Press release

26 February 2009

KBC clarifies its approach towards CDOs sold to private banking clients

KBC Bank Belgium had previously confirmed that a number of its private banking clients had asked critical questions about their CDO investments. In response to this situation, KBC Bank decided that, in the coming months, it would take the files of all those private banking clients who had purchased CDOs and examine them on a case-by-case basis. Should this thorough investigation reveal shortcomings on the part of KBC Bank in relation to certain files, the bank will assume its responsibility.

Background

Over the past few years, KBC Bank has offered investments in (synthetic) CDO structures to a number of institutional and corporate counterparties and private banking clients. The bank also has the investments/CDOs in its own portfolio.
CDO stands for Collateralised Debt Obligation, a type of bond based on repackaged loans, that involves both small and large risks (both good and bad credit).
These investments offered a number of benefits to the clients concerned, such as relatively good (initial) ratings monitored every quarter, an attractive return, a quarterly coupon payment and limited interest-rate risk.

There are many types of CDOs on the market. Depending on the risks involved – where necessary, assessed per tranche – CDOs have different risk profiles. There are relatively defensive tranches and tranches that are more dynamic or highly dynamic.
KBC Bank gave the clients concerned as much information as possible (prospectuses, information sheets, regular discussions about their portfolios, etc.), and made sure that primarily investment-grade CDOs (i.e. with ratings above Baa3) were sold to these clients.

The CDOs sold by KBC Bank are structured in such a way that a number of in-built mechanisms aim to keep the (credit) risks within certain limits. Although the risks are currently higher, it cannot simply be claimed that it was or is a careless move to invest in CDOs. One of the main factors that must be considered in this regard is the unprecedented (global) financial crisis.

CDOs are valued based on both ratings and credit spreads. Moody's rating agency recently (significantly) downgraded the rating category for certain CDOs, in part based on a lower assessment of the underlying assets. Coupled with the fact that credit spreads all over the world hit record highs during the past quarter, this has resulted in a lower valuation for the CDOs. The fair value measurement of such CDOs under compulsory International Financial Reporting Standards (IFRS) is not necessarily a true reflection of the current underlying economic reality. Many CDOs contain only a small number of subprime mortgages, while the remainder of the underlying assets (84%) is made up of credit risks attached to West European and US companies and financial institutions. However, since there is currently no market for CDOs, and therefore no market price, either, KBC must use another method – based on a model that takes account of the information available under the circumstances (primarily credit spreads and ratings) – to reasonably calculate an indicative valuation (i.e. Mark-to-Model).

This indicative valuation, which is advised to clients, is not the price they might obtain today for the CDOs, nor is it the expected value redeemable at maturity, because account must also be taken of the actual impact of the current global recession. The valuation is purely indicative, an estimate of the current value of the CDOs, based on a valuation model.

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