FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Outlook on KBC Group to Stable; Affirms at 'A'

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Fitch Ratings - Paris - 12 Oct 2021: Fitch Ratings has revised the Outlooks on KBC Group NV (KBC Group) and KBC Bank NV's (KBC Bank) Long-Term Issuer Default Ratings (IDRs) to Stable from Negative and affirmed their Long-Term IDRs at 'A' and 'A+', respectively. 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 revision of the Outlook reflects Fitch's updated economic assumptions for the group's main operating countries, indicating that while pandemic-related risks remain, they are likely to be absorbed by the group's current rating headroom. Fitch expects that the strong forecast economic recovery in these countries will support the group's asset quality and operating profitability, and we expect the latter to remain close to the four-year average level in 2021-2022.

Fitch forecasts Belgium's GDP to grow by 5.8% in 2021, supported by the robust growth in 1H21, before slowing, but remaining sound, in 2022 and 2023.

KEY RATING DRIVERS

VRS, KBC GROUP'S IDRS AND SENIOR DEBT

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, providing it with a competitive advantage, strong and diversified earnings generation, solid capitalisation and sound funding and liquidity. The VRs incorporate our view that the group operates in slightly weaker operating environments than domestic peers, due to material operations in less developed and more volatile countries in central and eastern Europe

(CEE), although with a fairly conservative risk appetite, implying the need to report better financial metrics to achieve the same rating.

KBC's asset quality is weaker than its peers but is supported by the dominance of the group's fairly low-risk Belgian lending and stable Czech operations.

Fitch equalises the VRs of KBC Group and KBC Bank as it assesses their credit profile 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 KBC Bank 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 reported an impaired loans/gross loans ratio of 3.3% at end-June 2021. Despite a moderate increase in the stock of impaired loans in the SME book, the Stage 3 loans ratio slightly declined from end-2019 to June 2021 in part because of write-offs in the Irish portfolio. We expect the ratio to further improve, following the recent sale of EUR1.1 billion non-performing legacy loans in Ireland. All else equal, this will allow the Stage 3 loan ratio to decrease to 2.6%, a level which is more in line with the sector average. Our assessment of the bank's asset quality (bbb+) incorporates the announced reduction in the legacy book and the lower expected impaired loans ratio.

We believe that downside risks on KBC Group's asset quality have receded and we expect only a moderate deterioration in KBC Group's asset quality driven by the group's material SME and corporate loan book (55% of loans including off balance sheet guarantees) following the expiry of government support. However, we expect this to be mitigated by the non-performing loan sale in Ireland.

KBC Group's earnings and profitability is a rating strength and compares favourably with peers. We have therefore reassessed this factor score to 'a+' on a stable trend from 'a' negative trend. The group continues to benefit from its leading market position in home markets and pricing power, and from its bancassurance business model that generates strong revenue and cost synergies. Revenue diversification between net interest income, net insurance income, and fee income from asset gathering operations supported the group's relatively good performance in a challenging operating environment, despite continued pressure on net interest margins from low interest rates and increasing deposits.

After a sharp decline in net income due to frontloading of pandemic-related provisions in 2020, KBC's profitability recovered to pre-pandemic levels in 1H21. KBC Group's operating profit/risk-weighted assets (RWA) at 3.2% was comparable with the ratio for

2019 after having fallen to 1.8% in 2020. This was supported by sound growth in non-interest income mainly from asset management and insurance and thanks to reversals of loan impairment charges (LICs).

We expect KBC Group to generate sound operating profit/RWA levels in 2021 and 2022, in line with its 3.2% four-year average (2017-2020), due to sound revenue growth, good cost control and below through-the-cycle LICs. Fitch expects the group to release a large part of the EUR783 million collective pandemic-related provisions recorded in 2020 (almost three quarters of the EUR1.1 billion LICs in 2020) against an improving economic backdrop. Consequently, Fitch expects LICs will be below the group's 30-40bp through-the-cycle average in the short term.

Cost efficiency is good and compares favourably with peers. Given continued pressure on net interest income, cost control remains a key focus for KBC's management, as highlighted in the current strategic plan. The cost/income ratio was at about 55% in 1H21 (when spreading bank taxes taken upfront in 1Q21), which is in line with the four-year average. We expect the ratio to remain at its long-term average of around 55-57%, supported by sound revenue growth from fee-generating business, insurance and from higher interest rate prospects in the Czech Republic and controlled operating costs.

Capitalisation is currently strong reflecting strong internal capital generation. The group's fully-loaded common equity Tier 1 (CET1, Danish compromise) ratio increased to 17.5% at end-June 2021, providing solid buffers against minimum capital requirements. However, we do not expect capitalisation to remain at these levels over the medium term, and our assessment of KBC Group's capitalisation reflects management's medium-term CET1 ratio target of at least 14.5% (excluding an additional 100bp buffer for potential M&A or unexpected shocks).

The group has a sound funding and liquidity profile. The bank has a stable and diversified 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, with highly liquid assets accounting for about 26% of total assets at end-June 2021, 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', and reflecting the group's Funding &Liquidity score of 'a+'. 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 because of the presence of resolution debt buffers raised by KBC Group to protect KBC Bank's senior external creditors. We therefore consider that in a failure scenario, the risk of default on senior obligations is lower than the risk of the bank failing.

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.

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.

KBC IFIMA's SENIOR DEBT

KBC IFIMAS.A.'s senior debt is aligned with KBC Bank's IDRs as it is guaranteed by KBC Bank and we believe that KBC Bank will ensure these obligations are met.

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:

Rating upside for KBC Group and KBC Bank's VR is limited, and would require significant further strengthening of asset quality metrics while maintaining strong profitability record and capitalisation levels.

KBC Group's and KBC Bank's Short-Term IDRs and short-term senior unsecured debt ratings would be upgraded if their Long-Term IDRs were upgraded to 'AA-' or if their Funding and Liquidity score was revised up to 'aa-' or above.

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:

We could downgrade the ratings of KBC Group and KBC Bank if asset quality and operating profitability deteriorate substantially and durably, most likely due to severe damage to the SME and corporate loan portfolios, with operating profit/RWA decreasing to a level significantly below 3%, and if the group's CET1 ratio fell below its internal target of 14.5% without a clear path to restore it in a relatively short period.

A change in KBC Group's risk appetite could be negative for the ratings, for example, if contribution of more volatile CEE countries to KBC Group's earnings grows rapidly.

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.

KBC Bank's Long-Term IDR and debt ratings could be downgraded to the same level as KBC Group's if Fitch considers that resolution buffers downstreamed into the bank no longer provide creditors with some protection in the event of the bank's failure.

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

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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
KBC Group NV	LT IDR	A Rating Outlook Stable	Affirmed	A Rating Outlook Negative

ENTITY/DEBT	RATING			PRIOR
	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

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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

KBC Group NV	EU Issued, UK Endorsed
KBC IFIMA S.A.	EU Issued, UK Endorsed

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