# KBC in Ireland
# Tightening up strategy execution

**KBC Group (rated A+, with a Stable Outlook) has fundamentally transformed its Irish franchise in the past few years. While the Group reconfirmed its commitment to Ireland, the bank's value proposition has substantially changed, and a new strategy taken shape, focused on its digital offering. While the bank has returned to profitability and improved asset quality and other fundamentals, the stock of NPLs represents a challenge. Outright portfolio sales may have to be part of the solution.**

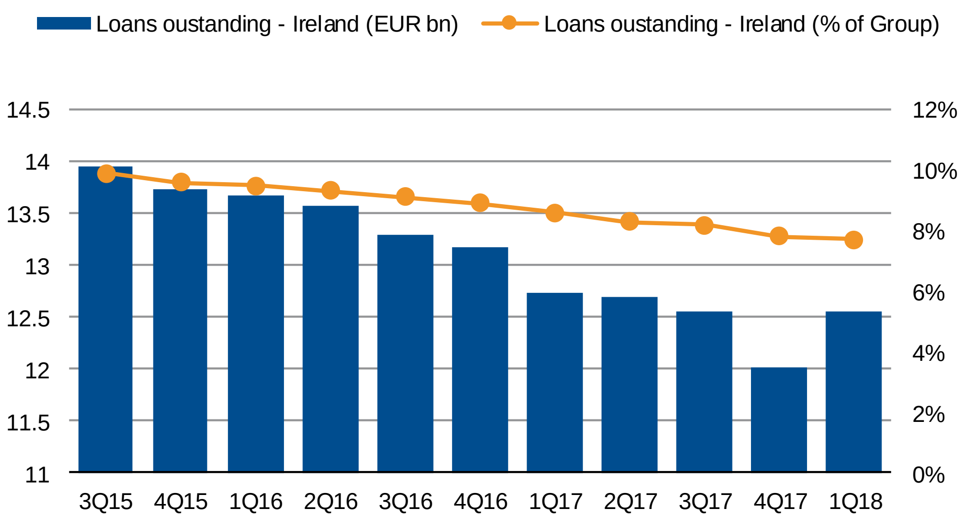
KBC opted to remain in Ireland when many continental European banks pulled out in the aftermath of the financial crisis; albeit with a substantial re-shaping of its business.

Given Ireland's difficult economic environment in the years immediately after the peak of the global financial crisis, KBC Group management refrained from framing a new strategic direction for its Irish operations. In 2014, however, the group indicated a timeline and targets for a return to profitability. The transformation from a digitally led mortgage bank to a fully-fledged retail franchise has involved expanding products and offers to retail and later to micro SME customers mostly via digital channels, while scaling back SME and corporate loans. In contrast to most other markets where KBC is present, and taking into account the specifics of the Irish market, insurance products are currently offered via local intermediaries.

KBC announced that Ireland would become one of the group's core markets in its 2016 results presentation. At the time Scope published a report highlighting how recovery in the region could support KBC's asset quality and cost-of-risk metrics. A year later, this has been borne out: the bank has made progress in NPL reduction via internal workout, and recorded releases in provisions.

However, remaining non-performing loans level coupled with the increased regulatory focus on resolution of legacy issues might warrant more decisive action from management.

**Figure 1: KBC lending in Ireland**




Source: KBC Group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**Related Research**

KBC Group NV:
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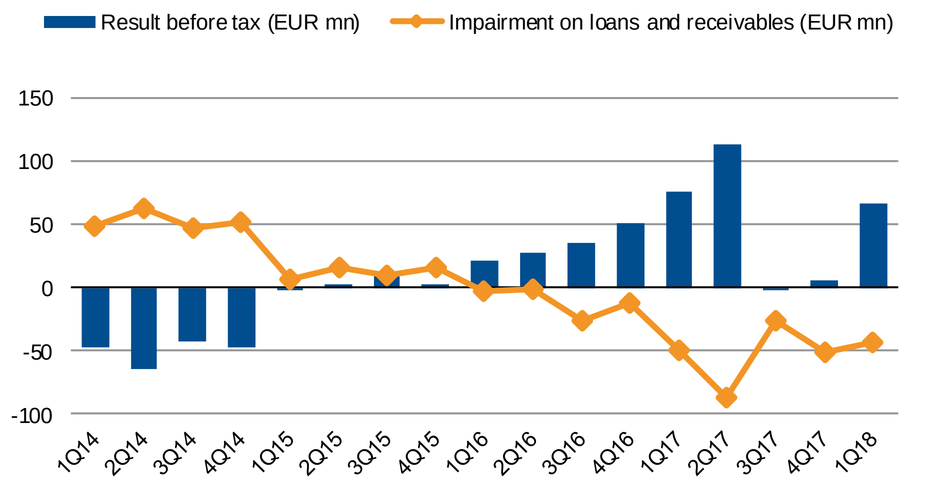
**Figure 2: KBC Ireland sub-segment results**




Source: KBC Group

**Retail-centered, omni-channel approach**

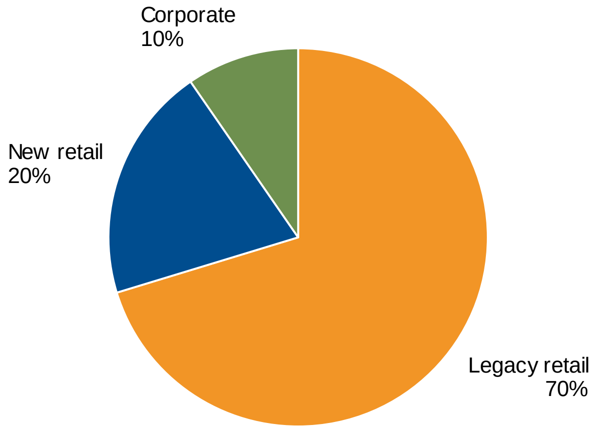
Of various core KBC geographies, Ireland is the fastest grower, with real GDP growth of 7.8% in 2017, a 5.7% outlook for 2018 (according to the EU Commission Spring 2018 forecast) and 4.1% in 2019.

KBC is positioning itself in Ireland as a digital challenger bank, designing products and services specifically for digital channels and acting as an incubator for innovation within the Group. KBC Group has earmarked a EUR 1.5bn investment to improve its digital capabilities.

Of the main factors shaping KBC's strategy in Ireland, we regard the combination of demographic factors (high proportion of young educated individuals), and strong mobile banking penetration as pivotal to its success in the retail market. Today, KBC has just 16 hubs complemented by pop-up points, with phone and chat assistance for new and existing clients available 24/7.

As of YE2017 the bank had an 8% market share in loans and deposits, while targeting 10% in Retail and Micro SMEs. Since Q3 2017 KBC has reported the retail portfolio separately for old and new (originated from 2014) loans: as of Q1 2018 new retail represents ca. 22% of the total retail outstanding and displays extremely good credit quality. In Q1 KBC Bank Ireland (KBCI) added 20,000 customer accounts, increased new mortgage lending by 61% YoY and launched its offer for micro SMEs (focusing on small or single-name practices.

**Figure 3: Outstanding breakdown, Q1 2018 (EUR 12.5bn)**




Source: KBC Group

**Legacy issues still taking a toll**

On 10th July, KBCI CEO Wim Verbraeken appeared in front of the Irish Joint Committee on Finance, Public Expenditure and Reform to discuss recent matters involving the lender and the banking industry as a whole, including the tracker mortgage issue and the strategy for reducing non-performing loans.

**Industry-wide review of tracker mortgage accounts**

The examination of tracker mortgages, initiated by the Central Bank of Ireland in December 2015, involved 11 lenders in the country and led KBCI to identify 2,974 affected customers (relating to loans originated before 2009). The bank processed redress and compensation payments for 98% of affected customers, recording EUR 4m of provisions in 2016, EUR 116m in 2017 and expects to exhaust compensation to all affected clients this year. An Administrative Sanctions Procedure brought forward by the Central Bank of Ireland is at an initial stage.

**Asset quality metrics improving**

KBC's models assign a rating class (PD) from 1 to 9 to performing loans, and 10 to 12 to impaired loans, corresponding to the European Banking Authority NPL definition.

In absolute values, KBCI NPLs (PD 10-12) almost halved between YE2014 and Q1 2018 although they still represent 36.6% of outstanding loans; higher than Irish peers.

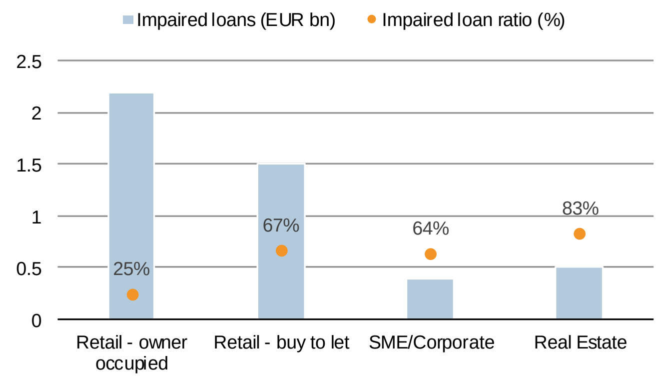
**In the retail segment more convincingly…**

For retail mortgages, the trend significantly differs between owner-occupied dwellings and buy-to-let (BTL) mortgages. In the former, the NPL ratio significantly declined (from 41% in Q3 2014 to 25% in Q1 2018) while coverage levels remained stable. For BTL mortgages, the NPL ratio declined by four percentage points over the same period, while coverage went from one-third to almost half of impaired loans. For retail as a whole, the asset-quality improvement is visible, with a higher proportion of loans curing than turning non-performing. And while the last stage of performance (PD 9) only represents 6% of total outstandings, 84% are under forbearance measures reflecting the bank's willingness to grant relief measures to avoid positions turning sour.

**… than in the corporate one**

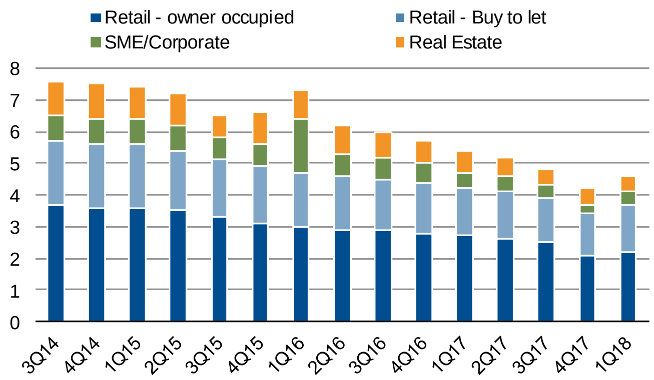
The situation for the corporate portfolio seems to be improving more slowly. As the overall portfolio is being run down and no new business is being written, asset quality doesn't benefit from a dilution effect. As a result, the NPL ratio has been relatively stable at around 64% in recent years, while coverage slightly increased to 64% in Q1 2018 (from 49% in Q3 2014).

**Figure 4: Impaired loans stock and ratio, Q1 2018**




Source: KBC Group disclosure

**Figure 5: Impaired loans (PD 10-12) development, EUR bn**




Source: KBC Group disclosure

**Internal workout the preferred strategy – so far**

The bank has been working out its NPL portfolio, constantly updating regulators and the committee referenced above on progress made. So far KBCI has generally refrained from outright sale of portfolios; residual retail mortgage balances on properties already sold the exception. Nor did the bank transfer loans to the National Asset Management Agency (NAMA), set up by the Irish Government in 2009.

During the hearing, one of the main concerns of the committee, being a political organ, was getting reassurance that KBCI would be fair in the treatment of borrowers in arrears while steering its NPLs reduction strategy.

**Although the situation might change**

The bank's management, while denying the presence of a specific NPL target for KBCI, referred to ECB guidance on reduction and its applicability at the Group level. For reference, KBC reported a 5.9% NPL ratio at the Group level in Q1 2018.

We believe that increased pressure from regulators to provision for and effectively tackle problem loans, albeit not comparable to other Irish institutions directly supervised by the ECB, might warrant KBCI's management reconsidering its stance with respect to NPLs sales.

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