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KBC Bank Ireland PLC

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KBC Bank Ireland PLC

SACP	bb-

\+

Support	+3

\+

Additional Factors	0

Anchor	bb	
Business Position	Moderate	-1
Capital and Earnings	Moderate	0
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Adequate	

GRE Support	0
Group Support	+3
Sovereign Support	0

Issuer Credit Rating
BBB-/Negative/A-3

Major Rating Factors

Strengths:	Weaknesses:
• 100% ownership by KBC Bank N.V. • Funding stability and liquidity underpinned by access to parental funding. • Relatively efficient operating model.	• Unlikely to move into profit until 2016 due to sustained weak asset quality. • Modest market position and geographic diversification. • Moderate capitalization, under our risk-adjusted capital methodology.

Outlook

Standard & Poor's Ratings Services' negative outlook on KBC Bank Ireland PLC (KBCI) principally reflects our view that while its regulatory Tier 1 capital ratio will likely remain robust, we see meaningful uncertainty around the 5.0%-5.5% range that we project for the bank's risk-adjusted capital (RAC) ratio. In addition, while we view KBCI's strategy as logical, we consider the success of management's attempt to reposition the KBCI franchise as unproven, for now.

We would expect to lower the ratings if KBCI's stand-alone credit profile (SACP) were to deteriorate. This would most likely happen if, following the expected capital injection in fourth-quarter 2013, KBCI's RAC ratio was below 5% or we believed that it would not remain above this level on an ongoing basis. We would reflect this in a lowering of our capital and earnings assessment to "weak" from "moderate."

We may also lower the ratings if we consider that management is unlikely to develop KBCI into a retail-focused bank that is able to generate solid and sustainable earnings, once impairments reduce and the economic environment improves. It could also result if we observe that the links between KBCI and KBC are weakening, even allowing for our expectation of continued support. This could lead us to revise our group status assessment for KBCI to "moderately strategic." Assuming no change in the SACP, the group status revision would lead us to lower the counterparty credit ratings by two notches. This is because a "moderately strategic" group status only allows for one notch of group support, compared with the current three notches.

We could revise the outlook back to stable if we consider it highly likely that KBCI will maintain a RAC ratio comfortably in excess of 5.0%. This revision would also need to be supported by strong indications that the bank will return to profitability in 2016, as we expect, and signs that the strategic repositioning is working successfully.

Rationale

The starting point for our ratings on KBCI is its 'bb' anchor, which is based on our view of the banking system in Ireland. We consider KBCI's business position to be "moderate" (as defined by our criteria) as we consider that it lacks the franchise and diversity of larger Irish peers. We view capital and earnings as "moderate" since we expect that the bank will likely maintain a RAC ratio above 5.0%, with capitalization aided where needed by the parent. Our assessment of KBCI's risk position is "adequate", reflecting geographical concentration on a par with relevant peers, and loss experience that, while heavy in the current environment, in our view is not indicative of materially better or worse like-for-like underwriting than peers. We view funding as "average" and liquidity as "adequate" due to support from KBC which has enabled KBCI to deal with any refinancing risk despite the relatively limited nature of its own deposit-taking franchise.

Table 1

KBC Bank Ireland PLC Key Figures					
	--Year-ended Dec. 31--				
(Mil. €)	**2012**	**2011**	**2010**	**2009**	**2008**
Adjusted assets	17,195	18,589	18,146	19,560	21,107
Customer loans (gross)	16,046	16,929	17,503	18,215	18,821
Adjusted common equity	500	842	836	1,105	1,012
Operating revenues	273	284	371	334	226
Noninterest expenses	75	67	49	58	65
Core earnings	(306)	(269)	(177)	92	94

Anchor:

The 'bb' anchor draws on our BICRA methodology and our view of the economic and industry risk in the Republic of Ireland (BBB+/Positive/A-2), where KBCI almost exclusively operates. We view Ireland's economic risk as high. Businesses, households, and government finances were all hit hard by the fallout from the collapse in property collateral values and the severe difficulties in the banking system. Although this was most apparent three to five years ago, and the Irish economy has since started to recover from its deep contraction, we still believe that the Irish banking system continues to suffer as a result of these events. In our view, Ireland's industry risk is also high. Most Irish banks remain loss-making, none has re-established full access to wholesale funding markets, and some continue to rely on funding support from the European Central Bank. Moreover, in our view the widespread remedial changes that the Irish government has made since 2009 to its institutional framework, while substantial, are far from complete.

Business position:Profitability would validate the repositioned business model

Table 2

KBC Bank Ireland PLC Business Position					
	--Year-ended Dec. 31--				
(%)	**2012**	**2011**	**2010**	**2009**	**2008**
Total revenues from business line (currency in millions)	273	284	371	334	226
Commercial & retail banking/total revenues from business line	93.0	95.7	92.8	N.A.	N.A.
Trading and sales income/total revenues from business line	5.0	4.0	7.1	N.A.	N.A.
Other revenues/total revenues from business line	2.0	0.3	0.1	N.A.	N.A.
Return on equity	(45.4)	(34.1)	(19.6)	9.3	9.7

N.A.--Not available.

We view KBCI's business position as "moderate" in comparison with larger and more diverse peers in Ireland such as Bank of Ireland (BOI) and Allied Irish Banks PLC (AIB).

KBCI has its roots in commercial banking but from the late 1980s increasingly diversified into residential mortgage lending, resulting in it having a broader spread of revenues than would typically be the case for a relatively small lender. The absence of a branch network and substantial use of parental funding significantly aid speed to market and efficiency, but in our view contribute to the "KBC" brand being less deeply ingrained in the Irish market than the leading bank brands.

While the bank has deleveraged across both sides of the business in the past several years, aided by financial support from its parent, KBC, the business has been relatively stable in our view. Over the past 18 months, KBCI has moved into its next phase: to position the franchise and operational capabilities for broad-based growth in retail banking once the environment becomes more supportive. Having focused investment on deposit gathering, management is now widening the product set and investing in distribution and brand enhancement.

We view this strategy as logical, but somewhat unproven, for now. We expect that KBCI will make progress in this repositioning initiative, in a system that remains competitive but which has consolidated substantially since 2008. However, it requires upfront investment, and an environment characterized by very low interest rates and low customer activity constrains prospects for revenue growth. We therefore expect this phase of development to weaken the bank's efficiency in the coming year (and therefore its loss-absorption capacity).

Capital and earnings: Parent remains supportive while KBCI is loss-making

Table 3

KBC Bank Ireland PLC Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	**2012**	**2011**	**2010**	**2009**	**2008**
Tier 1 capital ratio	11.1	11.0	10.3	9.3	9.2
S&P RAC ratio before diversification	4.3	5.1	8.0	9.3	N.A.
S&P RAC ratio after diversification*	3.6	4.3	6.9	7.9	N.A.

Table 3

KBC Bank Ireland PLC Capital And Earnings (cont.)					
Adjusted common equity/total adjusted capital	75.2	100.0	100.0	100.0	100.0
Net interest income/operating revenues	104.2	106.9	104.7	105.6	86.6
Fee income/operating revenues	(0.7)	0.3	1.1	2.6	4.7
Market-sensitive income/operating revenues	(3.5)	(7.5)	(7.1)	(10.8)	3.9
Noninterest expenses/operating revenues	27.6	23.5	13.3	17.2	28.9
Preprovision operating income/average assets	1.1	1.2	1.7	1.4	0.7
Core earnings/average managed assets	(1.7)	(1.5)	(0.9)	0.5	0.4

* For KBCI this is an add on for concentration N.A. -- Not available.

We view KBCI's capital and earnings as "moderate". Like domestic peers who are similarly exposed to residential mortgages and commercial real estate (CRE), KBCI has been loss-making since 2010 due to high loan impairment charges. These losses have been offset by regular capital injections from the parent, offering a degree of stability to capitalization. KBCI's Tier 1 ratio at September 2013 was a reported 12.5%, unchanged from end-June. We expect that it will remain close to this level for the foreseeable future, and that the RAC ratio will operate in the 5.0-5.5% range.

Table 4

KBC Bank Ireland PLC RACF [Risk-Adjusted Capital Framework] Data					
(€ 000s)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**Standard & Poor's RWA**	**Average Standard & Poor's RW (%)**
Credit risk					
Government and central banks	4,539,138	362,487	8	214,538	5
Institutions	2,247,343	188,049	8	353,125	16
Corporate	3,746,439	2,094,727	56	6,138,161	164
Retail	12,551,078	4,888,636	39	7,909,921	63
Of which mortgage	12,551,078	4,888,636	39	7,909,921	63
Securitization§	0	0	0	0	0
Other assets	102,163	102,163	100	217,825	213
Total credit risk	23,186,161	7,636,062	33	14,833,570	64
Market risk					
Equity in the banking book†	0	0	0	0	0
Trading book market risk		163		244	
Total market risk	--	163	--	244	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	521,175	--	610,067	--
(€ 000s)		Basel II RWA		Standard & Poor's RWA	% of Standard & Poor's RWA
Diversification adjustments					
RWA before diversification		8,157,399		15,443,881	100
Total Diversification/Concentration Adjustments				3,156,821	20

Table 4

KBC Bank Ireland PLC RACF [Risk-Adjusted Capital Framework] Data (cont.)				
RWA after diversification	8,157,399		18,600,702	120
(€ 000s)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	911,685	11.2	664,757	4.3
Capital ratio after adjustments‡	911,685	11.1	664,757	3.6

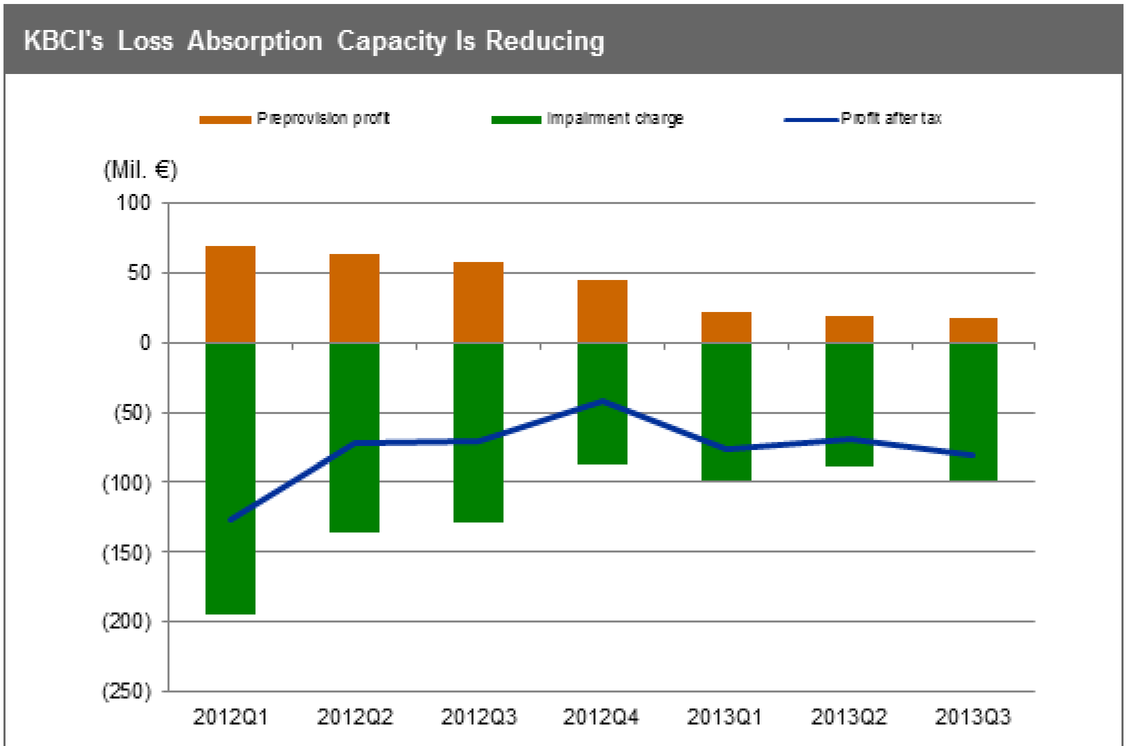
*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2012, Standard & Poor's.

On Nov. 14, 2013, KBC Group reported that KBCI made a post-tax loss of €80 million (on their internal management view basis) in the third quarter of 2013, after registering a €98 million impairment charge. This brings the post-tax loss to €226 million for the first nine months of 2013. In our view, this third-quarter result reflects that KBCI is making gradual progress in paring back losses, although this process has been uneven.

However, KBC group also announced that it expects KBCI to record a high impairment charge of up to €775 million in the fourth quarter related to restructured mortgage and corporate loans. We see this outsize charge as indicative of a need to recognize additional embedded losses in the loan book, rather than symptomatic of a deterioration in underlying asset quality.

While this indicates that the bank still has some way to go before it returns to profitability--something we do not expect before the end of 2014—in our view the third-quarter result reflects an ongoing, slow, and sometimes uneven trend of gradually paring back losses. However, a reduced interest margin, low customer activity, and ongoing investment continue to weigh on preprovision earnings. This has eroded the bank's previous high efficiency, its earnings buffer, and will likely slightly delay the return to profitability.

Chart 1



Source: KBC quarterly reports, S&P. Profit data reflects the KBC internal management view rather than statutory data.

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KBCI's RAC ratio was a low 4.3% at the end of June 2013, but taking into account subsequent capital actions to improve the mix of capital, we calculate a pro forma ratio of 5.2% for June. This ratio includes the "intermediate" equity content hybrid capital instruments that KBCI issued to KBC in 2012, and which now constitute one-quarter of KBCI's total adjusted capital (TAC). The large gap between the RAC ratio and the Tier 1 ratio primarily reflects a material difference in the risk-weights that we apply to credit exposures, as well as a lower tolerance for the proportion of hybrid capital instruments that can be included in the capital base, and our exclusion from TAC of deferred tax assets for tax-loss carryforwards. By contrast, regulatory Tier 1 capital includes a deduction for expected loss, but TAC does not.

We estimate that the RAC ratio will have dropped below 5% at end-September 2013. Taking into account the expected capital injection and the parent's record of support, we project that KBCI will maintain a RAC ratio in excess of 5%. However, we have some reservations. For example, there is potential volatility in the bank's defined-benefit pension scheme deficit (which we reflect in the TAC), and regulatory models and expected loss deductions may affect regulatory capital and risk-weighted assets (RWAs) but have no effect on Standard & Poor's TAC and RWA measures.

Our RAC projection takes account of management's refocusing of the bank toward retail banking and developing a base of customer deposit funding. We expect that a reduced interest margin, low customer activity, and ongoing investment will continue to weigh on preprovision earnings. We expect that the weakening of preprovision earnings will likely slightly delay the bank's return to profitability once impairments normalize. KBC expects that KBCI will return to profit in 2016, which we consider a reasonable expectation.

Risk position: Asset quality is typical of Irish peers

Table 5

KBC Bank Ireland PLC Risk Position					
	--Year-ended Dec. 31--				
(%)	**2012**	**2011**	**2010**	**2009**	**2008**
Growth in customer loans	(5.2)	(3.3)	(3.9)	(3.2)	6.3
Total diversification adjustment*/ S&P RWA before diversification	20.4	19.3	16.5	18.3	N.A.
Total managed assets/adjusted common equity (x)	34.4	22.1	21.7	17.7	20.9
New loan loss provisions/average customer loans	3.3	3.1	2.9	0.9	0.3
Net charge-offs/average customer loans	0.3	0.0	0.0	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	27.7	21.5	23.0	13.7	4.5
Loan loss reserves/gross nonperforming assets	38.7	34.1	18.6	9.4	7.9

* For KBCI this is an add on for concentration. N.A. -- Not available.

We view KBCI's risk position as "adequate" when compared with peers in systems with similar economic risk. We consider that the bank's straightforward business model aids management control and that, while it continues to underwrite new loans, the trend of gradual deleveraging will remain unchecked. The spread of retail and commercial credit exposures notionally offers some diversification, but given the pressures on the household and corporate sectors and the small size of the market we give relatively little analytical credit for this. While the RAC ratio may somewhat understate KBCI's risk exposures because higher risk buy-to-let mortgages (one quarter of the gross mortgage book) are treated as standard mortgages, we do not consider the effect to be out of line with peers.

KBCI's loan book is biased toward residential mortgages, with corporate lending (most of it real estate related) accounting for about 21% of balances. In our view, asset quality is, on average, proving to be broadly similar to most Irish peers. We consider the bank to have provisioned commercial real estate exposures in line with peers. At September 2013, provisions covered 77% of nonperforming development CRE exposures and 66% of nonperforming investment CRE exposures (see chart 2). At a reported 35%(see chart 3), provision coverage of mortgage nonperforming loans (NPLs) was slightly below some Irish peers, but we ascribe this in part to KBCI's unique use of mortgage indemnity insurance. We expect that mortgage NPL coverage will rise in the fourth quarter.

Chart 2

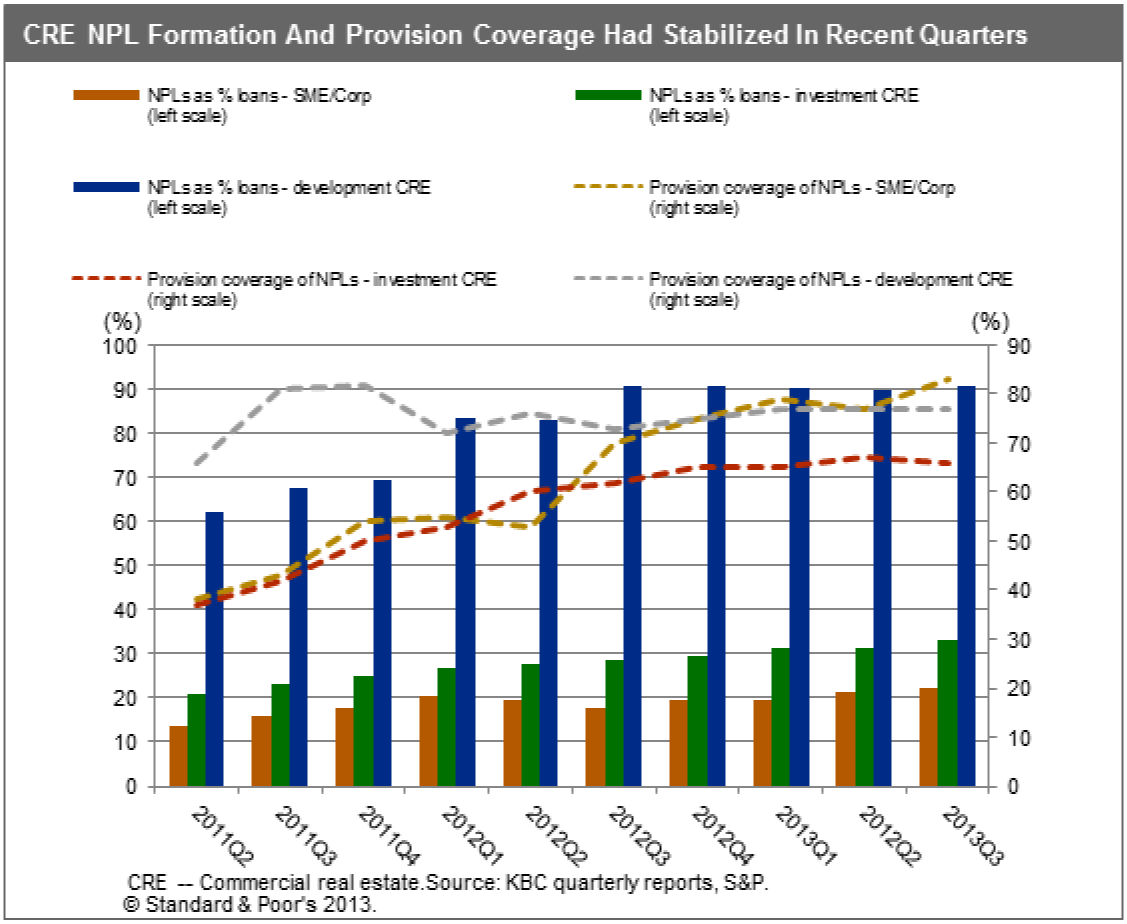
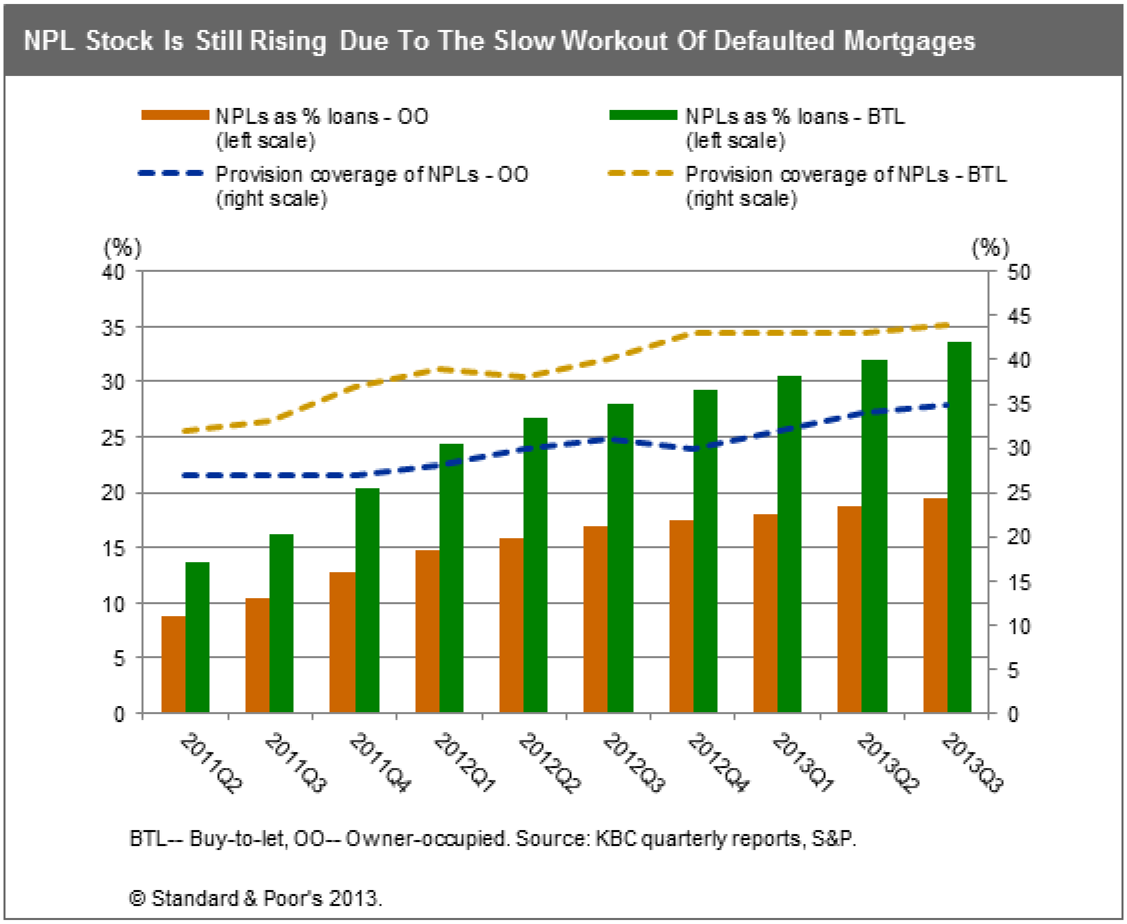

CRE NPL Formation And Provision Coverage Had Stabilized In Recent Quarters
NPLs as % loans - SME/Corp (left scale)
NPLs as % loans - investment CRE (left scale)
NPLs as % loans - development CRE (left scale)
Provision coverage of NPLs - SME/Corp (right scale)
Provision coverage of NPLs - investment CRE (right scale)
Provision coverage of NPLs - development CRE (right scale)
(%)
100
90
80
70
60
50
40
30
20
10
0
(%)
90
80
70
60
50
40
30
20
10
0
2011Q2
2011Q3
2011Q4
2012Q1
2012Q2
2012Q3
2012Q4
2013Q1
2012Q2
2013Q3
CRE -- Commercial real estate.Source: KBC quarterly reports, S&P.
© Standard & Poor's 2013.

Chart 3



NPL Stock Is Still Rising Due To The Slow Workout Of Defaulted Mortgages

BTL-- Buy-to-let, OO-- Owner-occupied. Source: KBC quarterly reports, S&P.

© Standard & Poor's 2013.

KBC stated that the reassessment of provisioning adequacy was prompted by the European Banking Authority paper on forbearance and nonperforming loans (NPLs), as well as the upcoming asset quality review in 2014. We understand that the charge is linked to the recategorization of restructured NPLs as impaired. KBC's quarterly data for KBCI suggests that underlying asset quality remains stable, with no increasing trend in the formation of NPLs. In addition, in our view collateral values are now showing some signs of stability. We therefore see the expected outsize impairment charge as indicative of a need to recognize additional embedded losses in the loan book, rather than symptomatic of a deterioration in underlying asset quality. Indeed, BOI and AIB have since announced that they expect additional impairments in the fourth-quarter, linked to the regulator's recent 'balance sheet assessment' exercise for the state-owned banks. KBC has said that it expects the impairment charge to fall to €100-€200 million in 2014, and €50-€100 million in 2015 and 2016. We consider this broadly reasonable, albeit that progress could be uneven from quarter to quarter as the bank works through its defaulted loans and either forecloses or seeks to agree arrangements with borrowers to put their debt servicing on a sustainable footing.

KBCI holds a pool of eurozone (European Economic and Monetary Union) government securities for liquidity purposes. At the end of 2012, the pool totaled €675 million nominal value, including €340 million exposure to Ireland, €35 million to Portugal, and €45 million to Italy, the remainder being to higher rated issuers. Given the relativities of our rating on KBCI to those on the above countries, and the risk weighting of these assets in our RAC ratio, we consider the associated credit risk to be a neutral factor for KBCI.

Funding and liquidity: Increased focus on deposit-gathering

KBCI's funding is "average" and its liquidity position is "adequate", in our opinion. Support from KBC has enabled KBCI to deal with any refinancing risk despite the limited nature of its own deposit-taking franchise.

KBCI's funding position remains underpinned by the role of the KBC group. Parental funding--sourced directly from Head Office and via customer deposits placed with KBC Dublin branch and on-lent to KBCI--has long accounted for the majority of the bank's funding base. Because we classify group funding as wholesale and it is largely contractually short-term in nature, KBCI's S&P stable funding ratio is relatively weak (and its liquidity ratio is similarly negatively affected). However, our overall assessment includes a qualitative overlay, where we reflect the stability of this funding.

Over the past 18 months, group-sourced funding has been generally reducing in absolute terms because KBCI is still deleveraging and because it is seeing steady growth in retail deposits. Over the 12 months to the end of September 2013, the retail deposit base grew by €1.2 billion, to €2.9 billion. We consider the development of a stronger, retail-focused deposit franchise to be supportive of the ratings. However, we give most analytical weight to franchise-based deposit bases that are granular and balanced between current and savings accounts, as they tend to be stickier in nature. While we expect the size of the customer deposit base to continue to grow, we see deposit quality as a longer-term development.

The bank's pool of eurozone government securities and ability to generate collateral from its mortgage book supports its liquidity. These provide scope for further access to contingent external sources, such as from monetary authorities. We understand that the group also remains willing to provide the bank with liquidity, should this be needed.

Table 6

KBC Bank Ireland PLC Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	**2012**	**2011**	**2010**	**2009**	**2008**
Core deposits/funding base	17.2	9.8	14.5	15.3	27.0
Customer loans (net)/customer deposits	522.6	921.8	677.9	648.9	356.7
Long term funding ratio	57.7	44.1	23.4	42.3	33.6
Stable funding ratio	62.5	48.8	26.8	N.A.	N.A.
Short-term wholesale funding/funding base	44.8	58.5	80.1	61.0	69.6
Broad liquid assets/short-term wholesale funding (x)	0.2	0.2	0.2	N.A.	N.A.
Short-term wholesale funding/total wholesale funding	52.5	64.8	93.7	72.1	95.4

N.A.--Not available.

External Support: Ratings benefit from continued KBC support

The long-term counterparty credit rating is three notches higher than the 'bb-' SACP, reflecting our view that KBCI is "strategically important" to its parent, KBC, in accordance with our group rating methodology for banks. While KBC remains highly supportive of its Irish subsidiary, we note it has publicly stated that KBCI is not a central part of its future growth strategy. KBCI would not ordinarily meet our criteria for being assessed as a "strategically important" subsidiary because we do not consider it to be important to the group's long-term strategy, and because its financial performance remains depressed by a high impairment charge and weakening preprovision earnings. However, we consider that any potential sale is highly unlikely over the two-year outlook time horizon and we understand that KBC will continue to support KBCI's capital and funding needs.

We consider KBCI to be of "low" systemic importance and we factor no government support into its ratings.

Related Criteria And Research

Related Criteria

- Group Rating Methodology, Nov. 19, 2013
- 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

Related Research

- KBC Bank Ireland Outlook Revised To Negative On Expected Fourth-Quarter Impairment Charge; 'BBB-/A-3' Ratings Affirmed, November 28, 2013
- Various Rating Actions Taken On Irish Banks Following Sovereign Review, July 16, 2013
- Banking Industry Country Risk Assessment: Ireland, July 16, 2013
- Outlook On Ireland Revised To Positive On Improved Prospects For Debt Reduction; Ratings Affirmed At 'BBB+/A-2', July 12, 2013

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	6	**7**	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	**bb**	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of December 11, 2013)	
KBC Bank Ireland PLC	
Counterparty Credit Rating	BBB-/Negative/A-3
Senior Unsecured	BBB-

Ratings Detail (As Of December 11, 2013) (cont.)	
Counterparty Credit Ratings History	
28-Nov-2013	BBB-/Negative/A-3
16-Jul-2013	BBB-/Stable/A-3
08-Dec-2011	BBB-/Negative/A-3
11-Jul-2011	BBB+/Negative/A-2
02-Feb-2011	BBB+/Watch Neg/A-2
26-Nov-2010	A-/Watch Neg/A-2
25-Aug-2010	A-/Stable/A-2
25-Jun-2009	A-/Negative/A-2
18-Mar-2009	A-/Stable/A-2
Sovereign Rating	
Ireland (Republic of)	BBB+/Positive/A-2
Related Entities	
CSOB Pojistovna a. s.	
Financial Strength Rating	
Local Currency	BBB+/Positive/--
Issuer Credit Rating	
Local Currency	BBB+/Positive/--
KBC Bank N.V.	
Issuer Credit Rating	A-/Positive/A-2
Certificate Of Deposit	A-/A-2
Junior Subordinated	BB+
Preferred Stock	BB+
Senior Unsecured	A-
Short-Term Debt	A-2
Subordinated	BBB
KBC Group N.V.	
Issuer Credit Rating	BBB+/Positive/A-2
Senior Unsecured	BBB+
KBC Group Re S.A.	
Financial Strength Rating	
Local Currency	BBB+/Positive/--
Issuer Credit Rating	
Local Currency	BBB+/Positive/--
KBC Insurance N.V.	
Financial Strength Rating	
Local Currency	A-/Positive/--
Issuer Credit Rating	
Local Currency	A-/Positive/--
K&H Bank (Unsolicited Ratings)	
Issuer Credit Rating	
Local Currency	BBpi/--/--

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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