. Entities classified as 'disposal groups' under IFRS 5 have also been excluded (at year-end 2011, their equity portfolios came to 0.39 billion euros (0.28 billion euros a year earlier), 28% of which was invested in unlisted equities (32% a year earlier).

2. The equity portfolio of KBC Pension Fund (0.5 billion euros) has only been included in the 'Group' columns and not in the 'Banking activities' or 'Insurance activities' columns in 2011, whereas it was reported under 'Banking activities' in 2010.

3. The participation in Nova Ljubljanska banka (financial sector) was treated as equity exposure in 2010, but has not been included in the 2011 figures.

The table provides an overview of the sensitivity of income and economic value to fluctuations in the equity markets.

Impact of a 12.5% drop in equity prices <sup>1</sup> (in millions of EUR)	Impact on net profit (IFRS)		Impact on value	
	2010	2011	2010	2011
	Insurance activities	-13	-36	-100
Banking activities	-27	-28	-142	-26
<b>Total<sup>2</sup></b>	<b>-40</b>	<b>-67</b>	<b>-242</b>	<b>-145</b>

1 Entities classified as 'disposal groups' under IFRS 5 have been excluded. A 12.5% drop in equity prices at year-end 2011 would have an impact of -6 million euros on the net profit of these entities and -37 million euros on economic value.

2 The total in 2011 includes KBC Pension Fund, which had an impact of -3 million euros on net profit and -61 million euros on economic value.

The table provides an overview of the realised and unrealised gains on the equity portfolio.

#### Non-trading equity exposure<sup>1</sup>

(in millions of EUR)	31-12-2010		31-12-2011	
	Net realised gains (in income statement)	Net unrealised gains on year-end exposure (in equity)	Net realised gains (in income statement)	Net unrealised gains on year-end exposure (in equity)
<b>KBC group<sup>2</sup></b>	<b>64</b>	<b>377</b>	<b>106</b>	<b>202</b>
Banking entities	21	91	31	29
Insurance entities	45	338	74	171

1 Excluding a number of small group companies. Entities classified as 'disposal groups' under IFRS 5 have also been excluded. For these entities, net unrealised gains amount to 71 million euros (recognised in equity) (58 million euros in 2010) and the losses on year-end exposure come to 4 million euros (recognised in the income statement) (0 million euros in 2010).

2 The total figure includes gains from some equity positions directly attributable to the KBC group. Gains from joint participations involving the banking and insurance entities of the KBC group have been eliminated, since these participations are consolidated at group level.

## Real estate risk

A limited real estate investment portfolio is held by the group's real estate businesses with a view to realising capital gains over the long term. KBC Insurance also holds a diversified real estate portfolio, which is held as an investment for non-life reserves and long-term life activities. The real estate exposure is viewed as a long-term hedge against inflation risks and as a way of optimising the risk/return profile of these portfolios.

The table provides an overview of the sensitivity of economic value to fluctuations in the property markets.

Impact of a 12.5% drop in real estate prices<sup>1</sup>  
(in millions of EUR)

	Impact on value	
	2010	2011
Bank portfolios	-80	-68
Insurance portfolios	-30	-43
<b>KBC Group<sup>2</sup></b>	<b>-110</b>	<b>-124</b>

<sup>1</sup> Excluding a number of small group companies. Entities classified as 'disposal groups' under IFRS 5 have also been excluded (for Fidea, a 12.5% drop in real estate prices had an impact of -8 million euros in 2011).

<sup>2</sup> In 2011, KBC Pension Fund was included in the KBC group line and not in 'Bank portfolios' or 'Insurance portfolios'. In 2010, it was reported under 'Bank portfolios'.

## Inflation risk

KBC's exposure to inflation is primarily secondary in nature, i.e. via changes in interest rates. This risk is monitored and hedged in line with the policy for managing interest rate risk (see above). The direct exposure of KBC to the inflation risk is limited and mainly arises from contractual payments that are linked to wage inflation, e.g., in the non-life insurance business in Central-Europe and in the pension fund for own employees. This direct inflation risk is monitored using the ALM VAR technique (see above), with a limit being set on the total exposure to 'other risks' for the KBC group.

## Foreign exchange risk

KBC pursues a prudent policy as regards its structural currency exposure, essentially seeking to avoid currency risk. Foreign exchange exposures in the ALM books of banking entities with a trading book are transferred to the trading book where they are managed within the allocated trading limits. The foreign exchange exposure of banking entities without a trading book, of the insurance entities and of other entities has to be hedged, if material. Equity holdings in non-euro currencies that are part of the investment portfolio do not need to be hedged. Participating interests in foreign currency are in principle funded by borrowing an amount in the relevant currency equal to the value of the net assets excluding goodwill.

# Market risk management (trading)

Market risk is defined as the potential negative deviation from the expected value of a financial instrument (or portfolio of such instruments) due to changes in the level or in the volatility of market prices, e.g., interest rates, exchange rates and equity or commodity prices. Market risk also covers the risk of price fluctuations in negotiable securities as a result of credit risk, country risk and liquidity risk. The interest rate, foreign exchange and equity risks of the non-trading positions in the banking book and of the insurer's positions are all included in ALM exposure.

This section focuses on the trading positions. The interest rate risk, foreign exchange risk, equity risk, etc. of the non-trading positions in the banking book and of the insurer's positions are addressed in this document in the 'Market risk management (non-trading)' section.

## Strategy and processes

The objective of market risk management (trading) is to measure and report the market risk of the aggregate trading position at group level, taking into account the main risk factors and specific risk.

KBC is exposed to market risk via the trading books of the dealing rooms in Western Europe, Central and Eastern Europe, the United States and Asia. The traditional dealing rooms, with the dealing room in Brussels accounting for the lion's share of the limit exposures and risks, focus on trading in interest rate instruments, while activity on the FX markets has traditionally been limited. The dealing rooms abroad focus primarily on providing customer service in money and capital market products, on funding local bank activities and engage in limited trading for own account in local niches.

KBC continued to divest trading activities in its subsidiaries by, *inter alia*, selling KBL EPB, continuing to wind down the remaining business lines at KBC Financial Products, and selling or unwinding selected ABS and CDO assets.

Market risk tolerance is determined by the Board of Directors through an annual limit review. The Group Capital and Risk Oversight Committee and the Group Trading Subcommittee advise on limits before they are submitted to the Board. This risk framework consists of a hierarchy of limits. Whereas HVAR calculations serve as a primary risk measurement tool, risk concentrations are monitored via a series of secondary limits, the most important being a three-dimensional scenario limit (based on movements in spot prices, volatilities and credit spreads). Other secondary limits include equity concentration limits, FX concentration limits and basis-point-value limits for interest rate risk. The specific risk associated with a particular issuer or country are also subject to concentration limits. In addition, secondary limits are in place to monitor the risks inherent in options (the so-called 'greeks').

The centralisation of trading risk management implies close co-operation between all value and risk management units at both group and local level. This close co-operation allows consistent reporting to group senior management through the Group Trading Subcommittee, which is chaired by the Group CRO and includes representatives from line management, risk management and top management. It manages market risk and addresses the operational and counterparty risks of the dealing rooms. It keeps track of structural trends, monitors group-wide risk limits and may decide to impose corrective actions. The subcommittee meets every two weeks in order to enable the KBC group to take decisions regarding trading risk on the basis of accurate and up-to-date information.

## Disclosures on market risk capital requirements and VAR model

As market risk exposure arises from the trading books in the dealing rooms of the banking entities, the scope relating to market risk capital requirements across trading portfolios covers all the group's banking entities.

As regards disclosures on the VAR model, the scope is confined to KBC Financial Products and KBC's Financial Markets activities, which encompass both the linear and non-linear exposure of the traditional dealing rooms. KBC Financial Products and Financial Markets easily account for the largest part of the Value at Risk (VAR) within the KBC group.

### VAR model and characteristics

The VAR method is the principal tool for managing and monitoring market risk exposures in the trading book. Accordingly, VAR is the primary building block of KBC's market risk management framework and regulatory capital calculations.

VAR is defined as an estimate of the amount of economic value that might be lost on a given portfolio due to market risk over a defined holding period, with a given confidence level. The measurement only takes account of the market risk of the current portfolio and does not attempt to capture possible losses due to further trading or hedging, counterparty default or operational losses.

KBC has chosen the Historical VAR (HVAR) approach to generate VAR calculations. This method does not rely on assumptions regarding the distribution of price fluctuations or correlations, but is based on patterns of experience in the past. KBC's current VAR methodology is based on a 10-day holding period and a 99% one-sided confidence level, with historical data going back 500 working days. The 99% quantile estimator equals the fifth worst loss (1% of 500 scenarios).

KBC captures the entire distribution of losses for its market risk limit framework. The VAR computation is euro-based. In compliance with regulatory requirements, KBC uses the 99% confidence level for the calculation of regulatory capital. A full revaluation method is used for calculating P/L figures arising in the series of historical simulations for the VAR calculation on a daily basis.

The 1-day horizon is used for back-testing the VAR model.

KBC's Financial Markets activities (referred to as 'KBC Bank' in the table below) and KBC Financial Products account for the largest part of (trading risk) HVAR exposure within the KBC group. Their respective quarterly average HVAR outcomes in 2010 and 2011 are displayed in the table below.

The HVAR for KBC Financial Products comprises all trading business lines. Business lines and exposures that are more illiquid and have more of a credit character, such as the fund derivatives business, do not lend themselves to VAR modelling and therefore fall outside the scope of HVAR. The fund derivatives business is considered to be a legacy activity (i.e. no new activity is carried out) and is monitored on the basis of Key Performance Indicators relating to, for example, strike and redemption trends.

Market risk (VAR) <sup>1</sup> (in millions of EUR)	2010 KBC Bank	2010 KBC Financial Products	2011 KBC Bank	2011 KBC Financial Products	2011 SVAR <sup>2</sup> KBC Bank	2011 SVAR <sup>2</sup> KBC Financial Products
Holding period	1 day	1 day	1 day	1 day	10 days	10 days
Average for 1Q	6	9	4	6	–	–
Average for 2Q	8	9	4	5	–	–
Average for 3Q	6	8	4	8	–	–
Average for 4Q	5	8	8	3	46	14
As at 31 December	4	7	9	6	36	17
Maximum in year	15	13	10	11	60	19
Minimum in year	4	6	3	1	24	11

<sup>1</sup> KBC Bank: excluding 'specific interest rate risk' (measured using other techniques); swap basis risk has only been included since 22 October 2011. KBC Financial Products: excluding Avebury and the fund derivatives business line.

<sup>2</sup> SVAR (stressed VAR) calculated only as of the fourth quarter of 2011.

## Regulatory acceptance of the VAR model and capital charges for market risk

Both KBC Bank and KBC Financial Products have been authorised by the Belgian regulator to use their respective VAR models to calculate regulatory capital requirements for part of their trading activities. ČSOB (Czech Republic) has also received approval from the local regulator to use its VAR model for capital requirement purposes. These models will also be used for the calculation of Stressed VAR, which is one of the new CRD III Regulatory Capital charges entering into effect at year-end 2011. One of the revisions concerns the calculation of a Stressed VAR measure, which is based on the normal VAR calculations and follows the same methodological assumptions, but is constructed as if the relevant market factors were experiencing a period of stress. The period of stress is taken from recent history and is calibrated regularly.

In addition, KBC Financial Products has implemented models (as required by CRD III) to calculate and report an Incremental Risk Charge (IRC) for the credit risk positions that carry default and migration risks (i.e. the single name corporate CDS). The risk is measured as a 99.9% loss over a one-year holding period for a constant level of risk (constant position). The liquidity horizon for the portfolio in scope is set to one year. Furthermore, a Comprehensive Risk Measure (CRM) is calculated to cover all price risks in the bespoke CDO tranches. The risk attached to ABS and retained CDO positions follows the (re)securitisation framework.

The resulting capital requirements for trading risk at year-end 2010 and year-end 2011 are shown in the table below. The regulatory trading risk capital requirements of local KBC entities that did not receive approval from their respective regulator to use an internal model for capital calculations and the business lines that are not included in the HVAR calculations are measured according to the Standardised approach. This approach sets out general and specific risk weightings per type of market risk (interest risk, equity risk, FX risk and commodity risk).

In millions of EUR

BASEL II – 31-12-2010	Interest risk	Equity risk	FX risk	Commodity risk	IRC	CRM	Re-securitisations	Total
KBC Bank consolidated	186	37	37	2	-	-	-	262
KBL EPB	14	0	11	0	-	-	-	25
CRD III – 31-12-2011								
KBC Bank consolidated	344	28	78	1	5	101	216	773
KBL EPB	9	1	1	0	-	-	-	11

## Stress testing

As the VAR model cannot encompass all potential extreme events, the VAR calculations are supplemented by stress tests. The VAR model captures potential losses under normal market conditions, whereas stress tests reflect the impact of exceptional circumstances and events with a low degree of probability.

For Financial Markets, hypothetical (portfolio-dependent and portfolio-independent) scenarios for interest rate (IR), exchange rate (FX) and equity (EQ) positions are used. Portfolio-independent stress tests examine the impact of a number of predefined events that simulate changes in the main risk factors, independent of the portfolio position. As for portfolio-dependent stress tests, the major risk factors that influence the value of the position are shifted.

Besides hypothetical stress tests, historical stress tests are carried out that use a number of historical scenarios, going back as far as 1987.

For KBC Financial Products, 3D stress tests (i.e. incorporating simultaneous shifts in spot, volatility and credit spreads) are run on a daily basis. Historical and generic hypothetical stress tests are run on a weekly basis. Stress tests on the CDO portfolio are performed on a quarterly basis. CDO stress tests are performed by stressing the correlation and level of credit spreads. Further stress tests are conducted by simulating losses in the underlying collateral pool, based on the current level of the credit spreads

The results from stress testing are presented to the Group Trading Subcommittee on a bi-weekly basis. In addition, a more in-depth report on stress test results, as well as historical stress tests, is submitted to it on a quarterly basis.

## Back testing

Back testing plays a crucial role in assessing the quality and accuracy of the VAR model, as it compares model-generated risk measures to daily P/L figures. The purpose of the back test is to examine the VAR's ability to predict losses at a given confidence level.

The back-testing process consists of three steps. Firstly, a 'no action P/L' is generated. This is the P/L that the portfolio produces if all positions remain unchanged, but the market data changes to the next day's data. This revenue excludes non-trading components such as commissions and fees, and estimated revenues from intraday trading. Secondly, the 'no action P/L' is compared with the VAR calculated (99%, one-day holding period). The last step entails reporting negative exceptions to the relevant risk committees, i.e. when the negative P/L result exceeds the one-day VAR. These negative exceptions are also referred to as outliers. The number of (negative) outliers, reported during an observation period of four quarters, impacts the multiplier used for capital requirement calculations. At the level of the Approved Internal Model for KBC Bank and ČSOB CR, the number of outliers increased due to the heightened volatility triggered by the sovereign debt crisis in the euro area. At KBC Financial Products, the number of outliers was within statistical expectations.

## Validation and reconciliation

VAR implementation is validated by an independent validation entity. In order to guarantee the quality of transaction data used in the risk calculation engine, a daily reconciliation process has been set up. The transaction data generated by the source system are reconciled with the data used in the risk calculation engine.

Furthermore, the VAR method is reviewed and subjected to a validation exercise by the KBC Risk Validation Unit at least once a year. In addition, the VAR model is audited on a regular basis.

## Valuation

One of the building blocks of sound risk management is prudent valuation. A daily independent middle-office valuation of front-office positions is performed. Whenever the independent nature or the reliability of the valuation process is not guaranteed, a parameter review is performed. Where applicable, adjustments to the fair value are made to reflect close-out costs, adjustments for less liquid positions or markets, mark-to-model-related valuation adjustments, counterparty risk, liquidity risk and operations-related costs.

# Operational risk management and other non-financial risks



Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risks include the risk of fraud, and legal, compliance and tax risks. This definition is similar to the one given in the Basel II Capital Accord and the Capital Requirements Directive.

The impact of incidents on the group's reputation is taken into consideration when establishing vulnerability to operational risk incidents.

For a description of business risk, reputation risk and business continuity management, see the 'Other non-financial risks' heading at the end of this section.

Information on legal disputes can be found in Note 36 of the 'Consolidated financial statements' section in the 2011 annual report of KBC Group NV (see [www.kbc.com](http://www.kbc.com)).

## Strategy and processes

KBC has a single, global framework for managing operational risk across the entire group. It consists of a uniform operational risk language embedded in group-wide key controls, one methodology, one set of centrally developed ICT applications, and centralised and decentralised reporting.

## Scope of operational risk management

KBC's operational risk management framework covers all entities in which it, directly or indirectly, holds at least 50% of the shares or in respect of which it has the power *de jure* or *de facto* to exercise a decisive influence on the appointment of the majority of its directors or managers.

Information is presented below on operational risk governance, the tools used to manage operational and other non-financial risks and the capital charges for them.

## Operational risk governance

The main precept of operational risk management is that ultimate responsibility for managing operational risk lies with business' line management, which receives support from local operational risk managers, and is supervised by local independent risk functions.

The Group Risk Management Committee (GRMC) advises the Group Executive Committee on the group-wide framework for managing operational risks, and the Group Risk and Capital Oversight Committee (GRCOC) oversees the main operational risks.

Besides these group committees, there are a variety of risk committees at business-unit level and at various group companies. They keep close track of the practical implementation of the operational risk management framework and also take concrete measures either directly or via line management. All departments that are involved in one way or another in managing operational risks can gain access to the risk committees whenever they feel it is necessary.

The Group Value and Risk Management Directorate is primarily responsible for defining the operational risk management framework for the entire group. The development and implementation of this framework is supported by an extensive operational risk governance model covering all entities of the group. This framework was redesigned in 2010 and will gradually be implemented (with full implementation during 2014).

The Group Value and Risk Management Directorate creates an environment where risk specialists (in various areas, including information risk management, business continuity and disaster recovery, compliance, anti-fraud, legal and tax matters) can work together (setting priorities, using the same language and tools, uniform reporting, etc.). It is assisted by the local value and risk management units, which are likewise independent of the business.

## Toolbox for the management of operational risks

KBC uses a number of building blocks for managing operational risks, which cover all aspects of operational risk management.

In 2011 specific attention was given to the structured set-up of process-based Group Key Controls, which will gradually replace the former Group Standards. These Controls are policies containing top-down basic control objectives and are used to mitigate key and killer risks inherent in the processes of KBC entities. As such, they are an essential building block of the Operational Risk Management Framework.

A first set was approved in 2011 for the Credit, Life, Non-life, Personal Financial Advice, Legal, Tax, Business Continuity Management and Risk & Capital Management processes. These Group Key Controls are assessed by the business and (local) control functions. The risk self-assessments are consolidated at the Group Value and Risk Management Directorate and ensure that there is a consistent relationship between (i) processes, (ii) risks, (iii) control activities and (iv) assessment scores. KBC created an objective management tool to evaluate its internal control environment and to benchmark the approach across its entities.

Besides these Group Key Controls, there are a number of other building blocks:

- *The Loss Event Database*. All operational losses of 1 000 euros or more have been recorded in a central database since 2004. This database also includes all legal claims filed against group companies. Consolidated loss reports are regularly submitted to the GRCOC, the Group Executive Committee and the ARC Committee.
- *Risk Scans (bottom-up and top-down)*. These *self-assessments* focus on the identification of key operational risks at critical points in the process/organisation that are not properly mitigated, and on new or emerging operational risks that are relevant at (sub)group level.
- *Case-Study Assessments*. These are used to test the effectiveness of the protection afforded by existing controls against major operational risks that have actually occurred elsewhere in the financial sector. One such assessment was used to test the internal controls for preventing and identifying rogue trading practices.
- *Key Risk Indicators*. A limited set of KRIs are used to monitor the exposure to certain operational risks and track the existence and effectiveness of the internal controls.

The quality of the internal control environment and related risk exposure as identified, assessed and managed by means of these building blocks is reported to KBC's senior management via a management dashboard and to the National Bank of Belgium and the FSMA via the annual Internal Control Statement. Information on the internal control and risk management systems can be found in the 'Corporate governance statement' section in the 2011 annual report of KBC Group NV (see [www.kbc.com](http://www.kbc.com)).

## Operational risk capital charge

KBC uses the Standard approach to calculate operational risk capital under Basel II (pillar 1 regulatory capital). Operational risk capital for KBC Bank at the consolidated level totalled 862 million euros at the end of 2011, compared with 860 million euros at the end of 2010, (the figures excludes KBL EPB, which had contributed approximately 78 million euros to the total operational risk capital of the KBC group at year-end 2011 and 72 million euros at year-end 2010).

For divested entities, KBC keeps operational risk capital (under pillar 2) in line with the outstanding contractual liabilities.

## Other non-financial risks

### Business risk

Business risk is the potential negative deviation from the expected economic value arising from changes in the macroeconomic environment, the financial services industry and/or the market for products and services, as well as from inadequacies relating to business resources that impact on business potential.

Risk factors that are taken into consideration include macroeconomic conditions, changes to the law or regulations, competitor actions, changes in distribution channels or distribution models, changed customer needs, human resources issues and ICT resources. Business risk is assessed on the basis of structured risk scans.

KBC reserves a pillar 2 capital charge specifically for business risk. Business risk capital is based on the operating expenses for the various KBC group entities. The portion of operating expenses to be set aside as economic capital for business risk depends on the level of risk attached to the activities of each entity, as determined on the basis of quantitative and qualitative assessments of activities across KBC group entities.

### Reputation risk

This is the risk arising from the negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a financial institution's ability to maintain existing, or establish new business relationships and to have continued access to sources of funding (for instance, through the interbank or securitisation markets). Reputation risk is a secondary or derivative risk since it is mostly connected to and will materialise together with another risk.

The Reputation Risk Management Framework is currently being refined in line with the KBC Risk Management Framework. The pro-active and re-active management of reputation risk is the responsibility of the business, supported by many specialist units (e.g., the Press Office, Investor Relations).

Under the pillar 2 approach to capital adequacy, the impact of reputation risk on the current business is covered in the first place by the capital charge for primary risks (such as credit or operational risk, etc.). It is also covered by the capital reserved for business risk.

### Business Continuity Management (BCM)

The Risk Centre of Excellence for Non-financial Risks is responsible for developing a group-wide framework to ensure the continuity of operations. This framework is submitted to the Group Risk Management Committee and the Executive Committee for approval. Via the local value and risk management units, the risk centre of excellence is also responsible for overseeing the practical implementation of this framework by line management. In addition, it supervises the quality of the risk management process, analyses the main risk data and reports to the GRCOC.

The annual business continuity report has also been included in KBC's Internal Control Statement as of 2011.

# Insurance risk management

Technical insurance risks stem from uncertainty regarding how often insured losses will occur and how extensive they will be. All these risks are kept under control through appropriate underwriting, pricing, claims reserving, reinsurance and claims handling policies of line management and through independent insurance risk management.

## Strategy and processes

The Insurance Risk Centre of Excellence in the Group Value and Risk Management Directorate develops and rolls out a group-wide framework for managing insurance risks. It is responsible for providing support for local implementation and for the functional direction of the insurance risk management process of the insurance subsidiaries.

The insurance risk management framework is designed primarily around the following building blocks:

- Adequate identification and analysis of material insurance risks by, *inter alia*, analysing new emerging risks, concentration or accumulation risks, and developing early warning signals.
- Appropriate risk measurements and use of these measurements to develop applications aimed at guiding the company towards creating maximum shareholder value. Examples include best estimate valuations of insurance liabilities, *ex post* economic profitability analyses, natural catastrophe and other life, non-life and health exposure modelling, stress testing and required economic capital calculations.
- Determination of insurance risk limits and conducting compliance checks, as well as providing advice on reinsurance programmes.

## Scope of insurance risk management

The following entities are in scope, viz. KBC Insurance (Belgium), Maatschappij voor Brandherv verzekering, Sepia, KBC Group Re, K&H Insurance, ČSOB Pojišťovna (Czech Republic), ČSOB Poist'ovňa (Slovak Republic) and DZI Insurance.

## Insurance risk classification

Part of the risk identification process consists of reliably classifying all insurance risks that may be triggered by (re)insurance contracts.

Firstly, all insurance cover provided by (re)insurance companies is classified according to a standardised (European) line of business classification. Traditionally, at the top level, the insurance risks inherent in the life insurance business can be separated from those which are related to the non-life insurance business. Both categories are then further broken down.

Moreover, from a risk identification point of view, a further breakdown for both categories is usually made between catastrophe (accumulation) risks and non-catastrophe risks. This results in the following main categories:

*Non-life non-catastrophe risks* which are broken down into three types of risk:

- The premium risk – the risk that the premium that will be earned next year will not be enough to cover all liabilities resulting from claims in this portfolio, due for instance to the fact that the number of claims will be higher than expected (frequency problem) or the severity of the claims will be higher than expected (severity problem).
- The reserve risk – the risk that the liabilities stemming from claims, which have occurred in the past, but have still to be finally settled, will turn out to be more expensive than expected.
- Cost-related risk – the risk that the cost assumptions used in pricing or valuing insurance liabilities in terms of acquisition costs, administration costs or internal settlement costs, turn out to be too optimistic.

*Life non-catastrophe risks* which are broken down into five types of risk:

- Mortality risk – the risk that the mortality rates used in pricing will turn out to be too low, i.e. people die earlier than expected.
- Longevity risk – the opposite of mortality risk, this is the risk that the mortality rates used in pricing annuity products (or other products with negative capital at risk) turn out to be too high, i.e. people live longer than expected.
- Lapse risk – the risk that the actual rate of policy lapses (i.e. premature full or partial termination of the contract by the policyholder) differs from those used in pricing.
- Health risk – the risk that the part of the premium charged to cover hospitalisation or disability claims is not sufficient, due to a higher number of claims or more expensive claims than expected.
- Expense risk – the risk that the assumptions about acquisition costs and administration costs turn out to be too optimistic.

For the *catastrophe risks*, a distinction is made between natural catastrophes (e.g., wind storms, floods, earthquakes) and man-made catastrophes (e.g., terrorist attacks like 9/11). Not only the non-life, but also the life insurance business can be exposed to catastrophes, such as the pandemic threat of bird flu or accidental events.

## Insurance risk measurement

KBC develops models gradually, from the bottom up, for all material group-wide insurance liabilities, i.e. (i) future claims that will occur over a predefined time horizon, as well as the claims settlement pattern, (ii) the future settlement of claims (whether already reported to the insurer or not) that have occurred in the past but have not yet been fully settled, and (iii) the impact of the reinsurance programme on these claims. These models are used to steer the group's insurance entities towards creating more shareholder value, by means of applications to calculate economic capital, support decisions on reinsurance, calculate the *ex post* profitability of specific sub-portfolios and set off economic capital requirements against the relevant return in pricing insurance policies.

Insurance risk management has developed an internal model for the group-wide exposure to natural hazards. This model measures most material natural catastrophe risks for all group insurance and reinsurance companies, with account being taken of outward reinsurance (external and intra group). Work is currently being carried out to develop other internal models for measuring insurance risks. The internally developed models and frameworks follow the Risk Measurement Framework and are validated within this scope by the independent validation unit.

## Best estimate valuations of insurance liabilities

As part of its mission to independently monitor insurance risks, the Group Value and Risk Management Directorate regularly carries out in-depth studies. These confirm that there is a high degree of probability that the non-life technical provisions at subsidiary level are adequate. Adequacy is checked per business line at subsidiary level and the overall adequacy is assessed at subsidiary level for all business lines combined.

In addition, 'Liability Adequacy Tests' (LAT) that meet local and IFRS requirements are conducted by the various group companies for the life technical provisions. Calculations are made using prospective methods (cashflow projections that take account of lapse rates and a discount rate that is set for each insurance entity based on local macroeconomic conditions and regulations), and extra market-value margins are built in to deal with the factor of uncertainty in a number of parameters. Since no deficiencies were recorded by year-end 2011, there was no need for a deficiency reserve to be set aside within the KBC group.

The techniques used to perform these best estimate valuations will become the foundation of future group-wide insurance liabilities' valuation frameworks to be used within Solvency II and IFRS 4/2.

## Technical provisions and loss triangles, non-life business

The table shows claims settlement figures in the non-life business over the past few years and includes KBC Insurance NV, Fidea (up to and including financial year 2010), ČSOB Pojišťovna (Czech Republic), ČSOB Poist'ovňa (Slovak Republic, from financial year 2008), DZI Insurance (from financial year 2008), K&H Insurance, Secura (up to and including financial year 2009), KBC Group Re (from financial year 2005) and WARTA (from financial year 2004 up to and including financial year 2010). All provisions for claims to be paid at the close of 2011 have been included. The claims-settlement figures incorporate all amounts that can be allocated to individual claims, including the Incurred But Not Reported (IBNR) and Incurred But Not Enough Reserved (IBNER) provisions, and the external handling expenses for settling claims, but do not include internal claims settlement expenses and provisions for amounts expected to be recovered. The figures included are before reinsurance and have not been adjusted to eliminate intercompany amounts.

The first row in the table shows the total claims burden (claims paid plus provisions) for the claims that occurred during a particular year, as estimated at the end of the year of occurrence. The following rows indicate the situation at the end of the subsequent calendar years. The amounts were restated to reflect exchange rates at year-end 2011.

Loss triangles, KBC Insurance (in millions of EUR)	Year of occurrence 2002	Year of occurrence 2003	Year of occurrence 2004 <sup>1</sup>	Year of occurrence 2005 <sup>2</sup>	Year of occurrence 2006	Year of occurrence 2007	Year of occurrence 2008 <sup>3</sup>	Year of occurrence 2009	Year of occurrence 2010	Year of occurrence 2011 <sup>4</sup>
Estimate at the end of the year of occurrence	925	769	1 048	1 077	1 159	1 230	1 360	1 436	1 420	808
1 year later	813	778	950	981	1 048	1 140	1 305	1 144	1 033	–
2 years later	818	746	907	946	1 022	1 098	1 141	987	–	–
3 years later	811	726	893	945	1 008	966	1 051	–	–	–
4 years later	801	711	884	926	874	892	–	–	–	–
5 years later	787	683	880	839	821	–	–	–	–	–
6 years later	781	676	821	803	–	–	–	–	–	–
7 years later	776	637	778	–	–	–	–	–	–	–
8 years later	744	609	–	–	–	–	–	–	–	–
9 years later	719	–	–	–	–	–	–	–	–	–
Current estimate	719	609	778	803	821	892	1 051	987	1 033	808
Cumulative payments	-662	-556	-714	-709	-729	-776	-896	-801	-763	-322
Current provisions	57	54	64	94	91	116	155	186	270	486

1 From the 2004 financial year, WARTA's figures have been included. If this company had not been taken into account, the following amounts would have been arrived at for financial year 2004 (amount and year of occurrence): 773 for 2002; and 684 for 2003.

2 From the 2005 financial year, KBC Group Re's figures have been included. If these figures had not been taken into account, the following amounts would have been arrived at for financial year 2005 (amount and year of occurrence): 803 for 2002; 744 for 2003; and 922 for 2004.

3 From the 2008 financial year, the figures for ČSOB Poist'ovňa (Slovak Republic) and DZI Insurance (Bulgaria) have been included. If these figures had not been taken into account, the following amounts would have been arrived at for financial year 2008 (amount and year of occurrence): 780 for 2002; 681 for 2003; 882 for 2004; 928 for 2005; 1 005 for 2006 and 1 097 for 2007.

4 For financial year 2011, the figures for WARTA and Fidea have been excluded. If these figures had been taken into account, the following amounts would have been arrived at for financial year 2011 (amount and year of occurrence): 736 for 2002; 633 for 2003; 812 for 2004; 838 for 2005; 861 for 2006; 958 for 2007; 1 129 for 2008; 1 074 for 2009; 1 255 for 2010; and 1 251 for 2011.

## Stress testing and scenario analysis

In 2011, the sensitivity of the technical insurance risks to extreme events was analysed mainly through participation in the European Insurance and Occupational Pensions Authority stress tests (see the 'Capital adequacy' section). The goal of these tests was to identify and quantify the impact of different stress scenarios on the financial position of the insurance group and included catastrophic and severe insurance events for both life and non-life insurance businesses.

In addition to the regulatory required stress tests, internal stress tests are performed. For the non-life business, KBC's internal natural catastrophe models are able to estimate the anticipated claim costs, should natural catastrophes that have been observed in the past occur again today. Moreover, they can determine the expected impact on bottom-line economic profit of natural catastrophe events, which are expected to occur on average only once within a given time frame (e.g., 100 or 250 years).

For the life insurance business, a sensitivity analysis is typically performed within the framework of the annual calculation of the market consistent embedded value. The results for three types of sensitivity to insurance risk are reported, viz. 'mortality rate: plus and minus 5%', 'lapses: plus and minus 10%', 'expenses: plus and minus 10%'.

Other stress testing exercises may be performed on an *ad hoc* basis.

## Insurance risk mitigation by reinsurance

The insurance portfolios are protected against the impact of serious claims or the accumulation of losses (due, for instance, to a concentration of insured risks) by means of reinsurance. These reinsurance programmes are broken down into three main groups i.e. property insurance, liability insurance and personal insurance, and are re-evaluated and renegotiated every year.

Most of the reinsurance contracts are concluded on a non-proportional basis, which provides cover against the impact of serious claims or loss events. The independent insurance risk management function is also responsible for advising on the restructuring of the reinsurance programmes, especially with a view to creating shareholder value. This approach has resulted in optimising the retention of the KBC group particularly in respect of its exposure to natural catastrophe risk.

Further information on the insurance activities of the group can be found under Notes 9, 10, 11 and 35 of the 'Consolidated financial statements' section of the 2011 annual report of KBC Group NV. A breakdown by business unit of earned premiums and technical charges is provided in the notes dealing with segment reporting.



# Glossary

## **ABS (Asset Backed Securities)**

ABS are bonds or notes backed by loans or accounts receivables originated by providers of credit such as banks and credit card companies. Typically, the originator of the loans or accounts receivables transfers the credit risk to a trust, which pools these assets and repackages them as securities. These securities are then underwritten by brokerage firms, which offer them to the public.

## **Add-On**

Basel-II-defined factor to reflect the potential future increase in exposure stemming from derivatives transactions.

## **ALM (Asset and Liability Management)**

The ongoing process of formulating, implementing, monitoring and revising strategies for on-balance-sheet as well as on off-balance-sheet items, in order to achieve an organisation's financial objectives, given the organisation's risk tolerance and other constraints.

## **Alt-A**

A classification of mortgages considered riskier than prime, but less risky than subprime. As a result of the subprime crisis, Alt-A mortgages came under particular scrutiny.

## **Asset class**

A classification of credit exposures according to the Capital Requirements Directive – IRB approach. The main classes are Sovereigns, Institutions, Corporates, SME Corporates and Retail. Classification depends on the type of obligor, the total annual sales of the obligor, the type of product and the exposure value.

## **Banking book**

KBC's banking book is defined as all positions in the KBC Bank group that are not in the trading book. A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any covenants restricting their tradability or be able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio actively managed.

## **Basel III**

Basel III is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the members of the Basel Committee on Banking Supervision in 2010. Basel III was developed in response to the deficiencies in financial regulation revealed by the late-2000s financial crisis.

## **Beta factor**

The capital charge for a business line in the context of operational risk is approximated by multiplying the gross income of that business line with the beta ( $\beta$ ) factor. Thus the  $\beta$  factor serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income of that business line.

## **BIS (Bank for International Settlements)**

The Bank for International Settlements (BIS) is an international organisation that fosters cooperation towards monetary and financial stability and serves as a bank for central banks. It is the world's oldest international financial institution and remains to this day the principal centre for international central bank cooperation. (Website BIS: [www.bis.org](http://www.bis.org)).

## **BPV (Basis Point Value)**

The measure that reflects the change in the net present value of interest rate positions, due to an upward parallel shift of 10 basis points (i.e. 0.10%) in the zero coupon curve.

## **Business risk**

The potential negative deviation from the expected value of the organisation arising from changes in the macroeconomic environment, the financial services industry or market for products and services, as well as from other changes in the regulatory, socio-demographic, political, cultural or ecological environment.

## **CAD ratio**

Total eligible capital / Risk-weighted assets (the result must be at least 8% according to the Basel regulations).

## **CDO (Collateralised Debt Obligation)**

CDOs are a type of asset-backed security and a structured finance product in which a distinct legal entity, a special purpose vehicle (SPV), issues bonds or notes against an investment in an underlying asset pool. Pools may differ with regard to the nature of their underlying assets and can be collateralised either by a portfolio of bonds, loans and other debt obligations, or be backed by synthetic credit exposures through use of credit derivatives and credit-linked notes.

The claims issued against the collateral pool of assets are prioritised in order of seniority by creating different tranches of debt securities, including one or more investment grade classes and an equity/first loss tranche. Senior claims are insulated from default risk to the extent that the more junior tranches absorb credit losses first. As a result, each tranche has a different priority of payment of interest and/or principal and may thus have a different rating.

## **CDS (Credit Default Swap)**

A privately negotiated bilateral agreement where one party (the protection-buyer or risk-shedder) pays a premium to another party (the protection-seller or risk-taker) in order to secure protection against any losses that may be incurred through exposure to a reference entity or investment as a result of an unforeseen development (or 'credit event').

## **Central Tendency**

Average through-the-cycle default probability of a segment.

## **CLO (Collateralised Loan Obligation)**

CDO holding only loans as underlying assets.

## **CP (Commercial Paper)**

Unsecured short-term promissory notes which generally have maturities of less than 270 days.

## **CRD (Capital Requirements Directive)**

European-Union-specific interpretation of the general Basel II regulations. The CRD is in turn transposed into the national legislation and regulations of the EU Member States.

## **Credit risk**

The potential negative deviation from the expected value of a financial instrument arising from non-payment or non-performance by a contractual party (for instance, a borrower, a guarantor, an insurer or re-insurer, a counterparty in a professional transaction or an issuer of a debt instrument), due to that party's insolvency or lack of willingness to pay or perform, or to events or measures taken by the political or monetary authorities of a particular country (the latter is also referred to as country risk).

## **Cure rate**

Rate of clients who default and revert subsequently to 'non-default' status.

## **Downturn LGD**

LGD in an economic downturn. The underlying idea in the Basel regulation is that LGD is correlated to PD and loss rates will be higher in a year with many defaults.

## **DPF (Discretionary Participation Feature)**

Part of the annual profit that is attributed to the policyholders of an insurance contract.

## **EAD (Exposure At Default)**

The amount expected to be outstanding if and when an obligor defaults. At the time of default, it is equal to the actual amount outstanding, and therefore is no longer an expectation.

## **EBA (European Banking Authority)**

The successor to the CEBS (Committee of European Banking Supervisors). A committee comprised of high level representatives from the banking supervisory authorities and central banks of the European Union. It gives advice to the European Commission on banking policy issues and promotes co-operation and convergence of supervisory practice across the European Union. The committee will also foster and review common implementation and consistent application of Community legislation.

## **ECAP (Economic Capital)**

Economic capital is the amount of capital needed to absorb very severe losses, expressed in terms of the potential reduction in the economic value of the group (= difference between the current economic value and the worst case economic value over a one-year time horizon and measured at a certain confidence level). It represents the minimum amount of capital which is required in order to protect KBC group debt holders against economic insolvency under extreme circumstances.

## **EIOPA (European Insurance and Occupational Pensions Authority)**

The successor to the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), EIOPA is part of the European System of Financial Supervision consisting of three European Supervisory Authorities and the European Systemic Risk Board. It is an independent advisory body to the European Parliament and the Council of the European Union. EIOPA's core responsibilities are to support the stability of the financial system, transparency of markets and financial products, as well as the protection of insurance policyholders, pension scheme members and beneficiaries.

## **EL (Expected Loss)**

The expected value of losses due to default over a specified horizon. EL is typically calculated by multiplying the Probability of Default (a percentage) by the Exposure At Default (an amount) and Loss Given Default (a percentage). It is always considered 'an expectation' due to the 'Probability of Default' factor.

## **Fair value**

The amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction. Market-consistent value or fair value is based on relative pricing or the 'no arbitrage' argument.

## **FSMA (Financial Services and Markets Authority)**

The FSMA is the successor to the former Banking, Financial and Insurance Commission (CBFA). It is responsible for supervising the financial markets and listed companies, authorising and supervising certain categories of financial institutions, overseeing compliance by financial intermediaries with codes of conduct and supervising the marketing of investment products to the general public, as well as for the 'social supervision' of supplementary pensions. The Belgian government has also tasked the FSMA with contributing to the financial education of savers and investors..

## **GMRA (General Master Repurchase Agreement)**

Standardised contract used when entering into (reverse) repo-like transactions.

## **GRCOC (Group Risk and Capital Oversight Committee)**

Overarching and integrated risk committee at KBC group level that among other tasks, monitors the integrated risk profile, proposes mitigating measures to the Group Executive Committee, when the risk profile exceeds the limits of the risk appetite

## **GRMC (Group Risk Management Committee)**

Overarching and integrated risk committee at KBC group level that among other tasks, monitors and ensures the adequacy of risk and capital governance, manages and supervises model frameworks and their implementation.

## **GVRM (Group Value and Risk Management)**

Directorate at KBC group level whose mission is to create – independently of the line and in keeping with advanced industry standards – a group-wide framework for value, risk and capital management, monitor the implementation of this framework, and provide assistance to the business on the use of value and risk management instruments and techniques.

## **Haircuts**

The difference between the market value of a security and its collateral value. Haircuts are taken in order to account for a possible decline in the market value of a collateralising security upon liquidation.

## **HVAR (Historical Value At Risk)**

Historical Value-at-Risk estimates the maximum amount of money that can be lost on a given portfolio due to adverse market movements over a defined holding period, with a given confidence level and using real historical market performance data.

## **ICAAP (Internal Capital Adequacy Assessment Process)**

The internal process a bank should have in place for assessing its overall capital adequacy in relation to its risk profile, as well as its strategy for maintaining adequate capital levels in the future.

## **Insurance Risk**

The potential negative deviation from the expected value of an insurance contract or pension claim (or a portfolio thereof).

## **Interest rate risk**

The potential negative deviation from the expected value of a financial instrument or portfolio thereof due to changes in the level or in the volatility of interest rates.

## **IRB (Internal Ratings-Based)**

An approach defined in the Capital Requirements Directive to calculate the credit-risk-related capital requirements, where a financial institution uses its own models to perform the calculation. There are two possibilities: the IRB Foundation or the IRB Advanced approach. When applying the IRB Foundation approach, internal estimates of the Probability of Default are used to calculate minimum requirements, while the IRB Advanced methodology also takes into account the internal estimates of Exposure At Default and Loss Given Default.

## **ISDA Master Agreements**

Standardised contracts developed by the International Swaps and Derivatives Association and used to document bilateral professional transactions. The presence of such contracts also allows professional exposures between the contracting parties to be netted.

## **LAPA (Liquidity Asset Purchase Agreement)**

An agreement to purchase an asset on a firm commitment basis when requested.

## **Lapse risk**

The potential negative deviation from the expected value of an insurance contract or a portfolio thereof due to unexpected changes in policy lapses. Note that the term surrender risk refers specifically to contracts with surrender value.

## **LCR (Liquidity Coverage Ratio)**

'Stock of high-quality liquid assets minus Total net cash outflows over the next 30 calendar days'. A result of 100% (or more) indicates that a bank is maintaining a sufficient stock of 'high-quality liquid assets' to cover net cash outflows for a 30-day period under a stress scenario. The parameters of the stress scenario are defined under Basel III.

## **LGD (Loss Given Default)**

The loss a bank expects to experience if an obligor defaults, taking into account the eligible collateral and guarantees provided for the exposure. It can be expressed as an amount or as a percentage of the EAD (Exposure At Default). At the time of default, the loss experienced is a loss of the actual amount outstanding, thus no longer an expectation.

## **Liquidity risk**

The potential that an organisation will be unable to meet its obligations as they fall due because of the inability to liquidate assets or obtain adequate funding (liability liquidity risk) or the risk that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (asset liquidity risk).

## **Market risk**

The potential negative deviation from the expected value of a financial instrument (or portfolio thereof) due to changes in the level or volatility of market prices.

## **Market value**

The cost that would be incurred or the gain that would be realised if an outstanding contract was replaced at current market prices (also called replacement value).

## **Mark-to-Market**

The act of assigning a market value to an asset

## **MVA (Market Value Adjustment)**

IFRS-inspired adjustments or reserves recognised on positions at fair value. MVAs cover close-out costs, adjustments for less liquid positions or markets, counterparty exposure resulting from OTC derivatives, model-linked valuation adjustments, operation-related costs, as well as transaction-specific adjustments.

## **NBB (National Bank of Belgium)**

One of the tasks of the NBB is financial supervision, which is the instrument for ensuring financial stability, and the second key function of a central bank, alongside monetary stability. Financial supervision covers the:

1. prudential supervision of financial institutions from both the micro-prudential and macro-prudential angle, and the prompt detection of systemic risk;
2. supervision of information, the functioning of the financial markets and respect for the appropriate code of conduct, together with consumer protection.

## **Netting**

An agreed offsetting of positions or obligations by trading partners or participants to an agreement. Netting reduces the number of individual positions or obligations subject to an agreement to a single obligation or position.

## **NSFR (Net Stable Funding Ratio)**

'Available Stable Funding/Required Stable Funding', where available stable funding is derived from different components on the liabilities side of the balance sheet (required funding = assets side). Basel III defined weightings for determining stability are assigned to the different components (both assets and liabilities). An NSRF of 100% means that the funding situation is stable.

## **ODR (Observed Default Rate)**

The observed default rate is the observed number of defaulted obligors during a certain time period as a percentage of the total non-defaulted obligors at the beginning of the period.

## **Operational Risk**

The potential negative deviation from the expected value of the organisation resulting from inadequate or failed internal processes, people and systems or from sudden man-made or natural external events. Operational risk excludes business, strategic and reputational risk.

## **ORSA (Own Risk and Solvency Assessment)**

The Own Risk and Solvency Assessment covers the entirety of the processes and procedures employed for identifying, assessing, monitoring, managing, and reporting on the short- and long-term risks a (re)insurance undertaking faces or may face, and for determining the own funds necessary to ensure that the undertaking's overall solvency needs are met at all times.

## **OTC (Over The Counter)**

An over-the-counter contract is a bilateral contract where two parties agree on how a particular trade or agreement is to be settled in the future. It is usually a direct contract between a (an investment) bank and its clients. It contrasts with exchange trading.

## **PD (Probability of Default)**

The probability that an obligor will default within a one-year horizon.

## **PIT PD (Point-In-Time PD)**

PD reflecting the expected default rate in the next year, based on current economic conditions (contrast with Through-the-cycle PD).

## **RAPM (Risk-Adjusted Performance Measurement)**

The risk-adjusted performance measurement policy defines a set of risk-adjusted performance metrics to be used for (1) allocating capital and (2) setting variable remuneration.

## **RAROC**

A measure, expressed as a percentage, used to reflect the profitability of transactions and/or financial instruments, account taken of the risk involved in these transactions and/or financial instruments. Generally speaking, it equals the 'expected profits minus the expected losses' divided by the capital invested.

## **RBA (Ratings-Based Approach)**

Basel II approach for calculating the risk-weighted assets applied to securitisation exposures that are externally rated, or where a rating can be inferred.

## **RMBS (Residential Mortgage-Backed Security)**

A type of structured credit product whose underlying assets are residential debt such as mortgages, home-equity loans and subprime mortgages.

## **RWA (Risk-Weighted Asset)**

An exposure weighted according to the 'riskiness' of the asset concerned. 'Riskiness' depends on factors such as the probability of default by the obligor, the amount of collateral or guarantees and the maturity of the exposure.

## **SFA (Supervisory Formula Approach)**

Basel II approach used to calculate the risk-weighted assets of a structured credit product based on a formula defined in the Basel II securitisation framework.

## **Solvency II**

Solvency II is a project, initiated by the European Commission in 2001, which establishes capital requirements and risk management standards that will apply across the EU and will affect all areas of an insurer's operations. Solvency II aims to move away from the idea that 'one approach fits all' and thus encourages companies to manage risk in a way which is appropriate to the size and nature of their business in order to provide protection to policyholders by reducing the risk of insolvency to insurers.

## **SPV (Special Purpose Vehicle)**

A Special Purpose Vehicle in the context of this document is any distinct entity created to achieve (a) narrow and well-defined objective(s). SPVs may be created by the KBC group, managed by the KBC group, created by third parties for the account of the KBC group or managed by third parties for the account of the KBC group.

## **SSS (Super Senior Swap)**

In the so-called unfunded portion of a synthetic CDO, the risk embedded in a portfolio of assets (as opposed to the assets themselves) is transferred directly to a 'super-senior counterparty' via a super-senior CDS. In this instance, the CDO acts as the protection-buyer, by agreeing to pay a premium to the counterparty (the protection-seller) in return for a commitment from the counterparty to pay compensation to the CDO in the event of any defaults in the reference portfolio. It is the best part in terms of subordination.

## **SVAR (Stressed Value At Risk)**

Stressed Value-At-Risk is analogous to the Historical VAR, but it is calculated for the time series of a maximum stressed period in recent history.



### **(Core) Tier 1-ratio**

[tier-1 capital] / [total weighted risks]. The calculation of the core tier-1 ratio does not include hybrid instruments (but does include the core-capital securities sold to the Belgian and Flemish governments).

### **Trading book**

The trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. Positions held for trading intent are those held intentionally for resale in the short term and/or with the intent of benefiting from actual or expected price movements in the short term or to lock in arbitrage profits.

### **TTC PD (Through-The-Cycle PD)**

PD reflecting the one-year expected default rate averaged out over a longer period (contrast with Point-in-time PD).

### **VAR (Value At Risk)**

The unexpected loss in the fair value (= difference between the expected and worst case fair value), at a certain confidence level and with a certain time horizon.