FITCH UPGRADES KBC BANK TO 'A +'; AFFIRMS KBC GROUP AT 'A'

Fitch Ratings-Paris/London-23 November 2018: Fitch Ratings has upgraded KBC Bank's Long-Term Issuer Default Rating (IDR) and senior debt ratings to 'A+' from 'A'. The Outlook on the Long-Term IDR is Stable. KBC Group NV's Long-Term IDR has been affirmed at 'A', with a Stable Outlook.

Both KBC Bank's and KBC Group's Viability Ratings (VRs) have been affirmed at 'a', and KBC Group's senior debt ratings have been affirmed at 'A'.

A full list of rating actions is at the end of this rating action commentary.

The ratings actions are part of a periodic portfolio review of major banks in Belgium and Luxembourg rated by Fitch.

The upgrades of KBC Bank's Long-Term IDR and senior debt ratings to one notch above its VR reflect the build-up of a significant and sustainable qualifying junior debt (QJD) buffer at the bank that provides additional protection for its senior unsecured creditors. KBC Bank has proposed a "single point of entry" approach at the KBC Group level, and most debt issued by the holding company is downstreamed to the bank in a subordinated form that ranks junior to external senior creditors to meet the upcoming minimum requirement for eligible liabilities and own funds (MREL).

KEY RATING DRIVERS

IDRs, DERIVATIVE COUNTERPARTY RATINGS (DCRs) AND SENIOR DEBT

The Long-Term IDR and senior debt ratings of KBC Bank have been upgraded to one notch above the bank's VR as its QJD buffer is sufficient and sustainable to protect senior obligations from default in case of failure, either under a resolution process or as part of a private-sector solution (ie, distressed debt exchange) to avoid a resolution action.

Without such a private-sector solution, we would expect a resolution action being taken on KBC when it breaches minimum capital requirements. The group is regulated on a consolidated basis but the bank makes up the bulk of the group. We assume the intervention point would be at a common equity Tier 1 (CET1) ratio no lower than 6.25% of risk-weighted assets. Fitch believes that KBC Group would need to meet its minimum capital requirements immediately after a resolution action. Given KBC Bank's domestic systemic importance, Fitch believes minimum capital requirements will include most, if not all, of its combined buffer requirements. On a risk-weighted basis, Fitch has estimated that a CET1 capital requirement around 15% is plausible under a bail-in scenario post resolution action, and that a QJD buffer of approximately 9% would most likely be sufficient to restore the bank's viability without affecting senior creditors.

At end-September 2018, the QJD buffer at KBC Bank amounted to 9.1% of group weighted risks. We expect KBC to maintain a buffer of approximately 9% on a sustainable basis. This is in line with the group's stated target of meeting the current MREL.

The Short-Term IDR of KBC Bank maps to the lower of the two options for an 'A+' Long-Term IDR as the Long-Term IDR benefits from the existence of the QJD buffer. Fitch views the group's liquidity as sound but not exceptionally strong compared to similarly rated peers.

KBC Group's Long-Term IDR and senior debt ratings are in line with its VR.

The DCRs of KBC Bank and KBC Group are at the same level as their respective Long-Term IDRs, because under Belgian legislation, derivative counterparties have no preferential status over other senior obligations in a resolution scenario.

VRs

Fitch assesses the group on a consolidated basis as it is managed as a group with the insurance and banking operations highly integrated.

KBC Group acts as the holding company for the group, and its VR is equalised with the VR of KBC Bank, which represents around 90% of group assets. In addition, the group is regulated on a consolidated basis, there is low 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.

The VR reflects the strong retail and commercial franchise of KBC Group in its two key markets, Belgium and the Czech Republic, its improved but still weaker than similarly rated peers' impaired loan ratio, fairly conservative risk appetite but also operations in potentially volatile countries, strong and diversified earnings generation, solid capitalisation, and sound funding and liquidity.

The stock of impaired loans has been steadily decreasing, and including the announced sale of Irish impaired loans, the gross impaired loan ratio was around 4.7% at end-September 2018, according to Fitch's calculation. This is still higher than at similarly rated peers, but the gap with banks with similar write-off policies is narrowing. We expect the ratio to reduce further as restructured Irish loans cure, aided by a solid economic recovery.

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

Capital encumbrance by unreserved impaired loans declined to a more moderate level, at 20% of equity including the positive impact of the expected loan sale. KBC's capitalisation is solid, with a fully loaded CET1 ratio of 16% at end-September 2018 at the KBC Group level. Risk-weighted capital ratios compare well with peers', mitigating the slightly higher risk appetite from operations in less stable CEE countries.

Earnings generation compares well with similarly rated peers'. Resilient and stable profitability is underpinned by the bancassurance business model in KBC's core markets and tight cost control. The Belgian and Czech operations have been resilient, contributing around half and a quarter of profit respectively. Earnings from the Irish operations benefit from reversals of provisions but also positive business momentum, which should support overall profit generation.

Liquidity is strong. The bank has a solid retail funding base, and nearly all of its subsidiaries are self-funded. Customer deposits are its largest source of funding and fund its lending. The group also has access to the debt capital markets through a wide range of products, at both the bank and the holding level. Its wholesale funding maturities are reasonably even, and the ample liquidity buffer further mitigates refinancing risk.

SUPPORT RATING AND SUPPORT RATING FLOOR

KBC Bank's and KBC Group'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
Subordinated debt and hybrid securities issued by KBC Bank and KBC Group are notched down from the entities' respective VRs.

Hybrid securities issued by KBC Bank are rated four notches lower than its VR (two notches for non-performance and two for relative loss severity). Subordinated debt issued by KBC IFIMA S.A. is rated one notch lower than KBC Bank's VR to reflect below-average recovery expectations. The notes are guaranteed by KBC Bank on a subordinated basis.

Subordinated debt issued by KBC Group is rated one notch lower than its VR to reflect relative loss severity. The CRD IV-compliant, undated, deeply subordinated, additional Tier 1 debt securities issued by KBC Group are rated five notches below its VR. The notching reflects the notes' higher expected loss severity relative to senior unsecured creditors (two notches) and higher non-performance risk (three notches).

SUBSIDIARY AND AFFILIATED COMPANY
The senior debt issued by KBC Bank's fully owned subsidiaries KBC IFIMA S.A. and KBC Bank Ireland plc is guaranteed by KBC Bank, and the subsidiaries' debt ratings have been upgraded, as these are aligned with the bank's IDRs to reflect our view that KBC Bank will ensure these obligations are met.

RATING SENSITIVITIES
IDRs, DCRs AND SENIOR DEBT
The Long-Term IDRs, senior debt ratings and DCRs of KBC Bank and KBC Group are sensitive to changes in the VRs. KBC Bank's ratings are also sensitive to a material reduction in the QJD buffer, in particular should it fall below 9%. The notching is also sensitive to changes in assumptions on the resolution intervention point and post-resolution capital needs, and the development of resolution planning more generally. KBC Group's ratings are also sensitive to deterioration in double leverage beyond 120%.

VRs
Rating upside is currently limited given the still weaker lending quality compared to similarly rated peers. Fitch expects further reduction in the bank's impaired loan ratio. An upgrade would also be contingent on an improved risk profile, including an improved operating environment in the more volatile countries in which the group operates. The current rating level factors in expectations that earnings generation and capitalisation will remain strong.

SUPPORT RATING AND SUPPORT RATING FLOOR
An upgrade of KBC Bank's or KBC Group's Support Ratings and upward revision of the entities' Support Rating Floors would be contingent on a positive change in the Belgian sovereign's propensity to support its banks. While not impossible, this is highly unlikely, in Fitch's view.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
Subordinated debt and hybrid securities issued by KBC Bank, KBC IFIMA S.A. and KBC Group are primarily sensitive to KBC Bank's and KBC Group's VRs. The ratings of the hybrid securities are also sensitive to changes in Fitch's assessment of the probability of the notes' non-performance risk relative to the risk captured by KBC Bank's and KBC Group's VRs. The ratings of notes issued by KBC Group are sensitive to a build-up of additional double leverage at the holding company.

SUBSIDIARY AND AFFILIATED COMPANIES

The senior debt ratings of KBC IFIMA S.A. and KBC Bank Ireland plc are sensitive to the same factors that might drive a change in KBC Bank's IDRs.

The rating actions are as follows:

KBC Bank
Long-Term IDR upgraded to 'A+' from 'A', Outlook Stable
Short-Term IDR affirmed at 'F1'
Viability Rating affirmed at 'a'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'No Floor'
Derivative Counterparty Rating: upgraded to A+(dcr) from 'A(dcr)'
Senior debt: Long-term upgraded to 'A+' from 'A'; Short-term affirmed at 'F1'
Perpetual subordinated debt securities (BE0119284710) affirmed at 'BBB-'

KBC IFIMA S.A.
Senior debt upgraded to 'A+' from 'A'
Short-term debt affirmed at 'F1'
Subordinated debt affirmed at 'A-'

KBC Bank Ireland plc
Commercial paper affirmed at 'F1'

KBC Group
Long-Term IDR affirmed at 'A', Outlook Stable
Short-Term IDR affirmed at 'F1'
Viability Rating affirmed at 'a'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'No Floor' '
Senior debt affirmed at 'A'/'F1'
Subordinated debt affirmed at 'A-'
Undated deeply subordinated securities (BE0002463389 and BE0002592708) affirmed at 'BB+'

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Applicable Criteria
Bank Rating Criteria (pub. 12 Oct 2018)
https://www.fitchratings.com/site/re/10044408