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Research Update:

KBC Group Upgraded On Belgium's Stabilizing Economic Risks And Our Expectation For Capital Strengthening; Outlook Stable

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Research Update:

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Overview

- We consider that Belgian banking and insurance group KBC operates in a more supportive environment following our recent revision of the outlook on Belgium to stable and our view that economic risks for domestic banks have turned stable.
- We believe KBC now has a greater ability to increase net income and strengthen its capitalization over the coming three years.
- We are raising our ratings on KBC Bank to 'A/A-1' from 'A-/A-2', on KBC Insurance to 'A' from 'A-', and on holding company KBC Group to 'A-' from 'BBB+'.
- The stable outlook indicates our belief that KBC will consolidate its capital and maintain asset quality, following its efforts in recent years to improve its risk position.

Rating Action

On March 10, 2014, Standard & Poor's Ratings Services raised its long-term and short-term counterparty credit ratings on Belgium-based KBC Bank N.V. to 'A/A-1' from 'A-/A-2', its insurer financial strength rating on KBC Insurance N.V. to 'A' from 'A-', and its long-term counterparty credit rating on holding company KBC Group N.V. to 'A-' from 'BBB+'. Simultaneously, we affirmed our 'A-2' short-term counterparty credit rating on KBC Group. We also raised our insurer financial strength ratings on "highly strategic" subsidiary KBC Group RE S.A. to 'A-' from 'BBB+' and on "strategic" Czech Republic-based subsidiary CSOB Pojitovna AS to 'A-' from 'BBB+'. The outlooks on these KBC entities are stable.

At the same time, we raised our long-term issue ratings on KBC's subordinated debt to 'BBB+' from 'BBB' and on its existing junior subordinated debt to 'BBB-' from 'BB+'.

We assigned our 'BB' long-term issue rating to the proposed Tier 1 undated deeply subordinated resettable notes to be issued by KBC Group. The rating is subject to our review of the notes' final documentation.

Rationale

The rating actions follow our revision of the outlook on Belgium to stable (see "Outlook On Belgium To Stable On Improved Structural Policy Environment; 'AA/A-1+' Ratings Affirmed," published Feb. 28, 2014, on RatingsDirect). We also factor in our view that the economic risk trend in Belgium is stable, under our Banking Industry Country Risk Assessment (BICRA) methodology. We consider that KBC now operates in more supportive economic environment and consequently believe it has a greater ability to increase its net income and strengthen its capital over the next three years. We also take into account the group's recent clarification of its dividend policy and its proposed tier 1 hybrid capital issue. In conjunction with our upgrade of KBC Bank, we have revised upward our assessments of its capital and earnings to "adequate" from "moderate" and its stand-alone credit profile (SACP) to 'a-' from 'bbb+'.

We estimate that the Belgian economy will grow in real terms by an average of 1.2% annually over 2014-2017. In the real estate market, despite the strong rise in residential prices during the 2000s, we do not expect any major price correction during the same period. In our base-case scenario, we foresee a trend toward stabilization in real-term property prices by 2015. We anticipate that banks' provisions for domestic credit losses will be about 30 basis points in 2014, which is low compared with levels in other Western European countries.

We now forecast a risk-adjusted capital (RAC) ratio, our main measure of a bank's capital, at 7.5% or more in 2014 and beyond, versus 6.3% in 2012, for the group. We calculate our RAC ratio at group level because we consider that KBC will remain an integrated bancassurance group in the foreseeable future, and because it manages capital allocation on a consolidated basis.

In our RAC ratio, we factor in our estimate of KBC's annual net income--about €1.6 billion--over the next three years, further pay back of government hybrids, and a skip in dividends and government hybrid coupons in 2015. At the KBC Bank Ireland subsidiary, we expect a pronounced decline in credit costs. This subsidiary has accounted for 50%-60% of total group credit costs in the past four years. We also believe that KBC will not face any material impairment charges as a result of the European Central Bank's (ECB) asset quality review because the group preemptively identified impairments in November 2013. Lastly, our RAC calculation includes the KBC Group's proposed issue of additional tier 1 hybrid instruments in excess of €1 billion, by our estimates. These instruments will comply with the EU's Capital Requirements Directive IV for banks.

We view positively KBC's stated intention to maintain a Common Equity Tier 1 ratio under full implementation of Basel III at above 10%. KBC's pro forma Common Equity Tier 1ratio stood at 12.5% at year-end 2013 under full implementation of Basel III.

KBC is one of Belgium's leading financial services groups. It reported total assets of €240 billion on Dec. 31, 2013. We base our ratings on KBC Bank on our analysis of the consolidated creditworthiness of KBC Group, which controls 100% of the bank, and KBC Insurance N.V., given the very high integration between the group's banking and insurance operations.

In accordance with our criteria for hybrid capital instruments, the 'BB' rating on the group's proposed additional Tier 1 hybrids stands four notches below KBC Bank's SACP, incorporating:

- The deduction of two notches, which is the minimum downward notching from the SACP under our criteria for a bank hybrid capital instrument.
- A deduction of an additional notch to reflect our view that reporting a loss in a particular accounting period while breaching Basel III equity buffers would prevent coupon payments, and that this could happen independently of the bank's collapse or non-viability. This risk may not otherwise be reflected in the SACP. Payments can be limited under Condition 3.2 in the notes' documentation, which refers to the "Maximum Distributable Amount," subject to respect of the "combined buffer" (as the Capital Requirements Directive IV defines these terms). Given that this limit is defined in reference to the "combined buffer," we understand that this trigger level will increase over time, along with the expected regulatory phase-in. We also factor in that if this earnings clause and trigger were to be activated, then KBC Group would not have flexibility to use otherwise distributable reserves to make coupon payments.
- The deduction of a fourth notch to reflect that the notes feature a contingency clause leading to principal write-down. This clause would become effective if KBC Group's consolidated Common Equity Tier 1 ratio was to fall below a 5.125% trigger, which we see as a "non-viability contingency clause."

The 'BB' issue rating also reflects the structural subordination of debt issued at KBC Group level, compared with debt issued by operating subsidiary KBC Bank.

We understand the Belgian regulator has granted the proposed hybrid instrument Tier 1 status and regulatory capital credit. Consequently, we have assigned "intermediate" equity content to the hybrid notes, reflecting our view that they would allow the absorption of losses on a "going-concern" basis, through coupon cancellation at the option of the issuer. Our assessment also reflects that the instrument is perpetual and has no step-up clause.

Outlook

The stable outlook indicates our belief that KBC will consolidate its capital and maintain asset quality following its efforts in recent years to improve its risk position.

We could consider a downgrade if the economies of KBC Bank's main countries of operation do not stabilize as we expect, or if we come to believe that KBC

Bank's asset quality will weaken significantly. In particular, we expect that the impairment charges linked to the ECB's upcoming asset quality review will not materially exceed the amount announced on Nov. 14, 2013, and that the cost of credit risk in 2014 will be lower than the 2012 level. In addition, higher losses than we currently expect could lead us to revise downward our view of KBC Bank's risk position.

We view very limited upside rating potential at this stage.

S&P Review Of Government Support In European Bank Ratings

European authorities have recently indicated their intention to avoid future bank bail-outs (government support) by using bail-ins (burden sharing with investors, potentially including senior unsecured obligations). Consequently, we plan to review our ratings on European banks, including KBC Bank, that benefit from uplift to reflect government support. For further details, see " Standard & Poor's To Review Government Support In European Bank Ratings," published March 4, 2014.

Ratings Score Snapshot

KBC Bank	To	From
Issuer Credit Rating:	A/Stable/A-1	A-/Positive/A-2
SACP:	a-	bbb+
Anchor:	bbb+	bbb+
Business Position:	Strong (+1)	Strong (+1)
Capital and Earnings:	Adequate (0)	Moderate (-1)
Risk Position:	Adequate (0)	Adequate (0)
Funding and Liquidity:	Average and Adequate (0)	Average and Adequate (0)
Support:	1	1
GRE Support:	0	0
Group Support:	0	0
Sovereign Support:	1	1
Additional Factors:	0	0

Related Criteria And Research

Related Criteria

- Group Rating Methodology, Nov. 19, 2013
- Insurers: Rating Methodology, May 7, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital

Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Standard & Poor's To Review Government Support In European Bank Ratings, March 4, 2014
- Outlook On Belgium To Stable On Improved Structural Policy Environment; 'AA/A-1+' Ratings Affirmed, Feb. 28, 2014
- Request For Comment: Assigning Issue Credit Ratings To Bank And Prudentially Regulated Finance Company Hybrid Capital Instruments, Feb. 6, 2014
- Banking Industry Country Risk Assessment: Belgium, Jan. 28, 2014

Ratings List

Upgraded; Ratings Affirmed

	To	From
KBC Bank N.V.		
Counterparty Credit Rating	A/Stable/A-1	A-/Positive/A-2
Certificate Of Deposit	A/A-1	A-/A-2
Junior Subordinated	BBB-	BB+
Certificate Of Deposit	A-1	A-2
Commercial Paper	A-1	A-2
KBC Insurance N.V.		
Counterparty Credit Rating		
Local Currency	A/Stable/--	A-/Positive/--
Financial Strength Rating		
Local Currency	A/Stable/--	A-/Positive/--
KBC Group N.V.		
Counterparty Credit Rating	A-/Stable/A-2	BBB+/Positive/A-2
CSOB Pojistovna a. s.		
KBC Group Re S.A.		
Counterparty Credit Rating		
Local Currency	A-/Stable/--	BBB+/Positive/--
Financial Strength Rating		
Local Currency	A-/Stable/--	BBB+/Positive/--
KBC Bank Funding Trust II		
Preferred Stock (1)	BBB-	BB+
KBC Bank Funding Trust III		

Preferred Stock (1)	BBB-	BB+
KBC Bank Funding Trust IV		
Preferred Stock (1)	BBB-	BB+
KBC Bank Ireland PLC		
Commercial Paper (1)	A-1	A-2
KBC Ifima N.V.		
Senior Unsecured (1)	A	A-
Senior Unsecured (1)	A-	BBB+
Senior Unsecured (2)	A-	BBB+
Subordinated (1)	BBB+	BBB
Kredietbank N.A. Finance Corp.		
Commercial Paper (1)	A-1	A-2

New Rating

KBC Group N.V.	
Junior Subordinated	BB

(1) Guaranteed by KBC Bank N.V.
(2) Guaranteed by KBC Group N.V.

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