FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms KBC Group's Long-Term IDR at 'A'; Outlook Negative

Tue 20 Oct, 2020 - 12:44 PM ET

Fitch Ratings - Paris - 20 Oct 2020: Fitch Ratings has affirmed the Long-Term Issuer Default Ratings (IDRs) of KBC Group NV at 'A' and of KBC Bank NV at 'A+'. The Outlooks on are Negative. Fitch has also affirmed KBC Group's and KBC Bank's Viability Ratings (VRs) at 'a'. A full list of rating actions is at the end of this rating action commentary.

The affirmations reflect Fitch's view that there is sufficient rating headroom, mainly due to the bank's solid capitalisation, to absorb pressure on asset quality and profitability from the coronavirus outbreak. We expect a fall in eurozone GDP of 9% this year before recovering by 5.5% in 2021. The Negative Outlooks reflect downside risks to the ratings should profitability and asset quality deteriorate more permanently without credible prospects being restored.

KEY RATING DRIVERS

VRS, KBC GROUP'S IDRS AND SENIOR DEBT

Fitch assesses KBC Group on a consolidated basis as the insurance and banking operations are managed in a highly integrated manner. KBC Group is the group's holding company, and its VR is equalised with the VR of KBC Bank, which represents around 90% of group assets. The group is regulated on a consolidated basis, there is no double leverage at the holding company, and we view fungibility of capital between the holding company and the bank as high. Liquidity and capital are managed centrally at the group level.

KBC Group's and KBC Bank's VRs are underpinned by the group's leading franchises in commercial banking and insurance in Belgium and the Czech Republic, strong and diversified earnings generation, solid capitalisation as well as sound funding and liquidity. They also reflect the group's operations in countries with less stable economies in central and eastern Europe (CEE), albeit with a fairly conservative risk appetite.

Asset quality is supported by the dominance of the group's fairly low-risk Belgian lending and stable Czech operations. Exposure to several other countries in CEE gives rise to potential volatility in earnings and asset quality, but we believe risk controls and credit standards are robust.

KBC Group's Stage 3 loan ratio of 3.3% at end-June 2020 continues to be penalised by its legacy residential mortgage loan portfolio in Ireland, which accounts for about a third of the group's total impaired loans. KBC Group has made significant progress in managing down this portfolio through write-offs and asset sales in recent years, translating into a steady improvement in the group's impaired loan ratio. However, we expect the ratio to increase again in the current weak economic environment.

The impact of the pandemic was not yet visible in 1H20 as Stage 3 loans decreased slightly. We expect asset deterioration to be cushioned this year by the various fiscal measures and government guarantee schemes in the countries KBC Group operates in. We expect a material increase in Stage 3 loans in 2021 as support measures mature, and given the group's relatively high exposure to the SME and corporate sectors (about 60% of credit exposure at end-June 2020). However, under our baseline scenario, the Stage 3 loan ratio should remain below the 2016-2019 average of 5.3%.

KBC Group's strong and recurring pre-impairment operating profitability is underpinned by its bancassurance business model in its core markets as well as tight cost control. The group's long-term operating profitability/risk weighted assets (RWA) of 2.7% compares strongly with peers and provides headroom to absorb higher provisioning amid weaker economic prospects.

Operating profit/RWA declined to 0.6% in 1H20 due to frontloading of loan impairment charges (LICs). The group expects LICs to be around 45bp of gross loans for 2020, which is in line with our baseline scenario, where we expect operating profit/RWA to decrease but to remain comfortably above 2%.

Cost efficiency is good, despite high bank taxes, mostly paid in the first quarter of each year. Management's 54% cost/income target for the banking activities by 2020 (1H20:

64%; 2019: 56%) is challenged by the weakened revenue outlook amid continued low interest rates and moderate volume growth.

Capitalisation is sound, with a fully-loaded common equity Tier 1 (CET1) ratio of 16.6% at end-June 2020 and a leverage ratio of 6% at group level. KBC Group's CET1 capital buffer being about 850bp above its revised regulatory requirements provides sizeable loss-absorption capacity. Management's CET1 ratio target is at least 14%, excluding an additional buffer for potential M&A (1.7% as of end-2019).

Funding and liquidity are a rating strength. The bank has a solid retail funding base, and nearly all of its subsidiaries are self-funded. Customer deposits are the main source of funding and are in excess of customer loans. KBC Group and KBC Bank also access the debt capital markets through a wide range of products. Wholesale funding maturities are reasonably well spread, and the ample liquidity buffer adequately mitigates refinancing risk.

KBC Group's Long-Term IDR is in line with its VR. The Short-Term IDR of 'F1' is the baseline option mapping to a Long-Term IDR of 'A', because the group's Funding & Liquidity score of 'a+' does not warrant a Short-Term IDR of 'F1+'. KBC Group's senior unsecured debt is rated in line with its IDRs as we view the probability of default on senior unsecured obligations as the same as the probability of default of the issuer.

KBC BANK'S IDRS, SENIOR DEBT AND DERIVATIVE COUNTERPARTY RATING (DCR)

KBC Bank's Long-Term IDR and senior debt ratings are one notch above the bank's VR, since Fitch believes the risk of default on senior obligations, as measured by the bank's Long-Term IDR, is lower than the risk of the bank failing, as measured by its VR. This is because of resolution debt buffers raised by KBC Group to protect KBC Bank's senior external creditors in a failure scenario.

The group has adopted a single-point-of-entry resolution strategy, with KBC Group the resolution entity. All MREL instruments, including senior debt, are issued by KBC Group and downstreamed to KBC Bank and rank junior to third-party senior creditors.

KBC Bank's Short-Term IDR of 'F1' is the baseline option mapping to a 'A+' Long-Term IDR. This reflects Fitch's funding and liquidity assessment of 'a+' for the group.

KBC Bank's DCR is aligned with its Long-Term IDR, because under Belgian legislation derivative counterparties have no preferential status over other senior obligations in a resolution scenario.

KBC Bank guarantees the senior debt issued by its fully owned subsidiary KBC IFIMA S.A. This senior debt's ratings are aligned with KBC Bank's IDRs to reflect our view that KBC Bank will ensure these obligations are met.

SUPPORT RATINGS AND SUPPORT RATING FLOORS

KBC Group's and KBC Bank's Support Ratings of '5' and Support Rating Floors of 'No Floor' reflect Fitch's view that senior creditors can no longer rely on receiving full extraordinary support from the sovereign in the event that KBC Bank becomes non-viable. The EU's Bank Recovery and Resolution Directive and the Single Resolution Mechanism for eurozone banks provide a framework for resolving banks that is likely to require senior creditors participating in losses, instead of or ahead of a bank receiving sovereign support.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The Tier 2 subordinated debt issued by KBC Group is rated two notches below its VR, reflecting Fitch's baseline notching for incremental loss severity.

The CRD IV-compliant, undated, deeply subordinated, additional Tier 1 securities issued by KBC Group are rated four notches below its VR. The notching reflects the notes' higher incremental loss severity (two notches) and non-performance risk (two notches) relative to senior unsecured creditors.

Subordinated debt issued by KBC IFIMA and guaranteed by KBC Bank on a subordinated basis is rated two notches below KBC Bank's VR to reflect below-average recovery expectations.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

IDRS, VRS AND SENIOR UNSECURED DEBT

The Negative Outlook on KBC Bank and KBC Group's Long-Term IDRs signals that an upgrade of the entities' ratings is unlikely in the short term. The Outlook could be revised to Stable if the pressure on asset quality and profitability turns out to be more moderate than our expectations. In the longer term, even if the group withstands rating pressure arising from the coronavirus crisis, an upgrade would require a significant and structural improvement in the bank's financial metrics, in particular of asset quality metrics, above pre-crisis levels.

KBC Group's Short-Term IDR and short-term senior unsecured debt rating would be upgraded if its Long-Term IDR was upgraded or if its Funding and Liquidity score was revised up to 'aa-' or above. KBC Bank's Short-Term IDR and short-term senior unsecured debt rating would be upgraded if its Funding and Liquidity score was revised up to 'aa-' or above.

SUPPORT RATINGS AND SUPPORT RATING FLOORS

An upgrade of KBC Group and KBC Bank's Support Ratings and upward revision of their Support Rating Floors would require an increased probability of state support in the event that the group becomes non-viable. This is highly unlikely in light of the prevailing regulatory framework, in Fitch's view.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

IDRS, VRS AND SENIOR UNSECURED DEBT

We could downgrade the ratings if asset quality and operating profitability deteriorate substantially and durably, most likely due to severe damage to the SME and corporate loan portfolios. In particular, an impaired loan ratio durably above 5% or operating profitability/RWA durably below 2% would lead to a downgrade. This could arise if the fallout from the coronavirus crisis is more severe than in Fitch's baseline scenario.

KBC Group's ratings could also be downgraded in case of a significant build-up of double leverage at the holding company, although this is not Fitch's expectation.

The senior debt ratings issued by KBC IFIMA are sensitive to a change in KBC Bank's IDRs.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The ratings of the subordinated Tier 2 and additional Tier 1 securities issued by KBC Group are sensitive to changes to KBC Group's VR. In addition, the rating of the additional Tier 1 securities is sensitive to changes in Fitch's assessment of the probability of the notes' non-performance risk relative to the risk captured by KBC Group's VRs.

The subordinated Tier 2 notes issued by KBC IFIMA are sensitive to changes to the VR of KBC Bank, which guarantees the notes.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

The ratings of KBC IFIMA S.A. are directly linked to KBC Bank. A change in Fitch's assessment of the ratings of KBC Bank may result in a change in the ratings of KBC IFIMA S.A.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR

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KBC Group NV	LT IDR	A Rating Outlook Negative	Affirmed	A Rating Outlook Negative
	ST IDR	F1	Affirmed	F1
	Viability	a	Affirmed	a
	Support	5	Affirmed	5
	Support Floor	NF	Affirmed	NF
• subordinated	LT	BBB+	Affirmed	BBB+

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Olivia Perney
Managing Director
Primary Rating Analyst
+33 1 44 29 91 74
Fitch Ratings Ireland Limited
60 rue de Monceau Paris 75008

Andreea Playoust
Director
Secondary Rating Analyst
+33 1 44 29 91 71

Patrick Rioual
Senior Director
Committee Chairperson
+49 69 768076 123

MEDIA CONTACTS

Louisa Williams
London
+44 20 3530 2452
louisa.williams@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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KBC Group NV	EU Issued
KBC IFIMA S.A.	EU Issued

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Structured Finance: Covered Bonds Insurance Structured Finance Banks Europe

Belgium Luxembourg