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KBC Group  
Risk Report 2008



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# Contents

Glossary .....	6
Mission and strategy .....	14
Vision and principles .....	15
General risk governance model .....	15
Model management framework .....	16
Market disclosure policy and scope .....	17
Market disclosure policy .....	18
Scope .....	18
Highest consolidation level .....	18
Solvency and capital profile .....	19
Description .....	20
Managing solvency .....	20
Capital-strengthening transaction with the Belgian State and the Flemish Regional Government .....	20
Solvency disclosures .....	21
Economic capital .....	24
Credit risk management .....	25
Description .....	26
Strategy and processes .....	26
Scope of credit risk disclosures .....	27
Exposure to credit risk .....	28
Total and average aggregated exposure to credit risk .....	28
Credit risk in the lending portfolio .....	29
Concentrations to credit risk in the lending portfolio .....	31
Impaired credit exposure in the lending portfolio .....	37
Counterparty credit risk .....	39
Credit risk mitigation .....	41
Internal modelling .....	44
Structured credit products .....	48
Description .....	49
Procedures .....	49
Scope of structured credit activities .....	49
Structured credit programmes for which KBC acts as originator .....	50
KBC's structured credit position (where KBC acts as investor) .....	53
Capital charges .....	58
Market risk management .....	59
Description .....	60
Strategy and processes .....	60
Scope of market risk disclosures .....	60
VAR model and characteristics .....	61
Acceptance of the VAR model and capital charges for market risk .....	61
Stress testing .....	62
Back testing .....	62

Validation and reconciliation .....	62
Non-trading equity and interest rate risk management.....	63
Description.....	64
Strategy and processes .....	64
Scope of non-trading equity and interest rate risk disclosures.....	65
Equity risk .....	65
Interest rate risk.....	66
Liquidity risk management.....	68
Description.....	69
Strategy and processes .....	69
Scope of Liquidity risk management.....	69
Structural liquidity risk.....	69
Operational risk management .....	71
Description.....	72
Strategy and processes .....	72
Scope of operational risk management .....	72
Operational Risk Governance.....	72
Toolbox for the management of operational risks .....	73
Operational Risk Capital Charge .....	73

# 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.

## **ALCO (Asset and Liability Management Committee)**

Committee in the governance process responsible for the development (and follow-up of implementation) of the ALM framework. The activities of the ALCO entail asset allocation, setting internal limits, decision-taking on investments for the ALM positions, the use of ALM opportunities to stimulate specific commercial initiatives, the monitoring of the impact on and of the policies of the business units, and reporting on the ALM profile.

## **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.

## **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 economic value of the organisation due to changes in the volumes and operational margins resulting from changes in the environment of the organisation and inappropriate or inadequately implemented strategies

## **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').

## **CEBS (Committee of European Banking Supervisors)**

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 cooperation and convergence of supervisory practice across the European Union. The Committee will also foster and review common implementation and consistent application of Community legislation..

## **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 its turn translated into national legislation and regulation of the EU countries.



## **Credit risk**

Credit risk is the potential negative deviation from the expected value of a financial instrument due to non-payment or non-performance of a borrower (of a loan), an issuer (of a debt instrument), a guarantor or re-insurer, or a counterparty (in a professional transaction), 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.

## **ECAP (Economic Capital)**

KBC Economic Capital (ECap) is defined as the unexpected loss in the fair value of the KBC group (= difference between the expected and worst case fair value). It is the minimum amount of capital that has to be available in order to protect the KBC group against economic insolvency.

## **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.

## **GCRC (Group Credit Risk Committee)**

Committee in KBC's governance process that supervises the composition and quality of the loan portfolio (including credit risk in respect of (re)insurance).

## **GMC (Group Model Committee)**

A cross-risk, cross-business and cross-border advisory body that provides independent advice on model validation prior to endorsement by the Executive Committee sub-panel, and that follows up on the implementation of review/validation recommendations. It ensures operational risk aspects are embedded in the advisory/decision-making process.

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

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

## **GTRC (Group Trading Risk Committee)**

Committee at KBC's group level that controls all risk in the group associated with trading activities.

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

Department at KBC group level whose mission it is to independently of the line and in keeping with advanced industry standards to create a Group-wide framework for value, risk and capital management, monitor the implementation of this framework, and provide assistance to the line 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**

Insurance risks stem from uncertainty regarding how often insured losses will occur and how extensive they will be.

## **Interest rate risk**

The potential negative deviation from the expected net asset value of the trading book or the financial investment book 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 ISDA (International Swaps and Derivatives Association) 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**

Lapse risk is the risk that the policy holder will end his policy before the maturity date. In modern universal life business where regular premium payments are used, the lapse risk includes the risk of dormancy. Dormancy occurs when policyholders pay less or stop paying premiums on an existing contract.

## **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**

Market risk is the potential negative deviation from the expected economic value of a financial instrument caused by fluctuations in market prices, i.e. interest rates, exchange rates and equity or commodity 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

## **MMF (Model Management Framework)**

Generic framework for managing model-related aspects of all types of risk (market risk, credit risk, operational risk, ALM and insurance risk) and value and capital (for example economic capital). The Model Management Framework covers portfolio models as well as transactional models.

## **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.

## **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.

## **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 economic value of the organisation resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal, IT and tax risk.

## **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, in contrast to Through-the-cycle PD.

## **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. Roughly 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 Risk**

Solvency risk is the risk that the firm will become insolvent, i.e. that the value of the liabilities will exceed the value of the assets. This entails checking solvency against the regulatory and in-house minimum solvency ratios (for a specific rating target).

## **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.

### **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, in contrast to Point-in-time PD.

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

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

# Mission and strategy

The business of bancassurance is exposed to a number of typical risks, such as credit risk, market risk and liquidity risk, as well as technical insurance risk, operational risk, reputation risk, and business and strategic risk. Controlling all these risks is one of the most crucial tasks of management. This section of our risk report provides an overview of how we approach value and risk management in our group. For KBC and for the financial industry as a whole, 2008 will be remembered as a turbulent year, one highlighting the importance of sound and prudent risk management to support decision-making and to identify problems at group level.

## Vision and principles

At KBC, the essential characteristics of value and risk management are as follows:

- Value, risk and capital management are inextricably linked to one another. Every company's aim is to create value. To achieve this aim, decisions are taken and activities developed, even though there is no certainty as to where they will lead. To ensure its own continuity, a company must have adequate capital to be able to deal with any unforeseen consequences of adverse developments.
- Risk management is approached from a comprehensive, group-wide angle, taking into account all the risks a company is exposed to and all the activities it engages in.
- Primary responsibility for value and risk management lies with line management, while a separate Group Value and Risk Management Directorate, operating independently of line management, performs an advisory, supporting and supervisory role.
- The group's risk governance model is also, where relevant, duplicated at the level of the business units and subsidiaries.

## General risk governance model

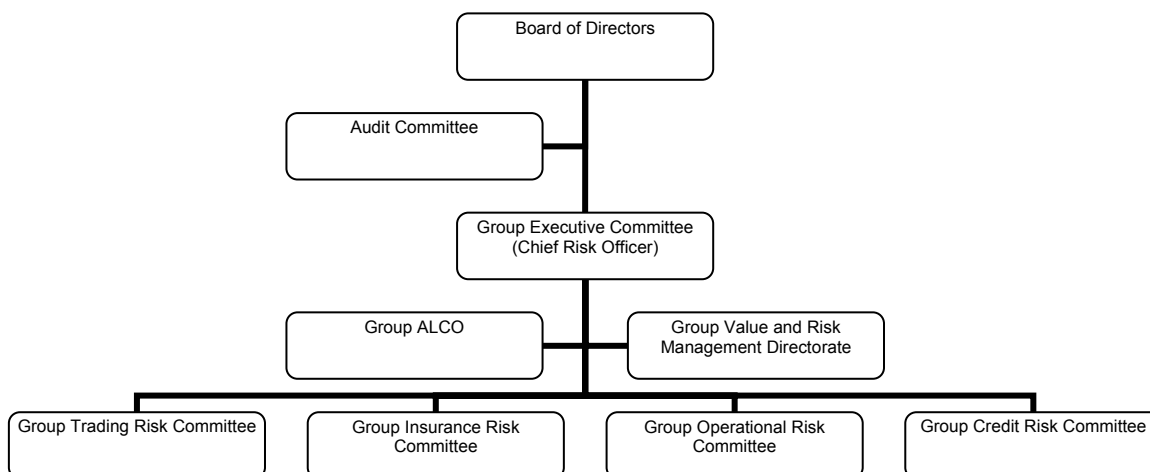
KBC's risk governance model defines the responsibilities and tasks required to manage value creation and all the associated risks. The governance model is organised in different tiers:

- *The Board of Directors (assisted by the Audit Committee), the Group Executive Committee and the Group Asset/Liability Management Committee (ALCO).* These committees concentrate on global risk management and on monitoring value creation and capital adequacy for the entire group. Regular reporting to the Audit Committee ensures that there is an ample flow of information to the relevant members of the Board of Directors. Each year, the full board sets the risk tolerance limits. The Group Executive Committee is responsible for the implementation of the value, risk and capital management strategy defined by the Board of Directors and outlines the structure of such management. The Chief Financial and Risk Officer (CFRO), a member of the Group Executive Committee, supervises risk management. The Group ALCO defines the strategic investment and funding mixes and also monitors the relevant risk exposure. In 2008, the tactical investment decisions previously taken by the Group ALCO were entrusted to a newly established investment committee.
- *Specialised group risk committees.* These committees concentrate on developing a group-wide framework for one particular type of risk or cluster of activities and monitor the associated risk management process. Chaired by the CFRO, the risk committees are composed of representatives from line management and the Group Value and Risk Management Directorate. The various group committees are shown in the schematic.

Depending on the materiality of specific risk types, local risk committees and local value and risk management units have been put in place at a lower level (e.g. business unit, country and subsidiary), to roll out the risk management framework.

- The Group Model Committee (GMC) uses reports drawn up by independent validation units to decide on the validity of quantitative and operational risk aspects (such as model usage, monitoring activities, etc.) of all the risk models developed and/or used within the group.
- The Group Internal Audit division 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.

- Line management has primary responsibility for value and risk management. It ensures that the risk management framework relating to the business is embedded in the business through policies and procedures. It is also entrusted with the task of developing transactional models.
- The Group Value and Risk Management Directorate measures risks, economic capital and value creation for all business entities and reports its findings to line management. It is also responsible for developing portfolio models, as well as for validating all models (both transactional and portfolio models). In this respect, there is a clear segregation of responsibilities within this directorate, as *validating staff* is different from *modelling staff*.



## Model management framework

In order to move from a 'project style' approach to an 'ongoing concern' approach for modelling purposes, KBC group developed a Model Management Framework (MMF) at the end of 2005. This generic framework addresses all types of risk (market risk, credit risk, operational risk, ALM risk and insurance risk) and encompasses value and capital issues (for example, economic capital models). The Model Management Framework covers portfolio models as well as transactional models.

The key elements of the MMF are:

- The 'Model Life Cycle' describing the different stages to be followed (request, design and implementation);
- The 'MMF roles' defining the roles and responsibilities of all parties involved in the model life cycle (model owner, policy manager, validator, etc.);
- The 'Model Guidelines' (Methodology, Policy, Implementation and Review Guidelines);
- The 'Model inventory'.

The framework is implemented for a specific risk type under the responsibility of the relevant Group Risk Committee.

For insurance risk, the implementation of the MMF for the main portfolio models started in 2008, with transactional insurance models to be brought into line with MMF requirements from 2009 onward. For the main models used in ALM, implementation continues in 2009.

The major principles embedded in the MMF are as follows:

- The transactional models are developed by the business;
- The portfolio models are developed by a central or local 'Value and Risk Management' unit;
- The responsibilities regarding the design and validation of models are strictly separated. The models are validated by an independent unit in the local and/or central Value and Risk Management unit;
- The review and validation process is characterised by an end-to-end approach (from the request for a model to its implementation and monitoring);
- All models are monitored and subject to periodic review and validation;
- All models are approved by the Group Model Committee (GMC) and endorsed by an Executive Committee (EC) sub-panel (CFRO and the EC member responsible for the business unit where the model is to be implemented). The internal audit department has a permanent member (as observer) in the GMC.



# Market disclosure policy and scope

## Market disclosure policy

In line with its general communication policy, KBC aims to be as open as possible in communicating with the market about its exposure to risk. Value and risk management information is therefore provided in a separate section of our annual report and - even more extensively - in this document.

This risk report is created to provide bundled and detailed risk information. It is also in accordance with the Pillar 3 disclosure requirements of the Capital Requirements Directive (as transposed into Belgian legislation), and is aimed at meeting the market's needs as much as possible.

This risk report is available in English on the KBC website and is updated on a yearly basis. Consequently, KBC's next update is scheduled for the beginning of April 2010. Depending on market needs, KBC may however decide to provide more frequent updates. For instance, since July 2008 information on structured credit products has been more frequently updated.

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 subjected to a final screening by an authorised committee to ensure quality.

When applicable a comparison with the previous year is available. This depends in part on equality of scope and methodology.

As regards Pillar 3 requirements, disclosures are incorporated if they are deemed relevant for KBC. Accordingly, in order to focus on what is relevant for the market, requirements that are not applicable for KBC are not mentioned in this document.

Some of the information provided coincides with the information required under IFRS and is provided in the relevant sections of the 2008 annual report. However, in order not to compromise on the readability of this document, relevant parts of the annual report have been reproduced here. Only when substantial parts are identical to information provided in the annual report, is the reader referred to the annual report.

## Scope

Since the materiality of subsidiaries of KBC can vary per topic, entities can be included or excluded depending on whether they are deemed important or unimportant for that topic.

In the information below, the scope will be clearly communicated whenever figures are given. KBC ensures that a representative picture is given at all times in its disclosures.

## Highest consolidation level

With regard to Pillar 3, information is only disclosed at the highest consolidated level. This level in a risk context varies depending on the issue covered.

Additional information on the material entities is confined to the capital information in the 'Solvency and capital profile' section. However, for more detailed information, see the local capital disclosures of the entity concerned.

# Solvency and capital profile

## Description

Solvency risk is the risk that the capital base of the group, the bank or the insurer might fall below an acceptable level. In practice, this entails checking solvency against the minimum regulatory and in-house solvency ratios.

## Managing solvency

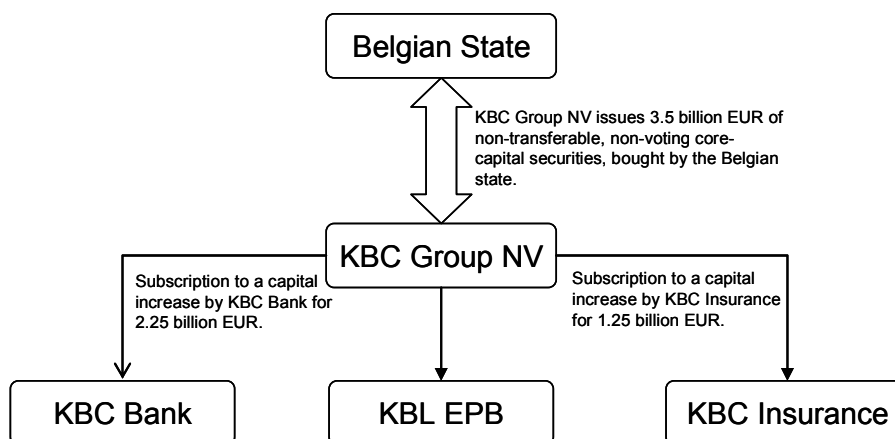
KBC reports its banking solvency calculated according to IFRS figures and the relevant guidelines issued by the Belgian regulator. The regulatory minimum is 8% for the CAD ratio and 4% for the tier-1 ratio. KBC reports its insurance solvency calculated according to IFRS figures and the new guidelines issued by the Belgian regulator in 2008. Although the regulatory minimum for the solvency ratio is 100%, KBC has much higher in-house solvency targets for both the banking and insurance activities. Consequently, regulatory minimum solvency targets were amply exceeded, not only at year-end, but also throughout the entire year.

In accordance with Basel II, pillar 2 requirements, KBC has developed an Internal Capital Adequacy Assessment Process (ICAAP). This process uses an economic capital model (see below) to measure capital requirements based on aggregate group-wide risks, and compares these requirements with the capital available to cover risks. The ICAAP examines both the current and future capital situation. To assess the latter situation, a three-year forecast is drawn up for required and available capital, according to a basic scenario that takes account of anticipated internal and external growth, and according to various alternative scenarios. In addition, contingency plans are chartered that might improve KBC's solvency under more difficult circumstances.

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.

## Capital-strengthening transaction with the Belgian State and the Flemish Regional Government

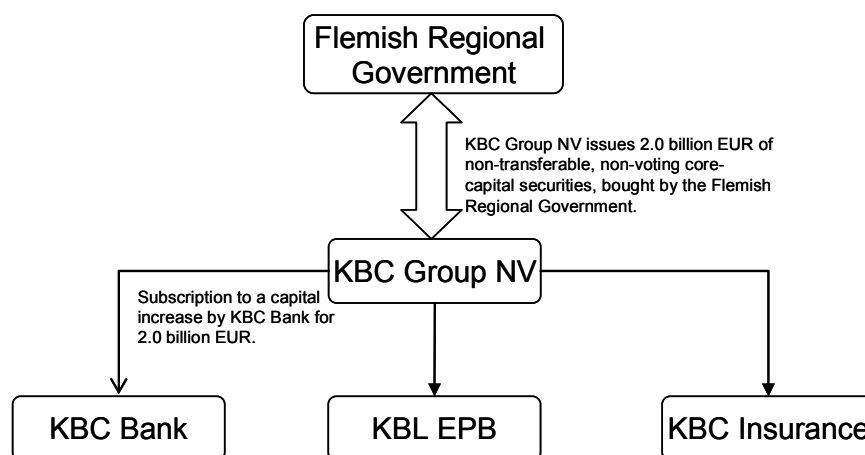
In October 2008, KBC and the Belgian government reached an agreement to further strengthen KBC's financial position. Signed at the end of December 2008, the transaction entailed KBC issuing 3.5 billion euros' worth of non-transferable, non-voting core-capital securities to the Belgian State. KBC has used the proceeds of the transaction to increase its core tier-1 capital in the banking business by 2.25 billion euros and to bolster the capital base of the insurance business by 1.25 billion euros, resulting in a further and significant strengthening of its banking and insurance solvency ratios. More detailed information on this transaction is provided in the 2008 annual report 'Consolidated annual accounts' section, Note 35.



*The Belgian state was represented by the 'Federale investerings- en participatiemaatschappij' which is a government owned and controlled entity.*

In January 2009, KBC's capital base was further strengthened by a similar transaction with the Flemish Regional Government, this time for 2 billion euros, plus a supplementary stand-by facility of 1.5 billion euros.

More detailed information on this transaction is provided in the 'Consolidated annual accounts' section of the 2008 annual report, Note 42. The transaction is subject to regulatory approval from the European Commission, which KBC is confident it will receive



*The transaction will be concluded by the Flemish Regional Government or by an entity controlled by this government.*

The Belgian Banking, Finance and Insurance Commission has confirmed that the securities issued in both transactions (ad 3.5 billion and 2 billion euros, respectively) qualify as core tier-1 capital.

## Solvency disclosures

### Scope of solvency disclosures

The capital profile is disclosed for KBC group NV as a whole, as well as for the major activities of the group, i.e. banking (KBC Bank consolidated and KBL European Private Bankers (KBL EPB below)) and insurance (KBC Insurance).

Solvency information is also disclosed for each of the significant banking subsidiaries. Significance in this respect is defined by KBC as suggested by the CEBS 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 to the local banking system as expressed in terms of market share, for instance.

Since Absolut Bank, CBC Banque, Centea, ČSOB (Czech Republic), ČSOB (Slovak Republic), KBC Bank, KBC Bank (Ireland), KBL EPB, Kredyt Bank and K&H Bank have been identified as significant banking subsidiaries, summary information is provided for each of these companies below.

### Solvency in 2008, group overview

KBC reports its group solvency calculated according to IFRS figures and the relevant guidelines issued by the Belgian regulator, using the so-called 'building block' method. This entails comparing group regulatory capital (i.e. parent shareholders' equity less intangible assets and a portion of the revaluation reserve for available-for-sale assets, plus subordinated debt, etc.) with the sum of the separate minimum regulatory solvency requirements for KBC Bank, KBL EPB and the holding company (after deduction of intercompany transactions between these entities) and KBC Insurance.

For more detailed information on the capital-strengthening transaction concluded with the Belgian State and the Flemish Regional Government, see the 'Consolidated annual accounts' section of the annual report of KBC Group, Note 35 and Note 42. The transaction with the Belgian State has been fully incorporated into the figures in the table.

Solvency, KBC Group	31-12-2007	31-12-2008
In millions of EUR	Basel II Solvency I	Basel II Solvency I
Total regulatory capital	19 194	19 370
Required minimum regulatory capital	11 760	12 423
Surplus above minimum regulatory capital	7 434	6 946

## Solvency, banking activities (KBC Bank and KBL EPB combined)

The table shows the tier-1 and CAD ratios calculated under Basel II. It should be noted that Basel II rules have been implemented in all entities throughout the group since 2008 (this was not yet the case at 31 December 2007, the end of the transition year). Primarily the Basel II IRB Foundation approach is being used (for about 70% of the weighted risks), while the weighted risks of the other companies (roughly 30% of such risks) are calculated according to the Standardised method.

In order to strengthen the solvency ratios of KBC Bank and with a view to optimising the use of those hybrid instruments allowed by the regulator, KBC Bank issued so-called non-innovative hybrid tier-1 capital instruments worth 2 billion euros in the second quarter of 2008. In Belgium, banks may issue both innovative and non-innovative hybrid capital instruments which qualify for a maximum 25% 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. they need 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.

For more detailed information on the capital-strengthening transaction concluded with the Belgian State in December 2008, see the 'Consolidated annual accounts' section of the annual report, Note 35. This transaction has been fully incorporated into the figures in the table.

For more detailed information on the capital-strengthening transaction concluded with the Flemish Regional Government in January 2009, see the 'Consolidated annual accounts' section of the annual report, Note 42. A pro forma tier-1 ratio, which includes the impact of the 2-billion-euro transaction, has been added to the table.

In millions of EUR	31-12-2007	31-12-2008
	Basel II	Basel II
Total regulatory capital, after profit appropriation	17 170	19 028
<b>Tier-1 capital</b>	<b>11 823</b>	<b>13 643</b>
Parent shareholders' equity	13 650	11 576
Intangible fixed assets (-)	-244	-169
Goodwill on consolidation (-)	-2 053	-2 451
Innovative hybrid tier-1 instruments	1 815	1 652
Non-innovative hybrid tier-1 instruments	0	1 793
Minority interests	584	599
Mandatorily convertible bonds and other tier-2 instruments	-204	-18
Revaluation reserve, available-for-sale assets (-)	7	946
Hedging reserve, cashflow hedges (-)	-73	352
Valuation differences in financial liabilities at fair value – own credit risk	0	-245
Minority interests in available-for-sale reserve and hedging reserve, cashflow hedges (-)	2	1
Dividend payout (-)	-1 077	0
Items to be deducted (-)	-583	-395
<b>Tier-2 and tier-3 capital</b>	<b>5 347</b>	<b>5 385</b>
Mandatorily convertible bonds	186	0
Perpetuals (including hybrid tier-1 instruments not used in tier-1 capital)	599	820
Revaluation reserve, available-for-sale shares (at 90%)	233	29
Minority interests in revaluation reserve, available-for-sale shares (at 90%)	2	-7
IRB provision excess (+)	139	209
Subordinated liabilities	4 754	4 586
Tier-3 capital	18	144
Items to be deducted (-)	-583	-395
<b>Total weighted risks</b>	<b>135 146</b>	<b>141 370</b>
Credit risk	113 415	108 038
Market risk	12 984	20 333
Operational risk <sup>2</sup>	8 747	12 999

Solvency ratios		
Tier-1 ratio	8.7%	9.7% ( <i>pro forma</i> 11.2% <sup>1</sup> )
of which core Tier-1 ratio	7.4%	7.2% ( <i>pro forma</i> 8.6% <sup>1</sup> )
CAD ratio	12.7%	13.5% ( <i>pro forma</i> 14.9% <sup>1</sup> )

1 Includes the impact of the 2-billion-euro transaction concluded with the Flemish Regional Government in January 2009 to strengthen the group's capital base.

2 The substantial increase is due mainly to the fact that, as of 1 January 2008, the scope of Basel II was extended to all KBC group entities, including those that had not previously been subject to Basel II regulations.

## Solvency in 2008, significant banking subsidiaries

For details on the capital profile of the significant banking subsidiaries (subsidiaries of KBC Bank; see definition above), see the capital disclosures in the annual reports of the relevant entities.

A summary is provided in the table. The reported figures are calculated according to IFRS or Belgium GAAP, and on a consolidated basis (except for CBC and Centea).

In millions of EUR 31-12-2008	Absolut Bank	CBC Banque	Centea	ČSOB (Czech Republic)	ČSOB (Slovak Republic)	KBC Bank	KBL EPB	KBC Bank Ireland	Kredyt Bank	K&H Bank
	IFRS	Belgian GAAP	Belgian GAAP	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
Total regulatory capital	594	498	484	1 553	488	17 941	1 086	1 106	646	682
Total weighted risks	4 549	3 341	4 253	15 060	4 282	135 557	7 559	10 214	7 249	6 878
CAD ratio	13.05%	14.90%	11.39%	10.31%	11.40%	13.24%	14.37%	10.83%	8.92%	9.91%

## Solvency insurance activities (KBC Insurance)

Since 30 September 2008, KBC Insurance applies new rules for the calculation of the solvency ratio, in conformity with the regulator's new guidelines. The main new elements in the calculation are:

- The equalisation reserve - calculated under Belgian GAAP - is deducted from available capital (in the past, the equalisation reserve was not deducted).
- The available capital now also includes
  - 90% of the *net positive* revaluation reserve on shares and 100% of the *net positive* revaluation reserve on bonds. In the past, the full net revaluation reserve was included.
  - Unrealised gains on property and equipment, investment property and held to maturity instruments (in the past, these unrealised gains were not included).

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

For more detailed information on the capital-strengthening transaction concluded with the Belgian State, see the 'Consolidated annual accounts' section of the annual report, Note 35. This transaction has been fully incorporated into the figures in the table.

In millions of EUR	31-12-2007	31-12-2008
Available capital	2 641	2 117
Share capital	29	59
Share premium	122	1 842
Reserves	2 600	796
Revaluation reserve, available-for-sale investments	953	-176
Translation differences	37	5
Dividend payout (-)	-617	0
Minority interests	35	56
Subordinated liabilities	0	0
Intangible fixed assets (-)	-24	-32
Goodwill on consolidation (-)	-495	-485
Elimination: Revaluation reserve, available-for-sale investments	-	176
Equalisation reserve	-	-123
Required solvency margin	997	1 127
Non-life and industrial accident (legal lines)	301	341
Annuities	8	8
Subtotal, non-life insurance	308	349
Class-21 life insurance	661	756
Class-23 life insurance	24	14
Subtotal, life insurance	685	770
Other	4	8
Solvency ratio and surplus		
Solvency ratio (%)	265%	188%
Solvency surplus (in millions of EUR)	1 643	990

## Economic capital

An economic capital model is used to measure the overall risk KBC is exposed to through its various activities, with consideration given to a variety of risk factors. The figures generated by this model are reported regularly at meetings of the Group ALCO, the Group Executive Committee, the Audit Committee and once a year to the Board of Directors.

KBC defines economic capital as the amount of capital required to cover unexpected losses in fair value that the group might incur over a one-year period, with a confidence level of 99.96% (i.e. with a degree of certainty of 99.96%). Economic capital is calculated per risk category using a common denominator (the same time horizon of one year and the same confidence interval) and then aggregated. An allowance is made for diversification benefits when aggregating the individual risks.

As mentioned previously, economic capital is used as a major building block for ICAAP (Basel II, pillar 2). In addition, it provides essential input for internal valuation models, such as the Market Consistent Embedded Value model (see the 'Asset/Liability management' section of the annual report).

The breakdown of KBC's economic capital per risk type is provided in the table.

Economic capital distribution, KBC group*	2007	2008
Credit risk	41%	45%
ALM risk	29%	27%
Market risk	4%	4%
Business risk	11%	11%
Operational risk	8%	8%
Insurance risk	6%	5%
Total	100%	100%

\* All percentages relate to figures at the end of September.



# Credit risk management

## Description

Credit risk is the potential negative deviation from the expected value of a financial instrument due to non-payment or non-performance of a borrower (of a loan), an issuer (of a debt instrument), a guarantor or reinsurer, or a counterparty (in a professional transaction), 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)

## 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 (systems, tools) in place to identify and measure the risks before and after accepting individual credit exposures. Managing the risk at portfolio level encompasses inter alia periodic measuring of and reporting on risk embedded in the consolidated credit 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 – transaction level

*Acceptance.* Credit proposals are submitted in writing by a commercial entity. Unless a small amount or a low risk is involved, a loan adviser makes a recommendation. In principle, significant loan decisions are taken jointly by two or more managers. The level at which decisions should be taken is determined by matrices that take account of such parameters as the group risk total (the total risk run by the entire KBC group vis-à-vis the group the counterparty belongs to), the risk class (determined primarily on the basis of internally developed rating models) and the type of counterparty (financial institutions, sovereign entities, companies, etc.).

Lending to individuals (e.g., home loans) is subject to a standardised process, during which the output of scoring models plays an important role in the acceptance procedure. Credit to individuals is generally granted in the local currency, except in some Central and Eastern European countries and Russia, where credit in foreign currency is provided on account of the significant gap between interest rates in the local currency and interest rates in other currencies. During 2008, there was a growing awareness of the inherent risk stemming from fluctuations in exchange rates, resulting in a tempering of foreign currency lending by year-end. A cautious approach has been adopted towards this particular type of lending for some considerable time, as reflected inter alia in an additional buffer (in terms of the loan-to-value ratio, net disposable income thresholds and shorter maturities) and close monitoring by means of stress tests. Moreover, if the remaining currency risk is still too high, it is hedged at group level.

*Supervision and monitoring.* Credit 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.

The 'normal' credit portfolio is split up into internal rating classes ranging from 1 (lowest risk) to 9 (highest risk) for the PD and – in a few buckets – for the LGD. Loans to large corporations are reviewed at least once a year, with the internal rating being updated, as a minimum. Reviews of loans to small and medium-sized enterprises are based primarily on risk signals (such as a significant change in the risk class). Moreover, a member of a credit committee will supervise decisions taken at the decision level immediately below, by checking whether the decision is consistent with lending policy. Loans to individuals are screened periodically at aggregate level for review purposes.

PD class 10 is for 'still performing' borrowers, i.e. borrowers with loans for which interest payments and principal repayments are not more than 90 days in arrears or overdrawn, but for which there is reason to believe that they are unlikely to pay (on time), for instance, because they are in arrears or overdrawn 45 or more days (but no more than 90 days).

Classes 11 and 12 are for 'non-performing' borrowers. Class 11 groups borrowers that are more than 90 days in arrears or overdrawn, while class 12 comprises borrowers whose credit has been cancelled or which are in danger of going bankrupt. For the larger loans, an overview of all borrowers in default is submitted to the Group Executive Committee every quarter.

*Impairment.* For credit granted to 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. In addition, for

credit 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).

## Credit risk management – Portfolio management

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. The largest risk concentrations are, in addition, 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. Whereas some limits are still in notional terms, concepts (such as 'expected loss' and 'loss given default') are increasingly being used. The scope of monitoring in terms of name concentration has been widened over the past few years, enabling the credit risk stemming from lending, investment and derivatives activities to be captured. Moreover, stress tests are performed on certain types of credit (for instance, mortgages, loans provided to specific business sectors), as well as on the full scope of credit risk.

As part of the credit function, the portfolio management desk actively manages and monitors the loan portfolio. Using a model, this unit pinpoints risk concentrations and enhances the diversification of the loan portfolio.

## Scope of credit risk disclosures

With regard to the timing of and approach to implementing Basel II, KBC has opted to phase the roll-out of the IRB Foundation approach to 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 of KBC Group NV. Compliance with this criterion is checked at least twice a year. 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 not adopting the IRB Foundation approach in 2008 follow the Basel II Standardised approach. 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 2011. Other entities will follow suit in 2013 at the earliest.

Roll-out of IRB approach	2008	2009	2010/2011
IRB Foundation approach	KBC Bank CBC Banque ČSOB Czech Republic KBC Bank Ireland KBC Homeloans KBC Credit Investments KBC Financial Products KBC Finance Ireland KBC Bank Deutschland KBC Bank Nederland <sup>3</sup> KBC Lease Belgium	2008 IRB F situation plus: Antwerp Diamond Bank <sup>1</sup> Kredietbank SA Luxembourgeoise	2009 IRB F situation Kredyt Bank K&H Bank Centea CSOB Slovak Republic
Standardised approach	Kredyt Bank K&H Bank Centea Antwerp Diamond Bank Kredietbank SA Luxembourgeoise ČSOB Slovak Republic Absolut Bank Non-material entities	Absolut Bank Kredyt Bank K&H Bank Centea CSOB Slovak Republic Non-material entities	Absolut Bank <sup>2</sup> Non-material entities

<sup>1</sup> Antwerp Diamond Bank obtained regulatory approval to adopt the IRB Foundation approach in early 2009.

<sup>2</sup> Absolut Bank will not apply to use the IRB Foundation approach and will continue to apply the Standardised approach until a switch to the IRB Advanced approach is implemented.

<sup>3</sup> Although KBC Nederland is not a material entity according to KBC's definition above, it also uses the IRB Foundation approach as it operates on a shared IT platform

The scope of the disclosures for credit risk can be inferred from the above roll-out plan, as this scope is limited to the KBC material entities mentioned above. In 2008 these material entities accounted for roughly 95% of the total weighted credit risks of KBC group. However, in view of its specific activities and because its transactions are all accounted for in trading books, KBC Financial Products (KBC FP) is only included in the figures on 'Counterparty Credit Risk' and the related 'Credit Risk Mitigation' figures below.

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's 2008 annual report.

## 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 2008. Exposure to securities in the trading book and to structured credit products is excluded. Information on the former is reported in the credit risk section of the annual report of KBC group. For the latter, 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, (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, 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. In all cases, the EAD is the exposure that serves as the basis for the capital calculation. It can be stated with or without application of eligible collateral, net or gross, respectively.

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 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.

For the portfolio of repo-like<sup>2</sup> instruments, the EAD is determined based on the nominal amount of the lending leg in the transaction.

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 aggregated 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 whose contract is booked on the balance sheet of KBC Group NV excluding derivative instruments, repo-like instruments and – in the case of this publication – securitisation-related assets. On-balance-sheet assets are dealt with in the sections on the 'lending portfolio'.

*Off-balance-sheet assets (Off-balance)*: this category contains assets whose contract is not booked on the balance sheet of KBC Group NV. The category excludes 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 also included as off-balance-sheet assets. Off-balance-sheet assets are dealt with in the sections on the 'lending portfolio'.

<sup>1</sup> In this report, credit exposure, where possible, is expressed as EAD (Exposure At Default), while in the annual report it is expressed as an amount granted or an amount outstanding.

<sup>2</sup> This includes repos, reverse repos and/or tri-party repos.

- *Derivatives*: this category contains all the credit exposure arising from derivative transactions like Interest Rate Swaps (IRS), Forex deals, etc. Derivatives are dealt with later in the section on 'Counterparty credit risk' and not in the sections on the 'lending portfolio'.
- *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 result by four. The gross EAD is the exposure at default after application of the credit conversion factor and substitution due to guarantees, but before application of eligible collateral. The net EAD is the gross EAD after application of eligible collateral.

In billions of EUR – 31-12-2008

Exposure [EAD]	On-balance	Off-balance	Derivatives <sup>2</sup>	Repo-like	Total
Gross total	211	29	28	35	303
Gross average <sup>1</sup>	213	32	23	63	330
Net total	203	28	10	4	244
Net average <sup>1</sup>	206	28	9	4	247
total RWA	83	16	5	1	105

<sup>1</sup> Average and total exposure of Absolut Bank was equalled.

<sup>2</sup> In this table, excluding the exposure of KBC FP, which is reported below under the heading 'Counterparty credit risk'.

## Credit risk in the lending portfolio

The lending portfolio excludes all derivatives 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. Details about the latter appear in the credit risk section of KBC's annual report.

In millions of EUR – 31-12-2008

Lending portfolio [EAD]	gross EAD of main categories*	'Other**	Total gross EAD
Subject to IRB approach	183 838	6 459	190 297
Subject to Standardised approach	47 204	2 073	49 286
Total	231 042	8 532	239 583

\* Exposure to 'Other' is excluded. This contains mostly 'other assets' (e.g., property and equipment, non-assignable accruals). 'Other' is not included in the further breakdowns into concentrations, since the data required to create the breakdowns is often missing.

The general information on the lending portfolio is divided into two tables below. One for a general overview of the exposure subject to the IRB approach and one for the overview of the exposure treated via the Standardised approach. Each approach has its own (regulatory) breakdown by type of exposure/asset classes. In the following sections and tables relating to the lending portfolio (with regard to concentrations and impairment), both are aggregated to provide a total overview of concentrations in the lending portfolio. This is done at the expense of a best-efforts mapping into the mainstream asset classes.

### 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 qualified 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.
- *Other*: besides 'other assets', this category includes the residual value of leasing transactions.

In millions of EUR - 31-12-2008

IRB exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail <sup>1</sup>	(sub)Total <sup>2</sup>	Other	Total
Gross Exposure	39 085	11 362	57 324	16 004	60 063	183 838	6 459	190 297
Net Exposure	39 080	11 339	52 668	11 956	60 063	175 106	6 457	181 563
RWA	1 306	3 491	43 551	11 126	10 236	69 711	3 799	73 510

1 The RWA of the retail class consists of 6 698 million euros in mortgages and 3 538 million euros in other retail.

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

In 2007, the total gross exposure subject to the IRB approach amounted to 169 759 million euros, whereas in 2008 it was 190 297 million euros. The substantial difference of 20.5 billion euros stems mainly from an enlargement of the scope, since KBC Homeloans was granted regulatory approval to adopt the IRB approach in 2008. Besides this – and to a lesser extent – there was also the impact of a general increase in the size of the portfolio.

### 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 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 all remaining 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 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 – 31-12-2008

Standardised exposure [EAD]	gross Exposure	net Exposure	RWA
Sovereign	12 316	12 316	507
RGLA	412	412	158
PSE	105	101	57
MDB	59	59	1
International Org.	0	0	0
Institutions	2 604	2 604	907
Corporates	12 135	11 969	11 803
Retail	7 227	7 215	5 459
Secured by real estate	11 724	11 285	5 182
Past due	463	439	563
CIU	159	159	159
(sub)Total	47 204	46 559	24 797
High risk	8	8	12
Covered bonds	0	0	0
Other	2 073	2 073	1 154
Total	49 286	48 640	25 963

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

## 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 asset class 'Sovereigns'.
- *CIU*: this exposure is mapped to the 'Institutions' asset class.

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

For reasons of relevancy/materiality/data availability the 'Other' category is not included in the following tables. The tables in this section only include breakdowns of the 'Sovereign', 'Institutions', 'Corporates', 'SME Corporates' and 'Retail' asset classes.

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 – 31-12-2008

Gross exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
Africa	14	116	139	1	14	284
Asia	1 032	1 451	2 648	141	32	5 304
Central and Eastern Europe & Russia	12 297	3 589	13 746	7 840	17 305	54 776
Latin America	282	308	663	0	7	1 261
Middle East	25	804	456	0	9	1 294
North America	2 370	1 910	7 716	88	18	12 103
Oceania	0	120	714	0	6	840
Western Europe	35 381	6 402	42 574	11 368	59 455	155 181
<b>Total</b>	<b>51 401</b>	<b>14 701</b>	<b>68 656</b>	<b>19 438</b>	<b>76 846</b>	<b>231 042</b>

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 importance of the second home market (Central and Eastern Europe & Russia) is also more evident compared to last year's risk report, since the material subsidiaries in Hungary, Poland and Russia are now included in the scope (see 'Scope of credit risk disclosures' heading above). The extent of KBC's presence in North America and Asia is also clear from the above table.



## Total credit exposure in the lending portfolio per sector

In millions of EUR – 31-12-2008

Gross exposure [EAD]	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
Agriculture, Farming & Fishing	0	0	675	908	2 405	3 989
Authorities	50 446	1 750	0	0	0	52 196
Automotive	0	0	1 869	832	675	3 376
Aviation	0	0	673	61	6	739
Beverages	0	0	1 582	85	11	1 678
Building & Construction	0	0	4 040	1 623	1 550	7 214
Chemicals	0	0	3 028	581	60	3 670
Commercial Real Estate	0	0	10 925	2 125	674	13 724
Consumer Products	0	0	333	89	43	465
Distribution	0	0	6 671	3 906	3 315	13 893
Electricity	0	0	2 633	149	2	2 784
Electrotechnics	0	0	1 332	300	79	1 711
Finance & Insurance	949	12 579	8 417	561	165	22 670
Food Producers	0	0	2 241	691	231	3 164
Horeca	0	0	634	404	562	1 599
IT	0	0	360	82	72	514
Machinery & Heavy Equipment	0	0	1 450	462	103	2 016
Media	0	0	505	109	54	668
Metals	0	0	1 991	598	272	2 861
Oil, Gas & Other Fuels	0	0	2 150	107	3	2 260
Paper & Pulp	0	0	470	88	21	579
Private Persons	0	0	332	162	62 305	62 799
Services	0	40	8 942	3 340	3 539	15 862
Shipping	0	0	1 346	327	103	1 776
Telecom	0	0	1 925	81	13	2 019
Textile & Apparel	0	0	513	310	95	918
Timber & Wooden Furniture	0	0	275	254	144	673
Tobacco	0	0	95	35	1	132
Traders	0	0	954	290	223	1 467
Water	0	0	561	108	82	752
Other	6	332	1 733	771	35	2 878
<b>Total</b>	<b>51 401</b>	<b>14 701</b>	<b>68 656</b>	<b>19 438</b>	<b>76 846</b>	<b>231 042</b>

In view of KBC's substantial retail activities in most markets, a large share of 'private persons' emerges in this sector distribution. Also, the large percentage of 'authorities' is accounted for predominantly by investments in government bonds.

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

In millions of EUR – 31-12-2008

Residual maturity	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
<1 year	8 167	5 916	26 573	6 871	4 073	51 599
=>1 to <5 years	20 361	5 709	22 446	5 105	6 974	60 596
=>5 to <10 years	10 303	1 656	8 176	2 949	29 460	52 545
=>10 years	5 197	936	8 101	3 535	33 057	50 826
Until Further Notice*	7 373	484	3 359	978	3 282	15 477
<b>Total</b>	<b>51 401</b>	<b>14 701</b>	<b>68 656</b>	<b>19 438</b>	<b>76 846</b>	<b>231 042</b>

\* Exposure without a concrete end-date is assigned to the 'Until Further Notice' category.

About 50% of the lending portfolio will mature within five years. The longest maturities are mainly found in the retail asset class and predominantly relate to mortgage loans to private persons.

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

The table on the next page shows credit risk exposure per Probability of Default (PD) class in terms of EAD on 31 December 2008. 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 is found in a subsequent table. In both cases, the scope is limited to the lending portfolio, meaning that derivatives, exposure to securities in the trading book and repo-like exposures are excluded. As indicated earlier, derivatives are reported in the 'Counterparty credit risk' section and repo-like exposures in the 'Credit risk mitigation' section.

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 presented for the exposure, however, is 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.

The PD scale presented is KBC's master scale for Probability of Default. For more information in this regard, see the 'Internal modelling' section.

No RWA are defined for defaulted exposure calculated via the IRB Foundation approach, since the required capital is determined via the provisions set aside for this defaulted exposure. For exposures calculated via the IRB Advanced approach, the required capital and relevant RWA are determined via the difference between the 'best estimate expected loss (EL) and the actual loss given default (LGD)'. For KBC, this is only applicable for exposures in the retail asset class.

The total EAD – before application of guarantees – for defaulted non-retail exposures amounts to 3 348 million euros. The EAD of the defaulted retail portfolio comes to 1 006 million euros.

The limited difference in 'total exposures' between this table and the previous table on IRB exposure is attributable to guarantees and associated PD substitution. More specifically, PD substitution results in shifts from and to the 'Other' asset class, which is not shown in the table. This explains the difference (albeit very limited) between the total exposure in the above tables (183 838 million euros) and the aggregation of the total in the table below for the non-default category (179 490 million euros) and the total defaulted exposure (3 348 + 1 006 = 4 354 million euros) reported above.

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

In millions of EUR – 31-12-2008

PD master scale	gross Exposure [EAD] RWA Average in %	Sovereign	Institutions	Corporates	SME Corporates	Retail	Total
1 [0.00% - 0.10%]	Sum of EAD	35 482	7 998	8 905	655	11 246	64 287
	Sum of RWA	657	1 670	2 224	148	208	4 906
	weighted average	2%	21%	25%	23%	2%	8%
02 [0.10% - 0.20%]	Sum of EAD	99	1 157	7 878	1 229	11 362	21 724
	Sum of RWA	41	359	3 044	422	476	4 342
	weighted average	41%	31%	39%	34%	4%	20%
03 [0.20% - 0.40%]	Sum of EAD	159	584	9 377	2 842	5 263	18 226
	Sum of RWA	100	239	5 342	1 339	588	7 607
	weighted average	62%	41%	57%	47%	11%	42%
04 [0.40% - 0.80%]	Sum of EAD	12	214	10 618	3 576	15 565	29 985
	Sum of RWA	3	111	7 904	2 292	2 223	12 533
	weighted average	22%	52%	74%	64%	14%	42%
05 [0.80% - 1.60%]	Sum of EAD	6	1 001	10 111	3 638	7 585	22 342
	Sum of RWA	1	703	9 756	2 909	1 894	15 262
	weighted average	11%	70%	96%	80%	25%	68%
06 [1.60% - 3.20%]	Sum of EAD	56	177	5 507	1 798	4 211	11 748
	Sum of RWA	2	137	6 629	1 736	1 446	9 950
	weighted average	4%	77%	120%	97%	34%	85%
07 <sup>1</sup> [3.20% - 6.40%]	Sum of EAD	188	148	4 155	1 223	994	6 708
	Sum of RWA	315	162	6 561	1 463	461	8 962
	weighted average	167%	109%	158%	120%	46%	134%
08 [6.40% - 12.80%]	Sum of EAD	0	42	890	356	1 203	2 491
	Sum of RWA	0	32	1 626	520	508	2 686
	weighted average	-	76%	183%	146%	42%	108% <sup>2</sup>
09 [12.80% - 100.00%]	Sum of EAD	0	19	294	175	1 491	1 979
	Sum of RWA	0	11	675	314	1 302	2 302
	weighted average	-	57%	230%	180%	87%	116% <sup>2</sup>
Total gross exposure		36 002	11 341	57 736	15 492	58 919	179 490
Total risk-weighted assets		1 117	3 423	43 761	11 144	9 104	68 548
Total weighted average		3%	30%	76%	72%	15%	38%

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

2 The counter-intuitive drop in the weighted average compared to the PD bucket PD 7 is due to the sharp decrease in relative weight of the 'Corporate' and 'SME Corporates' exposure, which has a relatively high weighted average.

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

The table shows credit risk exposure per risk bucket in terms of EAD as at 31 December 2008. 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.

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 – 31-12-2008

Standardised exposure [EAD]		Quality steps							Unrated	Total
		1	2	3	4	5	6			
Sovereign	gross	2 577	1 813	4 473	88	6	0	3 358	12 316	
	net	2 577	1 813	4 473	88	6	0	3 358	12 316	
RGLA	gross	55	82	0	0	12	8	256	412	
	net	55	82	0	0	12	8	256	412	
PSE	gross	0	40	0	0	0	0	64	105	
	net	0	40	0	0	0	0	60	101	
MDB	gross	9	0	0	0	0	0	50	59	
	net	9	0	0	0	0	0	50	59	
International Org.	gross	0	0	0	0	0	0	0	0	
	net	0	0	0	0	0	0	0	0	
Institutions	gross	1 759	478	90	35	58	0	183	2 604	
	net	1 759	478	90	35	58	0	183	2 604	
Corporates	gross	82	299	316	20	62	0	11 355	12 135	
	net	82	301	316	20	62	0	11 187	11 969	
Retail	gross	0	0	0	0	0	0	7 227	7 227	
	net	0	0	0	0	0	0	7 215	7 215	
Secured by real estate	gross	0	6	0	0	0	0	11 718	11 724	
	net	0	6	0	0	0	0	11 278	11 285	
Past due	gross	0	0	0	0	0	0	459	463	
	net	0	0	0	0	0	0	435	439	
High risk	gross	0	0	0	0	0	5	3	8	
	net	0	0	0	0	0	5	3	8	
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	159	159	
	net	0	0	0	0	0	0	159	159	
Other	gross	0	0	0	0	0	0	2 073	2 073	
	net	0	0	0	0	0	0	2 073	2 073	
Total	gross	4 482	2 719	4 880	143	138	13	36 905	49 286	
	net	4 482	2 721	4 880	143	138	13	36 257	48 640	

## Impaired credit exposure in the lending portfolio

The tables show impaired credit risk exposure per geographic region and per sector based on figures as at 31 December 2008.

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 by 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 by the Standardised approach, impairment is determined 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.

The obligor of the exposure is determined after application of guarantees and thus (PD) substitution. The latter accounts for the difference in exposure between the aggregated EAD on defaulted exposure reported above (4 354 million euros under the IRB approach and 459 million euros past due under the Standardised approach = a combined 4 813 million euros) and the total in the table below (4 731 million euros).

In millions of EUR – 31-12-2008

Impaired exposure per geographic region	gross exposure [EAD]
Africa	8
Asia	87
Central and Eastern Europe & Russia	504
Latin America	37
Middle East	16
North America	415
Oceania	22
Western Europe	3 640
Total	4 731

In millions of EUR – 31-12-2008

Impaired exposure per Sector	gross exposure [EAD]
Agriculture, Farming & Fishing	114
Authorities	11
Automotive	126
Aviation	82
Beverages	3
Building & Construction	211
Chemicals	108
Commercial Real Estate	389
Consumer Products	62
Distribution	635
Electricity	23
Electrotechnics	106
Finance & Insurance	446
Food Producers	65
Horeca	84
IT	155
Machinery & Heavy Equipment	59
Media	50
Metals	50
Oil, Gas & Other Fuels	55
Paper & Pulp	18
Private Persons	895
Services	357
Shipping	45
Telecom	32
Textile & Apparel	220
Timber & Wooden Furniture	21
Tobacco	2
Traders	53
Water	240
Other	14
<b>Total</b>	<b>4 731</b>

For all data on impairment, provisions and value adjustments, reference is made to the consolidated annual account section of KBC's 2008 annual report (Notes 14 and 24).

## 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), such as forex or Interest Rate Swaps (IRS), Credit Default Swaps (CDS), and Caps/Floors. In principle, it includes repo-like transactions, which are internally measured and managed like other over-the-counter transactions. However, in this report, repo-like transactions are not covered here, but instead in the section on 'Credit risk mitigation', as repo-like transaction are precisely a way of reducing (mitigating) credit risk and risk mitigation is highlighted separately.

No distinction is made between counterparty credit risk arising from exposures subject to the IRB approach or 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. As stated in 'Scope of credit risk disclosures', KBC Financial Products (KBC FP) is also included in detail in the counterparty credit risk disclosure. Counterparty credit risk is the most material credit risk in respect of KBC FP.

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 included in the table below.

In millions of EUR – 31-12-2008

Transaction type	Marked-to-market	Add-on	Gross counterparty risk [EaD]	Notional value of contracts	Regulatory capital*
CDS bought -Trading	20 501	7 655	28 156	124 868	284
CDS sold - Trading	265	5 006	5 272	123 306	48
Other	5	5	10	107	0
<b>Total credit derivatives</b>	<b>20 771</b>	<b>12 667</b>	<b>33 438</b>	<b>248 280</b>	<b>332</b>
Interest Rate Swaps (IRS)	8 529	2 577	11 105	541 708	162
Caps/Floors	439	237	676	26 443	7
Other	1 231	346	1 577	82 583	12
<b>Total interest related transactions</b>	<b>10 199</b>	<b>3 160</b>	<b>13 358</b>	<b>650 733</b>	<b>181</b>
FX forward	2 137	808	2 944	72 753	46
FX swap	1 319	619	1 937	58 768	14
Cross Currency IRS	3 036	3 581	6 617	76 274	50
Other	841	215	1 055	18 157	37
<b>Total currency-related transactions</b>	<b>7 332</b>	<b>5 222</b>	<b>12 554</b>	<b>225 952</b>	<b>147</b>
Equity swaps	4 983	3 361	8 344	90 556	52
Equity options	2 574	1 358	3 932	32 550	11
<b>Total equity related transactions</b>	<b>7 557</b>	<b>4 719</b>	<b>12 276</b>	<b>123 107</b>	<b>63</b>
<b>Total commodity transactions</b>	<b>26</b>	<b>69</b>	<b>96</b>	<b>573</b>	<b>1</b>
<b>Gross counterparty risk</b>	<b>45 885</b>	<b>25 837</b>	<b>71 722</b>	<b>1 248 645</b>	
- Netting benefit			-48 332		
<b>Total counterparty risk after netting</b>			<b>23 390</b>		
- Collateral benefit			-1 655		
<b>Total net Counterparty risk</b>			<b>21 734</b>		<b>668</b>

\* Based on the net counterparty risk of the transaction type.

Below, a breakdown of the net counterparty risk is provided 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 – 31-12-2008

Net derivative exposure per geographic region	Net exposure [EAD] <sup>1</sup>
Africa	12
Asia	430
Central and Eastern Europe & Russia	1 790
Latin America	101
Middle East	107
North America	4 708
Oceania	79
Western Europe	14 746
<b>Total</b>	<b>21 972</b>
Net derivative exposure per rating band <sup>2</sup>	Net exposure [EAD] <sup>1</sup>
AAA	1 946
AA	6 477
A	7 748
BBB	1 406
BB	3 122
B and below	211
No rating	1 063
<b>Total</b>	<b>21 972</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 FP. This is a simulation based methodology that takes fully into consideration the effect of collateral agreements in the counterparty exposure. 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 10 days. KBC FP uses then a PFE percentile of 99% as the internal risk measure to check limit utilisation.

By recognising threshold clauses in the collateral support annexes, this results in a much lower exposure.



## Credit risk mitigation

In line with the general scope for credit risk, this section addresses credit risk mitigation. Information on KBC FP's credit risk mitigants is only given in the table related to the covered exposure for counterparty credit risk.

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

In the tables below, the EAD covered is broken down into different portfolios and different types of credit risk mitigation. The retail segment is not included in the exposure classes in these tables, 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.

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 and only the total aggregated collateralised EAD is given.

### Netting

At the end of December 2008, KBC did not engage 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, nettability 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 2008, the netting impact on derivative exposure amounted to 48.3 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.
- *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 technical.

At the end of 2008, total EAD for reverse repo and buy and sell-back transactions amounted to 10.6 billion euros, for which credit risk mitigation through collateral amounted to 9.9 billion euros (the collateral amount is lower than the cash amount, as the collateral amount is corrected for regulatory haircuts and mismatches).

The total EAD in repos and sell and buy-back transactions amounted to 20.3 billion euros, for which credit risk mitigation through collateral amounted to 19.8 billion euros.

The securities underlying the reverse repo transactions are mainly government securities (9.8 billion of the 10.6 billion euros, or about 93%), 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) contract 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.

- *Tri-party repo transactions:* These transactions are a specific type of reverse repo, where KBC lends cash and receives 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. The total EAD in such transactions at the end of 2008 amounted to 4.0 billion euros, for which credit risk mitigation through collateral amounted to 3.4 billion euros (relatively lower compared to the cover in 'plain' reverse repos, as the impact of regulatory haircuts and mismatches is bigger for the types of collateral allowed in this type of transaction).

## 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.

### *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, 7% (1 655 million out of 23 390 million euros) was classified as collateralised at the end of 2008. A breakdown of covered exposure values by exposure classes and type of collateral is provided in the table below. At the end of 2008, only cash collateral was 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, whereas debt securities are acceptable collateral, but none were provided.

In millions of EUR – 31-12-2008

Covered exposure <sup>1,2</sup> [EaD]	LGD % applied under IRB Foundation			SME Corporates		Total
		Sovereigns	Institutions	Corporates		
Cash	0%	0	584	1 071	0	1 655
Debt securities	0%	0	0	0	0	0
Equity collateral	0%	0	0	0	0	0
<b>Total</b>		<b>0</b>	<b>584</b>	<b>1 071</b>	<b>0</b>	<b>1 655</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.

In mid-March 2009, an exercise was carried out within KBC to determine the impact on additional collateral to be posted in the event that KBC's long-term ratings were downgraded. At that time, KBC Bank enjoyed long-term ratings of 'A+', 'A+', 'Aa3' from Standard and Poor's, Fitch and Moody's, respectively. The exercise measured the impact if the lowest was downgraded to 'A', 'A-' and 'BBB+', and provided the following result: A rating downgrade to 'A' would mean that 21 million euros' worth of collateral having to be posted, a downgrade to 'A-' 54 million euros and a downgrade to 'BBB+' 230 million euros.

Taking into account a total amount of collateral posted of 3.7 billion euros at that time, the impact of such a downgrade can be considered relatively limited, accounting for 0.6% of the downgrade to 'A' scenario, 1.5% of the 'A-' scenario and 6.2% of the 'BBB+' scenario. It was also noted that the above impact predominantly stems from a decrease in the minimum transfer amounts, though there is also an impact, albeit to a lesser extent, from the reduction of some threshold amounts.

A similar exercise (one notch downgrade on the lowest rating) at KBC FP results in an additional 20 million euros to be posted by KBC FP.

### *Lending portfolio*

As already mentioned, the below table only relates to exposures subject to the IRB foundation approach. Of the non-retail lending EAD, 7.0% (8.7 billion euros of 123.8 billion euros) was classified as collateralised at the end of 2008 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>3</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 capital requirements directive) 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

<sup>3</sup> After the application of haircuts, mismatch corrections and collateralisation floors

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 reflected in the PD rating under the IRB approach.

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

In millions of EUR – 31-12-2008

Covered IRB lending exposure [EAD] <sup>1</sup>	LGD applied under IRB Foundation <sup>2</sup>	Sovereign	Institutions	Corporates	SME Corporates	Total
Cash	0%	0	13	293	89	396
Debt securities	0%	0	0	30	15	46
Equity collateral	0%	1	0	253	65	320
<b>Total financial collateral</b>		<b>2</b>	<b>1</b>	<b>577</b>	<b>170</b>	<b>761</b>
Real estate <sup>3</sup>	30%	4	10	2 667	2 259	4 939
Receivables	35%	0	0	1 302	1 441	2 744
Lease collateral	35%	0	0	0	0	0
Other physical collateral	40%	0	0	109	177	287
<b>Total physical collateral</b>		<b>4</b>	<b>10</b>	<b>4 079</b>	<b>3 877</b>	<b>7 970</b>
<b>General total</b>		<b>6</b>	<b>23</b>	<b>4 656</b>	<b>4 047</b>	<b>8 731</b>

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.

This table shows that the bulk of the collateralised amounts relates to physical collateral (8.0 billion euros or 6.5% of the total non-retail EAD), while financial collateral, which has a bigger impact on capital as it attracts a LGD of 0%, is limited to 0.8 billion (0.7% of the total non-retail EAD). 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 'SMEs 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.

Collateralised amounts in the lending portfolio subject to the Standardised approach came to 0.2 billion euros of financial collateral and 0.6 billion euros of other physical collateral.

## Unfunded credit protection

Unfunded credit protection is provided mainly through guarantees and – to a lesser extent – credit derivatives entered into for hedging purposes. For guarantees, the impacted exposure (i.e. amounts receiving a better rating through substitution, resulting in lower capital requirements) amounted to 4.9 billion euros at the end of 2008, or 3.2% of total non-retail lending EAD (154.2 billion euros). For credit derivatives, this impact is limited, as they only mitigate credit risk for an amount of 105 million euros.

In millions of EUR – 31-12-2008

Covered exposure [EAD] <sup>1,2,3</sup>	Sovereign	Institutions	Corporates	SME Corporates	Total
Credit derivatives	0	0	105	0	105
Guarantees	203	1 116	3 126	408	4 854
<b>Total</b>	<b>203</b>	<b>1 116</b>	<b>3 231</b>	<b>408</b>	<b>4 959</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 the IRB approach.

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) and the RAROC concept..

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);
- limit setting (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).

Since 2006, the design or re-design, the review and the validation of these models has been subject to specific guidelines for each model type with a view to achieving consistency in the development and use of the models. Provided below is a comprehensive description of the model development methods.

## Probability of Default models

Probability of Default (PD) is the likelihood that an obligor will default on its obligations within a one-year horizon, with default being defined in accordance with the 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: Here, 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 skillfully '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.
- Non-statistical models based on expert input: Rankings are based solely on expert assessments, without any regression techniques being used. At KBC, this method is used to rank customers in very specialised segments with a very low number of default observations, such as Belgian municipalities.
- 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. In general, the output of the ranking model will be bucketed, so that an equal number of default events can be observed in each bucket. If no (or too few) default events are available, expert assessments are used to infer a probability of default. Finally, the average default probability figure calculated for the overall segment will be calibrated to an expected default probability (the so-called Central Tendency).

An alternative approach to define the expected default probability is based on times series analysis and has been developed in the ČSOB retail models. This approach can be classified as a Point-In-time (PIT) default probability.

Note that this step (assigning default probabilities) is not needed for the development of pure scorecards as, in general, scorecards are only designed to rank obligors.

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 Masterscale. The Masterscale allows clients to be differentiated for nearly all of KBC's credit products.

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

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

## 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 amount outstanding at the time of default (EAD). Once a default event has occurred, LGD includes three types of loss: 1) the loss of principal, 2) the carrying cost of non-performing loans and 3) workout expenses (collections, legal, etc.).

In general, there are two ways of measuring the LGD:

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

The LGD models currently used at KBC are all workout LGDs enhanced through expert assessments when the available data is poor. The models developed are (methodologically) based on historical, weighted<sup>4</sup> average recovery rates (and cure rates<sup>5</sup>) per collateral type or per pool (segmentation-based approach). One exception however is an LGD pooling model for the retail segment at Hypotecní Banka (a subsidiary of ČSOB), which is used for three products based on scorecards, creating three pools for which average recovery rates and cure rates are calculated. The scorecards are developed with logistic regression using a target variable of 'at least a 70% recovery rate after one year of default' (regression-based approach).

A major challenge posed by the Basel II regulations is the 'downturn requirement'. The underlying idea is that 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 a workout LGD which is what is mainly used at KBC. Indeed, the indications are that LGD based on ultimate recoveries may not exhibit cyclical variability and therefore LGD estimates of downturn LGD may not differ materially from the long-run weighted average.

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 up- and downturn economic conditions. Market LGD is based entirely on information

<sup>4</sup> Exposure-weighted in contrast to e.g. number-weighted.

<sup>5</sup> The cure rate is the percentage of defaulted clients returning to a non-default state.

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.

Little consensus exists in the industry on how to incorporate downturn conditions in LGD. A major problem is the lack of data: the period for which LGD data is available is limited and in most cases does not include an economic downturn.

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

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

Measuring EAD tends to be less complicated and in general 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 will include an estimate of future lending prior to default (credit conversion factors).

### **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 aggregated 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 wants to do so in a cautious manner. In particular, it is recognised that no value or risk model provides a perfect prediction of future outcomes. Explicit measures for dealing with model uncertainty are therefore imposed. The potential shortcomings of credit risk models are grouped into three main dimensions, each of which is evaluated using a fixed group-wide assessment: model uncertainty due to (i) imperfect data quality, (ii) implementation shortcomings and (iii) statistical effects. The statistical uncertainty assessment makes a further distinction between uncertainty due to idiosyncratic and systemic effects. Whenever these assessments detect an important source of model uncertainty, either immediate remedial actions are taken, or an appropriate extra conservative margin is introduced to compensate for the known shortcomings of the model.

## Overview of credit risk models

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

PD models used in the IRB Foundation approach <sup>1</sup>	Exposure [gross EAD] In billions of EUR – 31-12-2008	Central Tendency <sup>2</sup>	Observed Default rate <sup>3</sup>	Average Model PD (excl. overrulings) <sup>4</sup>	Average Model PD (incl. overrulings) <sup>4</sup>
<b>PD models for the government and public sector segments</b>					
(world wide) model for central governments	37.5	1.62%	0.78%	1.62%	1.20%
<b>PD models for corporate and institutional segments</b>					
Asia-Pacific corporates	1.8	2.33%	2.14%	1.39%	1.44%
US corporates	2.9	1.15%	1.15%	1.34%	1.20%
Western-European corporates	20.5	1.68%	1.26%	1.16%	1.24%
Czech corporates	9.7	1.85%	1.52%	1.32%	1.59%
Czech Large Household cooperatives	0.3	0.26%	0.00%	0.36%	0.38%
Czech Small Household Cooperatives	0.4	0.34%	0.00%	0.31%	0.36%
(Worldwide) model for banks	40.0	Low Default Portfolio	1.27%	1.06%	1.38%
(Worldwide) model for project finance	3.6	1.54%	1.33%	1.06%	1.24%
(Worldwide) model for management buy outs	2.7	2.70%	1.28%	2.28%	2.72%
<b>PD models for SME segments</b>					
models for Belgian professionals	0.2	-	-	-	-
o/w liberal professions	0.0	0.54%	0.38%	0.55%	0.56%
o/w self-employed professionals	0.1	1.27%	1.41%	1.06%	1.07%
o/w private persons	0.1	1.17%	1.23%	1.11%	1.11%
Belgian farmers	0.6	0.90%	0.64%	0.89%	0.90%
Czech Municipalities	0.3	0.20%	0.00%	0.20%	0.30%

1 Non exhaustive list of models used within the IRB Foundation approach, and excluding all (pooling) models used in the IRB advanced approach.

2 The central tendency is the average through-the-cycle default probability of a segment.

3 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.

4 The average model PD is the mean PD of all obligors rated according to the model. The most recent value is shown.

# Structured credit products



## Description

This section reports on KBC's structured credit activities per end of December 2008. These activities are related to Asset-Backed Securities (ABS) and Collateralised Debt Obligations (CDO), 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. KBC acts as an originator when structuring credit deals for itself or for third parties. As an originator, KBC also takes on other roles such as sponsor, when it also provides liquidity support to the related SPVs. KBC also invested in structured credit products. These investments can be found back on KBC's balance sheet.

Apart from (i) briefly describing the procedures and defining the scope, this disclosure (ii) provides more insight into structured credit programmes where KBC acts as the originator. Subsequently (iii), information is given on KBC's investments in structured credit products as per year-end 2008, together with information on stress-tests and valuations. Finally (iv), an overview of the capital charges corresponding to the structured credit exposures is provided.

## Procedures

Strict governance procedures apply to KBC's structured credit activities, meaning that appropriate decision authority and business processes are in place for all decisions related to structured credit. In view of the turbulent financial markets and especially the structured credit products market, KBC duly tightened its strategy.

With regard to investment activities, procedures and processes are to a large extent based on the existing framework for granting credit and making investments, but additionally take into account specific risks and features related to these products.

In mid-2007, after spreads had widened and the ratings of subprime ABS were downgraded on a large scale, KBC decided to implement a moratorium on ABS/CDO investments. At that time, only very few exceptions were granted for prime European ABS.

In mid-2008, KBC further tightened the investment conditions and no new investments in RMBS/CMBS were allowed by either entity. It was also decided that KBC Financial Products (KBC FP), a 100% subsidiary of KBC Bank, would not originate any new deals related to its structured credit business.

## Scope of structured credit activities

All KBC group banking and insurance entities that engage in structured credit activities are covered in this disclosure.

# Structured credit programmes for which KBC acts as originator

Under this heading, the focus is on the structured credit programmes in which KBC entities played an originating role<sup>6</sup>. 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 involving third-party assets for which KBC acts as sponsor

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

The main objective of such structured credit is to provide additional potential sources of bank funding. The following structured credit programmes fall under this heading:

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

In millions of EUR – 31-12-2008

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	2 778
Phoenix II Funding 2008	Originator	Mortgage loans	7 477
Phoenix III Funding 2008	Originator	Mortgage loans	3 200

### Home Loan Invest 2007:

Home Loan Invest 2007 is a 'Residential Mortgage-Backed Securities' (RMBS) issue where KBC Bank acts as the originator. A SPV acquired KBC assets (a pool of Belgian residential mortgages) 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 for placement with the European Central Bank, and thus provide KBC Bank with a liquidity buffer. The portfolio of mortgages comprises more than 75 000 loans for a total of almost 4 billion euros. Since KBC holds notes worth 2 billion euros, 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. A portfolio of 2 778 million euros' worth of Belgian mortgage loans has been securitised. KBC Bank holds the subordinated loan of 279 million euros and 2 370 million euros 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. These notes are also eligible for placement with the European Central Bank, and thus provide KBC Bank with a liquidity buffer.

### Phoenix II Funding 2008:

On 16 June 2008, a new programme called Phoenix II Funding 2008 was set up as a new source of contingent funding. The SPV has an underlying pool of residential mortgages for an amount of 7 477 million euros, originated by KBC Homeloans (which – via its parent KBC Bank Ireland – indirectly is a 100% subsidiary of KBC Bank). KBC Bank Ireland retains 100% 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: 95% in class A (Moody's Aaa) and 5% in class B (S&P rating of A1/Moody's rating of P1), maturing in 2050. A liquidity facility has

<sup>6</sup> Excluding the Special Purpose Vehicle Picaros Funding as, from an economic point of view, this is merely a funding vehicle for the trading activities of KBC Financial Products.

been provided to the vehicle for 3.4% of the outstanding amount of notes that would be triggered if KBC Bank Ireland ceased to hold a Prime-1 and A-3 rating from Moody's. These notes are also eligible for placement with the European Central Bank, thus providing KBC Bank with a liquidity buffer.

Phoenix II is the successor of the Phoenix I Funding 2001 programme, which had an underlying pool of residential mortgages. No notes were retained by KBC. On 12 June 2008, Phoenix I Funding 2001 exercised its right to redeem the notes.

#### Phoenix III Funding 2008:

Phoenix III Funding, which is similar to Phoenix II Funding, was set up in November 2008. The SPV has an underlying pool of residential mortgages originated by KBC Homeloans for an amount of 3.2 billion euros. KBC Bank Ireland retains 100% 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: 95% in class A (Moody's Aaa) and 5% in class B (S&P rating of A1/Moody's rating of P1), maturing in 2050. A liquidity facility has been provided to the vehicle for 3.4% of the outstanding amount of notes that would be triggered if KBC Bank Ireland ceased to hold a Prime-1 and A-3 rating from Moody's. These notes are also eligible for placement with the European Central Bank, thus providing KBC Bank with a liquidity buffer.

### 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 – 31-12-2008

Programme	Roles	Type of underlying exposure	Nominal amount of the underlying
KBCFP CDO deals with ABS	Originator	Corporate reference names and/or ABS	22 915
KBCFP CDO deals without ABS	Originator	Corporate reference names	4 050

KBC FP structured synthetic Collateralised Debt Obligation (CDO) deals. These CDOs consist of a pool of reference entities selected and monitored by KBC FP. The underlying pools generally consist of either corporate reference names (80-85%) and ABS (15-20%), part of which is accounted for by so-called subprime loan exposure (see below), or consist entirely of corporate reference names.

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 FP 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.

The super senior portions of CDOs originated by KBC FP are mostly hedged through credit insurers via swap contracts. KBC mostly uses the American credit insurer, MBIA, whose creditworthiness has come under pressure. On 31 December 2008, KBC increased the counterparty credit risk provision for MBIA to 642 million euro (i.e. 40% of the market value of the underlying swap contracts). The total amount insured by MBIA (i.e. the notional amount of the super senior swaps outstanding with MBIA) amounted to 14 billion euros as at 31 December 2008.

KBC has no straightforward credit facilities to these credit insurers, but exposure relating 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 (37% are AA, 53% A, and 10% unrated).

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).

In the first half of 2008, the last CDO deal 'Lancaster Place Finance' was set up. The following table provides an overview of the assets underlying this structured credit programme.

Structured credit programme set up during 2008 involving third party assets with no sponsoring role for KBC  
In millions of EUR – 31-12-2008

Issue	Type	Notional Value of reference portfolio			Asset-backed notes*	
		Corporate reference names	ABS	Total	Number of tranches	Amount
Lancaster Place Finance	Synthetic	500	0	500	5	108

\* Only comprises the asset-backed notes and excludes the super senior swap.

## Structured credit involving third party assets for which KBC acts as sponsor

The purpose of this business line is to assist some of KBC's corporate clients to meet their funding needs. Economically, this activity can be considered as an extension of KBC's corporate lending activities that is similar to factoring, though in this case funding is provided to corporate clients through the commercial paper market via an SPV, which pools receivables from these clients. The risk involved for KBC boils down to liquidity support and credit enhancement provided via its role as a sponsor of these SPVs. As is the case with factoring, the risk ultimately hinges on the quality of the underlying receivables in the SPV. Quality is assured by diversification requirements and – to some extent – by credit insurance for the receivables, as well as by an over-collateralisation percentage applied to the pool of receivables based on an assessment of the risk they entail. The following structured credit programmes fall under this heading:

Structured credit programmes involving third party assets for which KBC acts as sponsor

In millions of EUR – 31-12-2008

Programme	Role	Type of underlying exposure	Nominal amount of the underlying
Rosy Blue Int	Originator/Sponsor	Structured pool of trade receivables	74
Quasar	Originator/Sponsor	Structured pool of receivables	803

### Rosy Blue International (1999):

Rosy Blue International is a SPV that purchases non-interest-bearing trade receivables that satisfy eligibility criteria specified in advance by the Belgian and US affiliates of Rosy Blue Holding SA (Rosy Blue). The purchase of the receivables is financed by the issuance of euro commercial paper denominated in USD and EUR with maturities of 1 month, 3 months and 6 months (rated P-1 and F1+ by Moody's and Fitch, respectively). KBC acts as its issuing and paying agent. Should Rosy Blue be unable to attract sufficient funding in the commercial paper market to repay maturing commercial paper, it can make drawings under a liquidity facility agreement with KBC. Rosy Blue has, in addition, entered into a swing-line facility agreement with KBC under which Rosy Blue International SA can make drawings in the event that, as a result of a timing mismatch, it has insufficient funds available to pay funding costs and/or operating expenses. Both the amount of commercial paper that Rosy Blue International SA can issue and the amount that Rosy Blue International SA can borrow under the liquidity facility agreement are limited to a total of 150 million USD. These credit enhancements are subject to the Supervisory Formula Approach (SFA) for the purpose of capital adequacy calculations.

### Quasar (2001):

Quasar Securitisation Company ('Quasar') is a SPV set up to invest in structured pools of receivables. At the end of June 2008, Quasar had four clients selling receivables on a revolving basis to the SPV. Funding is obtained in the euro commercial paper market by issuing commercial paper denominated in EUR, GBP and USD. The quality of the commercial paper issued by Quasar is reflected in the short-term rating of A-1 by S&P and of P-1 by Moody's. KBC acts as a sponsor by extending a liquidity line for 100% of the transaction-specific liquidity risk and issuing a programme-wide letter of credit (5% of the total outstanding notes). Both are subject to the Supervisory Formula Approach (SFA) for the purpose of capital adequacy calculations.

In 2008, a new client was added which led to an increase in the pool of receivables of 155 million euros to 803 million euros.

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

Under this heading, information is provided on KBC group structured credit investments, covering both the banking and trading portfolio. An overview of the credit quality of the securities and the underlying collateral is also given, as is information on more extensive stress tests set-up during 2008. Lastly, information is provided on valuation.

### KBC group investment in structured credit, 31-12-2008

In millions of EUR

KBC investments in structured credit products (CDOs and other ABS)	31-12-2007	31-12-2008
Total nominal amount	16 881	15 944 <sup>1</sup>
Initial write-downs of junior and equity CDO pieces <sup>2</sup>	- 779	- 779
Subtotal	16 102	15 165
Impact since the beginning of the crisis (mid-2007 to date)	- 347	-5 721
	<i>o/w value markdowns</i>	- 308
	<i>o/w other financial impact</i>	- 39

<sup>1</sup> Year-on-year decrease due in part to sales of RMBS and amortisation.

<sup>2</sup> The initial write-down of junior and equity CDO pieces had already been recognised through P/L when the CDOs were issued.

### Credit quality of securities held, 31-12-2008

A view on the quality of the notes and super senior swaps held at year-end 2008 is shown in the table below.

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

Amounts at nominal value, net of provisions for equity and junior CDO pieces - in billions of EUR – 31-12-2008

	Super Senior (SS)	Aaa	Aa	A	Baa	<Baa3	Unrated	Total
CDOs	5.4	0.3	0.3	0.2	0.7	1.7	0	8.7
Other ABS		5.8	0.3	0	0	0.2	0.1	6.4
Total	5.4	6.1	0.6	0.2	0.7	1.9	0.1	15.2

### Amortisation schedule of the CDO portfolio

The following table shows how the portfolio of CDOs originated by KBC FP amortises over the next eight years. These figures exclude one CDO in run-off, which means that repayments are in progress. Furthermore the junior and equity CDO pieces are excluded since these were already written down at origination.

Amortisation schedule of the portfolio of investments in CDOs originated by KBC FP

In billions of EUR

Time schedule	Total notional amount (SS & notes)	Notional amount of positions written down	Remaining notional amount (SS excl. Notes written down)
31-12-2008	7.4	2.6	4.8
07-01-2011	5.1	2.2	2.9
20-12-2012	5.0	2.1	2.9
07-07-2015	4.0	1.7	2.3
07-07-2016	2.7	1.1	1.6
07-10-2017	-	-	-

### Overview of the underlying collateral of the securities held, 31-12-2008

The next two tables provide a breakdown of the underlying collateral of the CDO portfolio and the other ABS portfolio (excluding CDO exposure). 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.

Underlying of the CDOs held broken down by type and quality – based on Moody's ratings

Amounts at nominal value - in millions of EUR – 31-12-2008

		Aaa	Aa	A	Baa	Ba	B	Caa	<=Caa3	NR	Total
Corporates		42	367	1 340	3 429	1 719	276	121	42	17	7 351
	Sector										
	Real Estate & Building	-	-	83	806	257	35	7	14	-	1 202
	Banking	-	203	381	222	17	-	22	-	15	860
	Finance	31	25	222	279	53	35	-	28	-	673
	Insurance	11	29	154	217	90	-	21	-	-	522
	Publishing	-	-	12	89	223	52	2	-	-	378
	Retail Stores	-	-	16	181	139	2	-	-	-	338
	Automobile	-	-	47	166	46	20	-	-	-	280
	Telecom	-	2	67	137	52	1	-	-	-	259
	Oil & Gas	-	1	44	160	51	-	-	-	-	256
	Monoline insurance	-	102	-	39	95	-	19	-	-	254
	Utilities	-	4	81	139	23	4	-	-	-	251
	Electronics	-	-	15	49	112	39	-	-	-	216
	other	0	3	218	943	560	87	50	-	2	1 864
	Region										
	US	42	167	416	1 959	1 074	205	79	42	17	4 003
	EU	-	130	351	726	384	57	-	-	0	1 648
	Asia	0	62	292	387	157	15	-	-	-	914
	Latin America	-	5	28	59	27	-	-	-	-	119
	other	-	5	230	312	81	-	42	-	0	669
CMBS		-	2	-	-	-	-	-	-	-	2
RMBS		44	69	123	84	153	156	91	386	-	1 107
	Origin										
	Prime	-	-	-	-	-	-	-	-	-	-
	ALT-A	44	30	26	20	82	93	16	3	-	314
	<i>Alt-A (&lt;2005 vintage)</i>	3	-	-	2	-	-	1	-	-	5
	<i>Alt-A (2005-2007 vintage)</i>	41	30	26	18	82	93	15	3	-	309
	Subprime	-	39	97	64	72	63	75	382	-	793
	<i>subprime (&lt;2005 vintage)</i>	-	2	56	34	20	9	3	1	-	126
	<i>subprime (2005-2007 vintage)</i>	-	37	40	30	52	54	73	381	-	667
	Region										
	US	44	69	123	84	153	156	91	386	-	1 107
Other ABS		-	-	4	3	-	-	-	-	-	7
CDO		35	33	65	39	10	15	21	40	-	259
<b>Total</b>		<b>122</b>	<b>471</b>	<b>1 531</b>	<b>3 555</b>	<b>1 882</b>	<b>447</b>	<b>233</b>	<b>468</b>	<b>17</b>	<b>8 726</b>

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

Underlying of the ABS held broken down by type and quality – based on Moody's ratings

Amounts at nominal value - in millions of EUR - 31-12-2008

		Aaa	Aa	A	Baa	<Baa3	NR	Total
<b>Corporates</b>								
CMBS		127	-	-	-	-	-	127
RMBS		3 856	212	-	33	189	-	4 331
Origin	Prime	3 211	160	-	-	-	-	3 377
	<i>prime (&lt;2005 vintage)</i>	1 783	79	-	-	-	-	1 862
	<i>prime (2005-2007 vintage)</i>	1 428	82	-	-	-	-	1 515
	ALT-A	529	19	-	6	-	-	554
	<i>Alt-A (&lt;2005 vintage)</i>	9	-	-	-	-	-	9
	<i>Alt-A (2005-2007 vintage)</i>	520	19	-	6	-	-	545
	Subprime	117	33	-	27	189	-	400
	<i>subprime (&lt;2005 vintage)</i>	22	-	-	2	2	-	32
	<i>subprime (2005-2007 vintage)</i>	95	33	-	25	187	-	368
Region	US	896	52	-	33	189	-	1 204
	Spain	1 080	26	-	-	-	-	1 112
	Italy	708	5	-	-	-	-	713
	Netherlands	506	31	-	-	-	-	537
	Portugal	412	25	-	-	-	-	437
	UK	122	50	-	-	-	-	172
	other	133	23	-	-	-	-	156
	Other ABS		1 786	120	-	12	62	-
Type	CLO	913	55	-	-	59	-	1 027
	Leases	376	-	-	-	-	-	376
	SME loans	152	-	-	-	-	-	152
	Consumer Loans	104	10	-	-	-	-	113
	Auto Loans/Leases	97	1	-	-	-	-	97
	other	145	55	-	12	4	-	215
<b>Total</b>		<b>5 770</b>	<b>332</b>		<b>45</b>	<b>251</b>	<b>-</b>	<b>6 439</b>

KBC's portfolio of CDOs:

- 84% of the underlying collateral is corporate and 13% is subprime or Alt-A, 71% of which is non-investment grade

KBC's portfolio of 'other ABS':

- 90% is Aaa rated, and 5% Aa rated
- 15% of all ABS held by KBC Group involves subprime/Alt-A RMBS, 20% of which is non-investment grade

### **Stress-test results for KBC group investments in structured credits, 31-12-2008**

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

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

KBC introduced the concept of 'fundamental value', which aims to estimate how (expected) credit events, when claimed, would 'eat' into the principal amounts of the tranches, according to the waterfall structure (reversed seniority). It serves as a reasonable prediction of the redemption value of the CDOs originated by KBC FP at or around the respective expected maturity date. The calculation of the fundamental value (in the table below referred to as the *fundamental value scenario*) is based on expected losses on ABS and claimed corporate names and on 8% expected cumulative losses on the underlying corporate portfolio

In addition, further stressed fundamental analysis took place under the following test assumptions:

*Stress scenario 1:* expected losses on ABS and claimed corporate names and 13% expected cumulative losses on the underlying corporate portfolio

*Stress scenario 2:* 26% subprime/Alt-A underlying cumulative losses, 100% losses on structured finance CDOs, claimed corporate names, 80% losses on monoline insurers, corporates with highest near term credit event risk and 9% losses on remaining underlying corporates.

In view of a further deterioration on the structured credit products market, KBC decided to conduct more stress tests on the CDOs originated by KBC FP during the second half of 2008. These tests were largely based on loss assumptions for ABS and CDOs that were published by rating agencies. Based on these results, KBC decided to completely write down the value of all non-super senior notes originated by KBC FP.

KBC stress tests possible future credit losses due to defaults in the underlying collateral viz. subprime and Alt-A mortgages, corporate reference names, and credit insurers. The assumptions regarding ABS losses are based on Moody's predictions of cumulative losses on underlying pools of ABS, under stressed conditions.

The assumptions regarding corporate default losses are based on Moody's October 2008 Publication (for stress scenario 2) and January 2009 Publication (for stress scenario 1).

The scope of the tests includes all investments (including the investment positions that have been written down) in CDOs structured by KBC FP.

As a basis for discussions on the booking of impairments on CDOs originated by KBC FP under Belgian GAAP, KBC has calculated the economic value of the portfolio of such CDOs held by Belgian group entities, based on the following assumptions:

*Impairment scenario:* expected losses on ABSs, claimed corporate names and corporates with highest near term credit event risk



The results of all these scenarios are summarised in the table.

In billions of EUR – 31-12-2008

Current situation	Value of CDOs	Loss	Loss as % of nominal
Nominal value (excluding one CDO in run-off)	7.4		
Market Value	4.2	-3.2	-43%
<b>Stress test results on credit default</b>			
Fundamental value scenario	6.2	-1.2	-16%
Stress scenario 1	5.6	-1.8	-24%
Stress scenario 2	4.1	-3.3	-44%
Impairment scenario	7.1	-0.3	-4%

#### *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 of 10% and 25%, respectively) on the value of the CDO notes originated by KBC FP.

Stress test result on the market sensitivity of CDOs

In millions of EUR – 31-12-2008 (pre-tax)

Market valuation sensitivity		Test result
Test assumptions	All non-Super Senior exposure written down	Credit spreads in December x 1.10
	All non-Super Senior exposure written down	Credit spreads in December x 1.25

Scope includes all CDOs originated by KBC FP that have been invested in (nominal value of 7.9 billion euros, or >90% of total investments in CDOs)

## Valuation

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

For CDOs, KBC applies a level-3 valuation technique based on the movement of, among other things, credit spread indices. Changes in credit ratings relating to non-super senior exposure originated by KBCFP will no longer have an impact on KBC Group's P/L or Equity, since this exposure was completely written down.

For ABS, KBC applied a level-2 valuation technique based on third-party pricing. As at 31 December 2008, KBC reclassified most of its ABS exposure from 'Available For Sale' assets to 'Loans and Receivables', meaning that these will no longer be measured at fair value in the future.

For synthetic CDOs, fair value changes are shown in P/L. These make up more than 95% of KBC's total CDO exposure. For non-synthetic ABS and CDOs, fair value changes are shown in equity, except when assets are sold or impaired (in such case, the fair value changes are shown through P/L). KBC's 'other ABS' are mostly non-synthetic.

Apart from the initial write-down on junior and equity CDO pieces (779 million euros), the total impact of the financial crisis on the value of the investments in structured credit products between mid-2007 and the end of 2008 amounted to 5.7 billion euros. Detailed information on this can be found in the table below:

Details on the impact of the financial crisis  
In millions of EUR – 31-12-2008 (pre-tax)

	over 2007	over 2008	Total up to 31-12-2008
Value markdowns	-308	-4 654	-4 962
o/w on CDOs (through P/L)	-165	-3 117	-3 282
o/w on CDOs (through Equity)	-	-	-
o/w on ABS (through P/L)	-13	-162	-175
o/w on ABS (through Equity)	-130	-1 375	-1 505
Other financial impact	-39	-720	-759
o/w CDO-related monoline counterparty risk	-39	-603	-642
o/w other impact on CDO	-	-117	-117
o/w other on ABS	-	-	-
Total impact of financial crisis	-347	-53 74	-5 721
o/w through P/L	-217	-3 999	-4 216
o/w through Equity	-130	-1 375	-1 505

## Capital charges

Regulatory capital for credit risk is held for all banking book positions in structured credit exposures. Positions in the trading book are incorporated into the capital requirements for market risk as measured using the VaR models.

Under Basel II, different approaches are 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 KBL EPB which reports under the Basel II Standardised Approach.

With regard to the investments in structured credit, the applied risk weights for regulatory capital calculations are directly linked to the external rating of the structured credit products invested in. Since the applied risk weights rise sharply with falling ratings, downgrades of the structured credit invested in have a strong effect on the capital charge. As the risk weights are applied to the market value of the asset, as required under IFRS rules, risk-weighted assets for non-super senior CDOs originated by KBC FP amount to zero, since these are fully written down.

Regulatory capital only has to be held by banking entities. Insurance entities are not required to hold it, but this will change with the implementation of the Solvency II regulation in the future.

Details on capital charges for structured credit products  
In millions of EUR – 31-12-2008

Programme	Invested amount	Size of liquidity facility/credit enhancements	Exposure by risk weight class				Total	required capital
			6 - 18%	20 - 650%	1250%			
KBC as Sponsor	0	146					5	
Quasar	0	38					2	
Rosy Blue	0	108					3	
KBC as Investor	10 361	0	4 744	918	96	5 758	2 074	
Atomium	1 777	0	1 066	88	81	1 235	1 374	
KBC Bank	5 188	0	3 678	22	8	3 708	439	
ČSOB CZ	435	0	0	1	5	6	64	
K&H	4	0	0	0	0	0	0	
KBC USA branch	248	0	-*	-*	-*	-*	-*	
KBC FP	1 556	0	-*	-*	-*	-*	-*	
KBL	1 157	0	0	807	2	809	197	
Total KBC banking entities	10 361	146	4 744	918	96	5 758	2 079	
Total KBC insurance entities	4 800	0	not applicable				0	
Total KBC Group	15 165	146	4 744	918	96	5 758	2 079	

\* indicates that capital charges cannot be reported separately as they are incorporated into the capital requirements for market risk as measured using the VAR models.

# Market risk management

## Description

Market risk is defined as the potential negative deviation from an expected economic value of a financial instrument caused by fluctuations in market prices i.e. 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. Equity and interest rate risk in the non-trading positions are discussed under 'Non-trading equity and interest rate risk management' in this document. For information on other non-trading risk exposure, please see the section on 'value and risk management' in the 2008 annual report of the KBC group.

## Strategy and processes

The objective of market risk management is to measure and report the market risk of the aggregated 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 limits and risks, focus on trading in interest rate instruments, and activity on the forex markets has traditionally been very 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.

Through its specialised subsidiaries (KBC Financial Products (KBC FP), KBC Securities and KBC Peel Hunt), the group also engages in trading in equities and their derivatives. KBC FP also sells and deals in structured credit derivatives (services for hedge funds and the launch and management of collateralised debt obligations). KBC FP was also involved in the seeding and management of Alternative Investment Management (AIM) hedge funds. However, it has been downsizing its activities in response to the current market situation: the proprietary trading and alternative investment management business lines are being closed down completely, while secured advances to hedge funds will be run down as rapidly as possible.

The market risk tolerance is determined by the Board of Directors through an annual limit review. The Group Value and Risk Management Directorate and the Group Trading Risk Committee (GTRC) advise on limits before they are submitted to the Board.

Trading risk management decisions are taken by the GTRC which is chaired by the Group CFRO and includes representatives from line management, risk management and top management. It manages market risk and addresses counterparty and operational risk related to the trading activities. It keeps track of structural trends, monitors group-wide risk limits and may decide to impose corrective actions.

The development of portfolio models, the measurement of the risk position, monitoring and reporting is performed centrally on group level.

The centralisation of trading risk management implies close cooperation between all value and risk management units at both the group and the local level. In the Group Value and Risk Management Directorate, risk co-ordinators are the first contact point for the group's local trading entities when they have questions relating to market risk. The responsibilities of the risk co-ordinators are clearly set out in risk protocols. Local risk management policy and procedures are described in the risk management framework document.

## Scope of market risk disclosures

As market risk exposure arises from the trading books in the dealing rooms of the banking entities, the scope of this section on market risk disclosures is confined to KBC Bank (consolidated) and KBL European Private Bankers (KBL EPB).

## VAR model and characteristics

The VAR (Value at Risk) 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.

The Belgian regulator (CBFA) prescribes the use of a 10-day VAR with a 99% confidence level in the limit system. KBC has chosen the historical VAR approach to generate VAR calculations. 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. In this case, the 99% quantile estimator equals the 5th worst loss, while the 95% estimator equals the 25th worst loss. KBC captures the entire distribution of losses for its market risk limit framework. The VAR computation is euro-based. In compliance with the BIS (Bank for International Settlements) requirement, KBC uses the 99% confidence level for the calculation of regulatory capital.

The 1-day horizon is calculated for back testing purposes.

KBC uses the full revaluation method for the calculation of P/L figures arising in the series of historical simulations for the VAR calculation.

## Acceptance of the VAR model and capital charges for market risk

The 'Approved Internal Model' (i.e. the VAR model accepted by the regulator), which serves as the input for regulatory capital calculations, covers KBC Bank and its branches, CBC and KBC Netherlands. ČSOB Czech Republic and KBC FP have also obtained approval from their respective regulators to use an Internal Model for their capital calculations.

Market risk (VAR, 1-day holding period) In millions of EUR	KBC Bank <sup>1</sup>	KBC Financial Products <sup>2</sup>
Average, 1Q 2007	4	10
Average, 2Q 2007	4	10
Average, 3Q 2007	4	13
Average, 4Q 2007	5	15
31-12-2007	5	13
Maximum in 2007	7	19
Minimum in 2007	3	4
Average, 1Q 2008	5	15
Average, 2Q 2008	7	11
Average, 3Q 2008	7	15
Average, 4Q 2008	13	24
31-12-2008	10	15
Maximum in 2008	17	30
Minimum in 2008	3	9

<sup>1</sup> Excluding 'specific interest rate risk' measured using other techniques.

<sup>2</sup> Excluding Atomium, fund derivatives and insurance derivatives businesses.

The resulting capital requirements for market risk at 31 December 2007 and 2008 are included in the table below. For the capital requirement calculations not covered by the aforementioned 'Approved Internal Model', the Standardised method is used.

In millions of EUR

BASEL II – 31-12-2007	Interest risk	Equity risk*	FX risk	Commodity risk	Total
KBC Bank consolidated	283	244	60	2	588
KBL EPB	40	2	10	0	52
BASEL II – 31-12-2008					
KBC Bank consolidated	459	193	217	3	872
KBL EPB	22	8	11	0	41

## Stress testing

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

KBC uses hypothetical (portfolio-dependent and – independent) scenarios, covering interest rate (IR), exchange rate (FX), equity (EQ) positions and credit spreads. Combined 'global' stress tests, covering IR, FX and EQ have also been developed.

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. Most events are based on absolute shifts in interest or exchange rates or equity prices. 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, such as the Gulf War.

KBC Financial Products has developed its own stress testing. Historical and 3D stress tests are run on a daily basis. As of the second half of 2007, KBC set up stress tests on the CDO portfolio originated by KBC FP, based on the loss assumptions for ABSs and CDOs as published by market participants. In the second half of 2008 the stress tests were further refined, based on loss assumptions of rating agencies.

Contrary to the situation for VAR, KBC has opted not to apply a limit to the stress loss exposure.

The worst-case stress testing results are presented to the GTRC on a bi-weekly basis. In addition, a more in-depth report on stress test results, as well as historical stress tests is presented to the GTRC 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 predictive ability to determine loss at a given confidence level.

The back testing process consists of three steps. First, 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. Second, the 'no action P/L' is compared to the VAR calculated (99%, one-day holding period). The last step entails reporting negative exceptions, where the negative P/L result exceeds the one-day VAR, to the GTRC. These negative exceptions are also referred to as outliers. The number of (negative) outliers, reported during an observation period of 250 working days, impacts the multiplication factor, used for capital requirement calculations.

## Validation and reconciliation

The 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 stemming from the source system are reconciled with the data used in the risk calculation engine.

# Non-trading equity and interest rate risk management

## Description

This section covers KBC's management of the structural exposures to equity risk and interest rate risk. This is part of the group's Asset and Liability Management (ALM) which, besides equity risk and interest rate risk, also manages the exposure to other macroeconomic risks such as real estate risk, foreign exchange risk, inflation risk and credit risk (limited to the investment portfolios).

'Structural exposure' encompasses all exposure inherent in the commercial activity of KBC or the long-term positions held by the group (banking and insurance). Consequently, trading activities are not included here (see the previous section on market risk management). 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

The main purpose of ALM (and by extension non-trading equity and interest rate risk management) is to optimise the risk/return profile of the group, subject to the risk tolerance limits set by the Board of Directors. ALM risks are managed and monitored by a Group Asset and Liability Committee (ALCO), which is responsible for establishing a group-wide framework for identifying, measuring and overseeing ALM activities and for taking strategic investment decisions for the entire group. At the subsidiaries outside the euro area, local ALCOs have been set up.

A team in the Group Value and Risk Management unit provides support to the Group ALCO and helps to develop ALM risk management. Similar teams exist at the subsidiaries outside the euro area. Risk management responsibilities for the life insurance business (including the tasks of the certifying actuary for the life insurance business and embedded value modelling) are also included in the scope of ALM risk management.

The ALM strategy is implemented locally by front-office units, co-ordinated by a central investment function which is responsible for co-ordinating the various ALM strategies.

The main building blocks of KBC's ALM framework are:

- a focus on 'economic value' as the cornerstone of ALM policy, with attention also being paid to additional 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 behaviour of 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 stress testing, using basic and extreme scenarios, to get an insight in the behaviour of the different portfolios under variable circumstances.
- 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 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 a breakdown of this limit into various types of risk and entities;
- VAR is calculated using fair value models for non-maturing products, taking into account different embedded options and guarantees in the portfolio. However not all these options are valued on a stochastic basis at this point in time (pre-payments in the mortgage business and lapses in the life insurance business).
- the VAR is supplemented by other risk measurement methods such as BPV, notional amounts, economic value etc.

The group VAR limit framework is translated into pragmatic risk limits for the various group companies and individual ALM positions.



KBC group ALM risk, by risk category (VAR 99%, 1-year time horizon, marginal contribution of various risk types to VAR)\*

In billions of EUR	31-12-2007	31-12-2008
Interest rate risk	0.37	1.41
Equity risk	1.70	1.03
Real estate risk	0.16	0.15
Other risks	0.09	0.17
<b>Total diversified VAR (group)</b>	<b>2.31</b>	<b>2.76</b>

\* The figures for 2007 exclude Absolut Bank, DZI Insurance, KBC Banka and a number of small group entities. The figures for 2008 include Absolut Bank and KBC Banka, but still exclude a number of non material group entities.

## Scope of non-trading equity and interest rate risk disclosures

The ALM risk framework, including the management of non-trading equity and interest rate risk, is applicable to all KBC group entities that are subject to ALM 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, and ALM only deals with the risks incurred in the banking book.

Equity risk and interest rate risk account for the lion's share of the total ALM risk and will be discussed in more detail. For further information on the other ALM risks, reference is made to the Group Value and Risk Management chapter in the 2008 annual report.

## Equity risk

The equity risk profile depends largely on the core activity (banking or insurance) of the group company. Insurance companies traditionally keep relatively large equity portfolios, since equity can be used as a hedge for the discretionary participation feature (DPF) of insurance liabilities (especially profit-sharing in the Belgian market). Apart from the insurance entities, smaller equity portfolios are also held by group banks (KBC Bank, KBL EPB, KBC Asset Management and KBC Private Equity).

Given the uncertain environment, the Group ALCO decided in 2008 to lower the equity exposure by installing a moratorium on equity purchases throughout the group. This decision is evaluated on a regular basis by the Group ALCO and the Group investment committee.

Accounting techniques and the impairment procedure for equity are described in Note 1b in the 2008 annual report of the KBC group. An impairment committee decides each quarter on impairment based on a set of coherent indicators. The annual report also provides figures on impairment during the accounting period. The tables below show the total non-trading equity exposures at KBC and the realised and unrealised capital gains in the portfolio.

Non-trading equity exposure

In millions of EUR	31-12-2007	31-12-2008
<b>KBC group*</b>	<b>5 296</b>	<b>3 617</b>
banking entities (KBC Bank)	1 256	1 212
insurance entities (KBC Insurance)	4 122	2 203

\* KBC group total includes the equity exposure of KBL EPB (not shown separately) and some equity positions directly attributed to KBC group. Mutual participations between the banking and the insurance entities of KBC group are eliminated.

#### Non-trading equity exposure

In millions of EUR	31-12-2007		31-12-2008	
	Net realised gains (in income statement)	Net unrealised gains in year-end exposure (in equity)	Net realised gains (in income statement)	Net unrealised gains in year-end exposure (in equity)
KBC group*	834	1 200	107	-63
banking entities	335	171	-5	11
insurance entities	482	1 075	101	-86

\* KBC group total includes gains from KBL EPB (not shown separately) and some equity positions directly attributed to the KBC group. Gains from mutual participations between the banking and insurance entities of KBC group are eliminated.

The distribution of the insurance equity portfolio into sectors is given in the table below. This table excludes investments for unit linked portfolios in the insurance companies.

Distribution of the insurance equity portfolio by sector	31-12-2007	31-12-2008
Financial	29%	16%
Consumer non-cyclical	15%	16%
Communication	7%	11%
Energy	8%	9%
Industrial	7%	12%
Utilities	10%	11%
Consumer cyclical	9%	8%
Basic materials	7%	7%
Other	7%	9%
Total	100%	100%

## Interest rate risk

All the commercial production activity of the bank (credits, deposits,...) is actively managed in a risk-neutral way. There is no active risk-taking in funding or investing client-driven production. Active risk-taking is organised in separate positions for which a separate profit/loss account is kept which can be set 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 (non-maturity; 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.

Where the 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-linked life activities (class 21) combine a guaranteed interest rate with a discretionary participation feature 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. For the single premium life savings products (which account for most of the existing reserves and new production), this cash flow matching is combined with derivative strategies. The lapse risk and the expected profit-sharing policies are managed with a mixed investment portfolio of fixed-income investments and equities.

To measure interest rate risks, KBC uses two main techniques: Basis-Point-Value (BPV) and Value-at-Risk (VAR). The BPV measures the extent to which the value of the portfolio would change if interest rates were to rise by ten basis points across the entire curve (positive (negative) figures indicate an increase (decrease) in the value of the portfolio). 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.

Reports on the interest rate exposures of the bank and insurance companies are produced each month and presented to the Group ALCO.

The group-wide sensitivity 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 of a 1% increase in the yield curve, given the positions at the reporting date.

Impact of a parallel 1% increase in the yield curve for the KBC group<sup>1</sup>  
In millions of EUR

	Impact on net profit (IFRS)		Impact on economic value <sup>2</sup>	
	2007	2008	2007	2008
Insurance	-33	-8	2	-98
Banking	61	-37	-506	-874
Total KBC Group	28	-45	-504	-972

<sup>1</sup> The 2007 figures exclude Absolut Bank, DZI Insurance, KBC Banka and a number of small group entities. The 2008 figures include Absolut Bank and KBC Banka but still exclude a number of non material group entities.

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

Figures below show the impact per currency of a 10 basis points parallel upward shift of interest rate curves. End of 2008 figures show an increased sensitivity because of the tactical position that was opened during 2008.

Interest Rate Risk - BPV  
in thousands of EUR – 31-12-2007

	Overall	EUR	CHF	USD	GBP	CZK	HUF	PLN	SKK	other
Bank	-47 935	-45 783	-8	2 081	219	-4 484	1 396	-1 031	-111	-217
Insurance	2 102	1 564	0	-10	30	-291	-145	954	0	0
KBC Group	-45 833	-44 219	-8	2 071	249	-4 775	1 251	-77	-111	-217

Interest Rate Risk - BPV in thousands of EUR – 31-12-2008

	Overall	EUR	CHF	USD	EUR	CZK	HUF	PLN	SKK	other
Bank	-80 807	-69 538	1 321	-711	119	-7 751	-460	-1200	2	-2 590
Insurance	-8 128	-9 364	0	60	-1	479	-57	757	0	0
KBC Group	-88 935	-78 902	1 321	-651	118	-7 272	-517	-443	2	-2 590

# Liquidity risk management

## Description

Liquidity risk is the risk that an organisation may not be able to fund increases in assets or meet obligations as they fall due, unless at an unreasonable cost.

## 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.

The liquidity management framework and liquidity limits are set by the Group ALCO. Operational liquidity management is organised within the Group Treasury unit, which centralises collateral management and the acquisition of long-term funding. Primary responsibility for operational liquidity management lies with the respective group companies, since they know best the specific features of their local products and markets and deal directly with local regulators and other officials. However, the liquidity contingency plan requires all significant local liquidity problems to be escalated to group level. The group-wide operational liquidity risks are also aggregated and monitored centrally on a daily basis and are reported periodically to the Group ALCO and the Audit Committee.

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

- Contingency liquidity risk:

Contingency liquidity 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 (a) a period that is required to restore market confidence in the group following a KBC-specific event and (b) a period that is required for markets to stabilise after a general market event. 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 wholesale funding. Therefore, the forecast structure of the balance sheet is reviewed regularly and the appropriate funding strategies and options developed and implemented.

- Operational liquidity risk

Operational liquidity management is conducted in the treasury departments, based on estimated funding requirements. The most volatile components of the balance sheet are monitored on a daily basis by the Group Treasury unit, 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

The scope of this liquidity risk report covers the most material entities of KBC Group with banking activity a.o. KBC Bank NV, CBC, Centea, KBC Lease, Antwerp Diamond Bank, KBC Financial Products, ČSOB Czech Republic, ČSOB Slovakia, KBC Ireland, K&H, Kredyt Bank and Absolut Bank. KBC Insurance entities are not included in the report since insurance entities are in general liquidity providers instead of liquidity users.

## Structural liquidity risk

The table illustrates structural liquidity risk by grouping the assets and liabilities at year-end 2008 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 2008, KBC attracted 68 billion euros' worth of funding from the professional market. When interbank lending is also taken into account, net funding attracted through the professional market amounted to 28 billion euros.

Liquidity risk at year-end<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>31-12-2007 (including intercompany deals)</b>								
Total inflows	99	44	43	65	33	27	48	361
Total outflows	115	46	33	35	11	10	159	409
Net liquidity gap in 2007	-15	-3	10	31	22	17	-111	-48
<b>31-12-2008 (excluding intercompany deals)</b>								
Total inflows	105	23	26	69	40	45	16	323
Total outflows <sup>3</sup>	128	32	25	27	7	10	94	323
Professional funding	49	12	4	1	-	1	0	68
Customer funding	26	12	15	6	1	6	76	142
Debt certificates	5	7	6	20	6	3	0	47
Other <sup>4</sup>	48						18	66
Liquidity gap in 2008 (excl. undrawn commitments)	-23	-9	0	42	33	35	-78	0
Undrawn commitments							-43	
Net liquidity gap in 2008 (incl. undrawn commitments)	-23	-9	0	42	33	35	-122	-43

1 Absolut Bank and CIBank included for the first time in the 2008 figures.

2 Differences with Note 18 of the annual report stem from differences in scope: non-material banking entities and insurance entities are not included in the table.

3 Professional funding includes all deposits from credit institutions and investment firms, as well as all repos with other customers. Savings certificates are included in the 'Customer funding' category, whereas they are included under 'Debt certificates' in Note 18 of the annual report.

4 'Other' in the first time bucket comprises mainly derivatives with negative fair value. These are compensated by derivatives with positive fair value incorporated into inflows.

# Operational risk management

## Description

Operational risk in the KBC group is defined as 'the risk of loss resulting from inadequate or failed internal procedures, people and systems or from external events'. This definition is similar to the one given in the Basel II Capital Accord and the Capital Requirements Directive.

Operational risks at KBC include the risk of fraud, as well as legal, compliance and tax risks. The impact of incidents on the group's reputation is taken into consideration when establishing vulnerability to operational risk incidents.

## Strategy and processes

KBC uses a single global framework (referred to as 'the framework' below) to manage operational risk throughout the group. This single framework consists of a governance model, a unique methodology, a single set of concepts and tools, centrally developed supporting ICT applications and reporting – monitoring. The framework covers all aspects of managing operational risk end-to-end, from risk identification to monitoring and reporting. The framework is being implemented throughout KBC under the direct supervision of the Group Operational Risk Committee (GORC).

## Scope of operational risk management

KBC Group's Operational Risk Management Framework covers all entities in which KBC group, 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.

Below, information is presented on the operational risk governance, the tools used to manage operational risks and the capital charges for operational risk.

## Operational Risk Governance

- The main precept of operational risk management is that ultimate responsibility for managing operational risk lies with line management, which receives support from local operational risk managers and is supervised by the operational risk committees.

A Group Operational Risk Committee (Group ORC or GORC) advises the Group Executive Committee on the group-wide framework for managing operational risks and monitors the implementation of this framework throughout the group – including in the new group entities – and oversees the main operational risks. The Group CFRO chairs the GORC.

Besides the GORC, there are a variety of Operational Risk Committees (ORC) 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 Operational Risk Committees whenever they feel it is necessary. In addition, representatives from the internal audit, legal and compliance divisions sit on the Operational Risk Committees as observers.

The Group Value and Risk Management Directorate is primarily responsible for defining the operational risk management framework for the entire group. This framework is submitted to the Group Operational Risk Committee and the Executive Committee for approval. The unit 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 Group ORC.

The Group Value and Risk Management Directorate creates an environment where risk specialists ((Information Risk Management, Business Continuity and Disaster Recovery Managers, Compliance, Anti Fraud Units, Legal, Tax, etc) work together (setting priorities, using the same language and tools, uniform reporting, etc). Assisting this unit are the local value and risk management units – which are likewise independent of the business – in the main bank and insurance subsidiaries.



# Toolbox for the management of operational risks

KBC uses a number of tools for the actual management of operational risk. These tools include:

**The Loss Event Database.** KBC has been uniformly recording all operational losses of 1 000 euros or more in a central database since 2004. This database includes all legal claims filed against group companies. Twice a year, a global loss event data report is submitted to the Group Operational Risk Committee and to the Group Executive Committee.

**Risk Self-Assessments.** These assessments focus on actual (= residual) key operational risks at critical points in the process/organisation that are not yet properly mitigated. Risk Self-Assessments are forward-looking and allow future developments to be taken into account. Risk Self-Assessments can be organised as brainstorming sessions or as structured interviews (e.g. with senior management).

**Group Standards.** KBC has defined some 40 Group Standards to ensure that important operational risks are managed uniformly throughout the group. Each group entity has to translate these group standards into specific local procedures. The various operational risk committees monitor the proper implementation of group standards and may allow exceptions to be made (subject to the observance of a strict waiver procedure).

**Recommended Practices.** These help sharpen the internal controls against key risks that 1) were identified during Risk Self-Assessments, 2) are inherent in new activities started by a group entity, 3) have manifested themselves through a significant loss event, or 4) were identified by Internal Audit during an audit assignment.

**Case Study Assessment.** This is the process of testing the level of protection of the current control environment against severe operational risk events that have actually happened in the banking and insurance industry. The aim is to make the business assess the adequacy of their current internal controls in light of actual severe operational risk events that they did not readily identify during risk self assessments (blind spot for internal fraud, extreme risks, etc.).

**Key Risk Indicators (KRIs).** These track the exposure to potential incidents. KRIs inform the management of the current level of risk exposure and/or the effectiveness of the controls in place. KRIs may be relevant for the whole organisation or only parts thereof.

## Operational Risk Capital Charge

In 2002, KBC decided to apply the Standardised approach for the calculation of regulatory operational risk capital.

KBC wants to focus in the first place on the (qualitative) management of operational risks, rather than concentrate on the optimisation of operational risk capital via the use of a financial model. However, KBC applies the same strict qualitative standards as required under the Advanced Measurement approach. The current KBC approach does not preclude a switch to the Advanced Measurement approach.

Under the Standardised approach, the total capital requirement for operational risk is the simple sum of the capital requirements calculated per 'Basel Business Line'. The capital for each business line is calculated by multiplying the 3-year average eligible gross income by the beta factor assigned by the Capital Requirements Directive to that business line.

The consolidated operational risk capital numbers are submitted for approval to the Group Operational Risk Committee.

### Beta factors, operational risk

Basel Business Lines	Beta Factor	Basel Business Lines	Beta Factor
Corporate Finance	18%	Payment and Settlement	18%
Trading & Sales	18%	Agency Services	15%
Retail Banking	12%	Asset Management	12%
Commercial Banking	15%	Retail Brokerage	12%

## Capital charge, operational risk

In millions of EUR – applicable in 2009<sup>1</sup>

KBC group consolidated operational capital charge		
Banking activities (CRD)	1.036	87%
Insurance activities (QIS 4) <sup>2</sup>	154	13%
<b>Total Group<sup>2</sup></b>	<b>1.190</b>	<b>100%</b>

1 The capital charge for 2009 is determined at year-end 2008 and based on eligible gross income for 2006, 2007 and 2008.

2 The total result and the result of the insurance activities is 'pro-forma', since they are not yet subject to operational risk regulations, but a result has already been calculated.

More information on the operational capital charge of the banking entities is provided in the table below.

In millions of EUR

Basel II Business Line	capital charge - 2008	capital charge - 2009
Retail Banking	384	418
Trading & Sales	247	128
Commercial Banking	237	257
Asset Management	84	86
Corporate Finance	53	44
Retail Brokerage	47	48
Payments & Settlement	26	44
Agency Services	10	11
<b>Total Banking</b>	<b>1 088</b>	<b>1.036</b>