KBC Group NV
Ireland as a New Core Market

Along with the release of 2016 results, KBC announced that Ireland would become one of the group's core markets, along with Belgium, the Czech Republic, Bulgaria, Slovakia and Hungary. The move is in line with the strategy that management detailed in June 2014 at its investor day. KBC has an established track record in Ireland which should help the group manage potential challenges. We would also expect KBC to prudently grow its operations in Ireland.

KBC Group NV's long-and short-term ratings are A+ and S-1, respectively, both with Stable Outlook.

Solid capital position provides flexibility to pursue growth opportunities

For FY2016, KBC reported a net profit attributable to equity holders of EUR 2.4bn, generating a ROE of 18% and with strong results across all business units. The group's fully loaded CET1 capital ratio under the Danish Compromise stood at 15.8%, well in excess of the SREP requirement for 2017 of 8.7% as well as the expected requirement for 2019 of 10.4%. Even with the addition of a 1% Pillar 2 guidance, KBC's capital position remains comfortably above the levels expected by regulators.

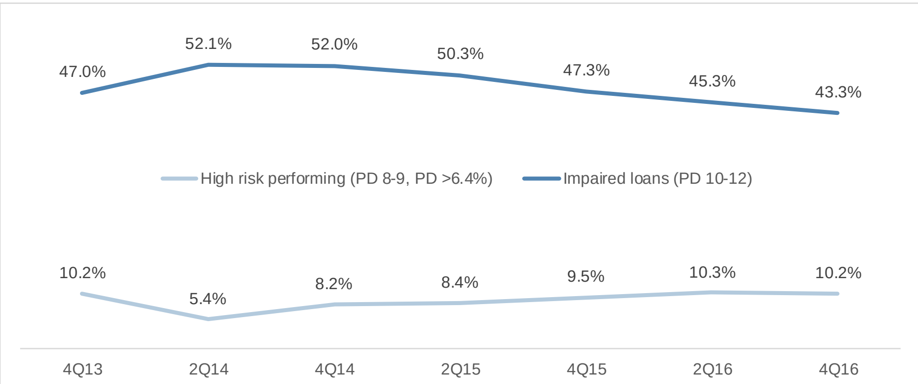
Consequently, the group has flexibility to pursue growth opportunities. Management has said that available excess capital may be used for dividends, to address regulatory uncertainties and/or invest in the business – through organic growth and potential small add-on acquisitions which strengthen the group's position in core markets. In December 2016, KBC agreed to acquire United Bulgarian Bank and Interlease, creating the largest bank-insurance group and the third largest banking group in Bulgaria. The cost will be EUR 610m, to be paid with available funds and will have a limited impact of 54bps on the group's CET1 capital ratio.

Operations in Ireland returned to profitability in 2015

KBC has been active in Ireland since 1978 when it acquired Irish Intercontinental Bank (became KBC Bank Ireland in 2008). The operations were loss making from 2010 to 2014, suffering as others did from the real estate market correction and the subsequent economic recession. In 2015, KBC Bank Ireland (KBCI) returned to profitability, generating a net profit of EUR 13m followed by a net profit of EUR 184m in 2016.

The primary driver of losses was high impairments but the bank's asset quality has materially improved, with both impaired loans and credit costs declining (Figure 1). In 2016, KBCI benefitted from impairment releases and management has guided to further impairment releases in the range of EUR 25-75m for 2017.

Figure 1: Improving asset quality



Note: Impaired loans follows EBA definition (90 days past due and/or unlikely to pay irrespective of collateral).
Source: Company data, Scope Ratings

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Aim is to be "digital-first customer centric bank"

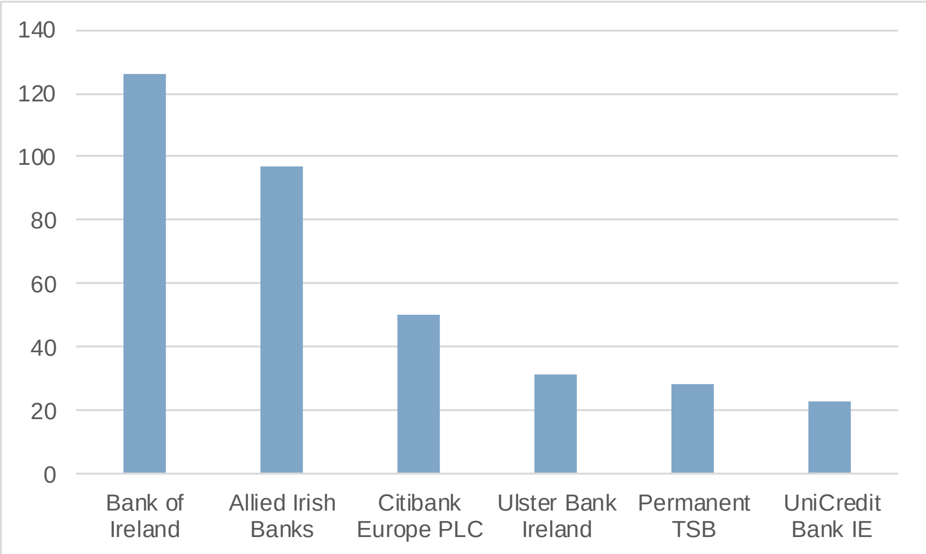
Over the past few years, management has also been transforming the business model of KBCI from a mortgage and corporate lender to a fully-fledged retail bank. The retail product offering has been expanded while corporate and SME business has declined. Another major initiative has been to decrease funding costs by increasing the deposit base. As of end-2016, deposits were EUR 5bn while the loan portfolio was EUR 13.1bn (of which nearly 70% were owner-occupied mortgages and another 18% were buy-to-let mortgages).

Management has stated that KBCI will aim to achieve at least a 10% market share in the retail and micro SME segments. As well, the group will develop KBCI into a bank-insurance player like in other core markets. For the "foreseeable future", insurance products will continue to be offered through partnerships and collaborations. Management considers KBCI to be a "digital challenger bank"; KBCI has less than 20 branches.

Irish banking market on solid recovery path

Since the crisis, the banking system has significantly contracted and is now more concentrated. In November 2016, the Central Bank of Ireland identified six institutions as being systemically important and assigned buffer rates ranging from 0.25% to 1.5% to them. The three largest domestic institutions which are still state-owned to some degree are amongst them as well as three foreign-owned institutions.

Figure 2: Irish systemically important institutions (by total assets, EUR bn)



Note: Data as of 30 June 2016 except for Ulster Bank Ireland which is as of end-2015.
Source: Central Bank of Ireland, SNL

Areas of risk remain: highly leveraged households and smaller domestic firms

The IMF's July 2016 assessment of financial stability in Ireland highlighted the following risks:

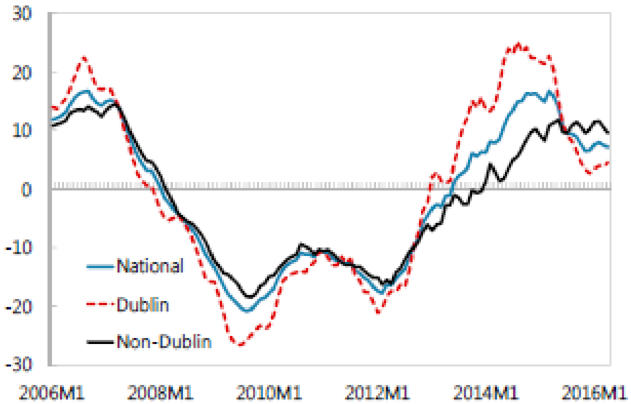
- In recent years, real estate prices in Ireland have rapidly increased (Figure 3). This raises concerns about possible overvaluation and a build-up of new imbalances. Positively, the Central Bank has introduced mortgage measures since February 2015 such as loan to value and loan to income limits. Further refinements were made to these measures in November 2016.

- Households have deleveraged but continue to be burdened with mortgage debt (Figure 4). In its H2 2016 Household Credit Market Report, the Central Bank also concluded that debt sustainability continues to improve with both debt-to-income and debt-to-asset levels decreasing. However, the indebtedness of Irish households remains high in a European context.

  The stock of mortgages in arrears (more than 90 days past due) is still material at 14% although it has declined from a peak of nearly 20% in 3Q 2013. Further, with the prevalence of variable rate mortgage loans, an economic slowdown, higher lending rates, or a reversal of the recovery in real estate prices could lead to more provisioning and write-offs.

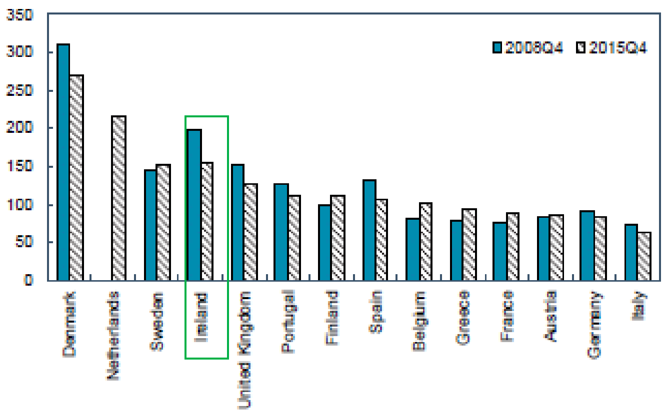
- In the corporate sector, "vulnerabilities have moderated in recent years" with the interest coverage ratio (ICR) and the share of higher risk debt (the share of debt owned by firms with an ICR below one) returning to pre-crisis levels. However, smaller firms remain vulnerable. Small firms account for the majority of firms that are considered to be in technical default, with an ICR below one. Furthermore, the share of debt owned by firms with an ICR below one among small domestic firms comprised nearly half of their total debt, well above the respective shares among medium-sized and large enterprises.

Figure 3: House price growth rates (%)



Note: Year on year, nominal
Source: IMF

Figure 4: Household debt % gross disposable income



Source: IMF

Brexit may bring challenges as well as opportunities

Over the last few years, the Irish economy has strongly recovered and the prospects for future growth remain promising. There is a strengthening trend in the domestic economy, supported by investment and retail spending. Unemployment has dropped to a level of 7.2% in December 2016, below the EU average of 8.3%. The budget deficit has also decreased more quickly than expected.

Given the close economic and trade linkages with the UK as well as the very open and export-oriented Irish economy, Brexit could have serious implications. Trade with the UK accounts for a third of Irish GDP and there would be knock-on effects from a potential slowdown in UK growth. On the other hand, companies which currently use the UK as a base for their European operations could move to Ireland, supporting the economy.

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