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Ratings

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KBC Bank Ireland PLC

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KBC Bank Ireland PLC

SACP	bb	+	Support	+3	+	Additional Factors	0

Anchor	bbb	
Business Position	Weak	-2
Capital and Earnings	Strong	+1
Risk Position	Weak	-2
Funding	Average	0
Liquidity	Adequate	

ALAC Support	0
GRE Support	0
Group Support	+3
Sovereign Support	0

Issuer Credit Rating
BBB/Stable/A-2
Resolution Counterparty Rating
BBB+/--/A-2

Major Rating Factors

Strengths:	Weaknesses:
• 100% ownership by KBC Bank N.V. (KBC). • Funding stability and liquidity underpinned by access to parent. • Strong capitalization, by our measures.	• Modest market position. • Still-high stock of nonperforming loans (NPLs), even after announced portfolio sale. • Limited income diversity.

Outlook: Stable

The stable outlook over our two year horizon balances KBCI's improving financial profile with its yet-to-be-proven ability to generate stronger and more predictable statutory earnings, as it progresses with its digital strategy.

We could raise the ratings if we considered that KBCI had become more important to its parent, becoming a stronger and more material contributor to group earnings, and if we saw the development of profitable bancassurance operations that were more reflective of KBC group's overall business model. This could lead us to revise up our group status assessment. We could also raise the ratings if KBCI's own stand-alone credit characteristics improved as a result of a further significant reduction in NPLs.

We could lower the ratings if we observed KBCI having difficulties translating its digital banking efforts into earnings that were acceptable to its parent.

Rationale

As the smallest of the five main retail banks in the Irish market, we believe KBCI's business position is less competitive than peers' because it lacks the franchise and diversity of larger banks in Ireland. While we acknowledge that management is gradually developing KBCI into a full-service retail bank with a strong digital focus, we have yet to see firm evidence of improved and sustainable pre-provision earnings. The ratings are also constrained by our relatively weak assessment of KBCI's risk position, which reflects its high, albeit reducing, ratio of NPLs relative to the domestic industry average, as well as its business and geographical concentration.

The ratings are supported by KBCI's position within the KBC group. In particular, our assessment of KBCI's funding and liquidity is bolstered by the support KBC provides to KBCI, which has enabled KBCI to deal with any refinancing risk despite the modest, albeit improving, nature of its deposit-taking franchise.

Anchor: 'bbb' for a bank operating primarily in Ireland

The starting point for our ratings on KBCI is its 'bbb' anchor, which reflects our view of the economic risks in Ireland, where KBCI operates.

In our view, the economic risk trend in Ireland is stable. This reflects our assumption that Ireland's GDP growth will remain brisk, which in turn will continue to feed through to further property price appreciation and reduced unemployment--all of which should help, at least in the short term, to improve the resilience of banks' balance sheets. We assume that the era of household and corporate deleveraging is now largely over and we would need to see evidence of a substantial further reduction in NPLs before we could consider improving our assessment. Even then, ongoing house price inflation and any potential risks to Ireland from its close trading partner, the U.K., leaving the EU may also cause us to delay a stronger assessment.

The industry risk trend is also stable. We assume that our measure of deposits to loans will remain above 75% on a sustainable basis, as lending growth revives, and that regular access to wholesale markets will persist. We also assume that net interest margin (NIM) pressure will not emerge sufficiently to weigh on statutory earnings. Banks will likely continue to invest in their operations and digital capability. Finally, we also assume that the longstanding government stakes in a large part of the banking system will only reduce to zero during the 2020s.

Table 1

KBC Bank Ireland Key Figures

	--Year ended Dec. 31--				
(Mil. €)	**2017**	**2016**	**2015**	**2014**	**2013**
Adjusted assets	13,267.1	13,128.4	13,443.7	13,681.0	14,628.3
Customer loans (gross)	12,232.0	13,249.3	14,088.4	14,647.8	15,234.1
Adjusted common equity	981.3	954.6	750.0	502.6	528.9
Operating revenues	292.7	287.3	268.4	242.7	260.9
Noninterest expenses	188.7	146.7	149.0	136.0	102.0
Core earnings	290.7	227.8	74.8	(81.2)	(863.7)

Business position: KBCI's small size and domestic concentration weighs on its assessment, despite its repositioning initiative

We recently revised our assessment to weak from moderate, following an improvement in our view of Irish industry risk, which informs our peer analysis. This revision does not reflect a fundamental deterioration in our view of KBCI, rather it shows its positioning relative to peers that operate in countries with a '4' industry risk score.

Our assessment is based on KBCI's lack of business diversity and franchise depth relative to the two "pillar" banks in Ireland: AIB Group PLC, and Bank of Ireland Group PLC. We also consider that its small size (€13.3 billion in assets at Dec. 31, 2017) and concentration in Ireland makes it more vulnerable to any shock in the economy.

Other rated peers active in the Irish banking industry include Permanent TSB Group Holdings PLC (UGCP 'bb+') and foreign-owned Ulster Bank Ireland DAC (SACP 'bbb-'). Peers outside Ireland include Spanish banks Cecabank (SACP 'bbb'), Caja Laboral (SACP 'bbb-)' and Abanca (SACP 'bb+'), and Portuguese bank Banco BPI (SACP 'bb-'). These banks are somewhat similar in size and operate in systems with fairly similar industry risks as Ireland.

In our view, KBCI's lack of business diversity is evident from its high reliance on net interest income, which we estimate will average 98% of revenues over the three years to 2019 (compared to 75% for AIB, BOI, and Ulster). Loan book diversity is also reducing as KBCI is now focusing on retail banking while continuing to deleverage its corporate loan book. As of Sept. 30. 2018, corporate loans were €1.1 billion (€1.8 billion at year-end 2016). We expect to see a further year-end 2018 decrease as KBCI factors in the sale of a nonperforming corporate loan book to Goldman Sachs.

KBCI has repositioned its franchise and its operational capabilities for broad-based growth in retail banking. The bank is undergoing a digital transformation and is extending its physical reach by opening a number of hubs in city centers in Ireland. This strategy reflects KBC's commitment to Ireland and its position as a "Digital First" retail bank. The results of these initiatives appear to have been positive yet it is still a work-in-progress. Furthermore, KBCI has continued to introduce options to attract new customers and facilitate switching to grow its retail loan book. New mortgage lending in the first nine months of 2018 was €622 million, a 1% increase on the same period last year.

We expect KBCI will continue building on the progress it has made in its repositioning initiative in a banking system that is becoming more competitive as banks rebuild their financial health and loan demand recovers. However, the initiative is needing significant upfront investment while prospects for material volume and recurring revenue growth remain somewhat constrained by the low-interest environment and competitive pressures. In 2017, the cost-to-income ratio was about 65% and we foresee limited improvements over our two-year outlook period.

Capital and earnings: Risk-adjusted capital ratio comfortably in the strong category

We view KBCI's capital and earnings as strong based on our expectations that its risk-adjusted capital (RAC) ratio will be around 14.5%-15.0%, as progress is made on NPL reductions. However, we doubt that the 15% threshold will be exceeded owing to the modest internal capital generation and the dividend policy.

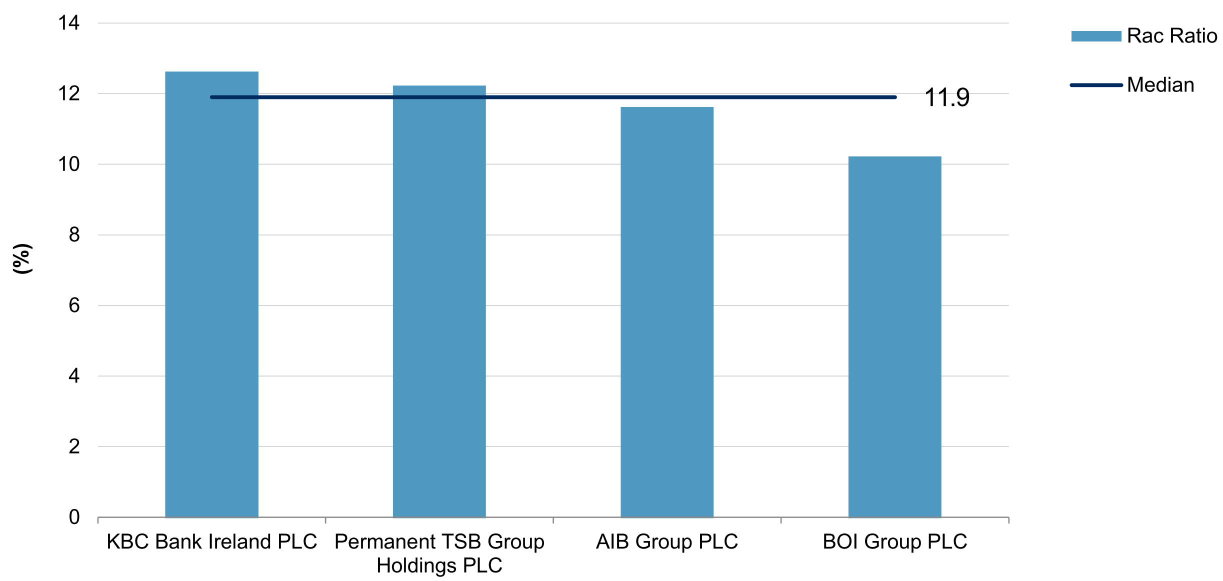
KBCI's RAC ratio improved to 12.6% at year-end 2017 from 10.7% at year-end 2016, as commercial loans, which carry a higher risk weight, continued to be deleveraged. Although the bank reported a stronger post-tax profit, improvements in its level of capital were constrained by its 100% dividend payout ratio for 2017. The bank reported a regulatory fully loaded Common Equity Tier 1 (CET1) of 14.4% as of June 30, 2018.

Like domestic peers who are exposed to residential mortgages and commercial real estate, KBCI was loss-making between 2010 and 2014 due to high loan impairment charges. However, these charges subsequently reversed, which has helped a recovery in earnings.

The bank continued to report post-tax profit as of September 2018, of €144 million, albeit down from €165 million in the same period in 2017. Earnings were supported by an improving NIM as a result of lower funding costs, but reported impairment provision releases were significantly reduced.

Chart 1

KBC Bank Of Ireland PLC And National Peers' S&P Global Ratings Risk-Adjusted Capital Ratio
As of year-end 2017



Source: S&P Global Ratings. Data excludes Ulster Bank Ireland DAC (RAC of 33%)

We base our RAC projection on the following assumptions:

- Gross customer loans will continue to decline until 2019. This is because of KBCI's stated strategy to focus on reducing its corporate loans and NPLs, while increasing its focus on new mortgage and consumer lending. In 2018, we expect gross loans to fall by around 15% due to the sale of €1.9 billion of performing and nonperforming loans.
- As a result of the above, we expect S&P Global Ratings RWA to reduce in 2018-2019.
- The trend release of credit provisions will continue albeit with lower provision releases. The provision release was €215 million for 2017 and we assume that it will be around €300 million in total through 2018-2020.
- Competitive pressure means that we expect NIM to reduce.

- We have incorporated the negative impact of International Financial Reporting Standard (IFRS) 9 on total adjusted capital (TAC) of €57 million.
- We expect KBCI will continue to pay out 100% of its earnings as a dividend to its parent.

Our assessment of capital and earnings also looks beyond the capital analysis and considers the quality and capacity of earnings. We project KBCI's earnings buffer--which measures the capacity of earnings to cover normalized losses through the credit cycle--to be around 32 basis points (bps) in our forecast period, which is lower than some peers. We do see the quality of earnings as solid given that adjusted common equity to total adjusted capital was 100% at year-end 2017. We also consider KBCI's earnings profile should become more predictable than before.

Table 2

KBC Bank Ireland--Capital and Earnings

	--Year ended Dec. 31--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Tier 1 capital ratio	14.3	13.4	13.3	12.7	12.2
S&P Global Ratings' RAC ratio before diversification	12.6	8.8	8.9	5.6	4.9
S&P Global Ratings' RAC ratio after diversification	9.1	6.3	7.2	4.6	4.0
Adjusted common equity/total adjusted capital	100.0	100.0	75.2	75.2	75.2
Net interest income/operating revenues	98.3	97.3	102.7	105.8	108.0
Fee income/operating revenues	(0.3)	(0.2)	(1.2)	(1.1)	(1.6)
Market-sensitive income/operating revenues	1.9	2.9	(1.5)	(4.8)	(6.4)
Noninterest expenses/operating revenues	64.5	51.0	55.5	56.0	39.1
Preprovision operating income/average assets	0.8	1.1	0.9	0.8	1.0
Core earnings/average managed assets	2.2	1.7	0.6	(0.6)	(5.4)

Table 3

KBC Bank Ireland PLC RACF [Risk-Adjusted Capital Framework] Data

	Exposure*	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global RWA**	**Average S&P Global RW (%)**
Credit risk					
Government and central banks	1,632,166,540	337,990,237	21	102,531,432	6
Of which regional governments and local authorities	32,100,991	35,892,386	112	1,926,059	6
Institutions and CCPs	2,352,617,379	209,537,265	9	145,955,117	6
Corporate	1,387,436,074	653,465,550	47	1,611,503,956	116
Retail	11,454,371,743	5,233,832,940	46	5,400,150,064	47
Of which mortgage	11,405,584,332	5,198,505,738	46	5,343,992,713	47
Securitization§	0	0	0	0	0
Other assets†	52,069,932	46,557,023	89	85,288,415	164
Total credit risk	16,910,762,660	6,481,383,016	38	7,345,428,984	43
Credit valuation adjustment					
Total credit valuation adjustment	--	2,094,057	--	0	--

Table 3

KBC Bank Ireland PLC RACF [Risk-Adjusted Capital Framework] Data (cont.)

Market risk					
Equity in the banking book	0	0	0	0	0
Trading book market risk	--	0	--	0	--
Total market risk	--	0	--	0	--
Operational risk					
Total operational risk	--	367,246,841	--	468,562,507	--

	Basel III RWA		S&P Global RWA	% of S&P Global RWA
Diversification adjustments				
RWA before diversification	6,854,861,147		7,813,991,491	100
Total Diversification/Concentration Adjustments	--		3,026,857,146	39
RWA after diversification	6,854,861,147		10,840,848,636	139

	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	982,233,931	14.3	981,320,000	12.6
Capital ratio after adjustments‡	982,233,931	14.3	981,320,000	9.1

*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. ‡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, 2017, S&P Global.

Risk position: Nonperforming assets would have to further reduce significantly for us to reconsider our assessment

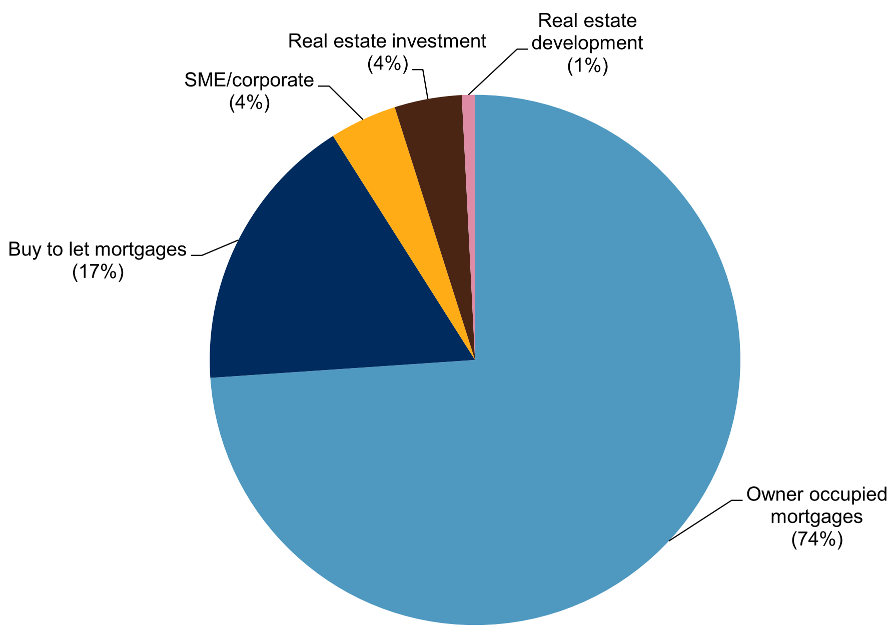
We view KBCI's risk position as weaker than peers with similar product mixes and that operate in banking systems with comparable economic risk. As of year-end 2017, our calculation of KBCI's NPL ratio (under International Accounting Standard [IAS] 39)--which includes impaired loans, loans over 90 days, and performing renegotiated loans--was 40.7%. We consider this to be high relative to the average of 20% for its domestic peers.

However, we acknowledge that KBCI has been organically reducing its legacy portfolio of NPLs over the past few years. For example, as of Sept. 30, 2018, KBCI's reported stock of impaired loans reduced by €0.7 billion, relative to year-end 2017, to €4.3 billion. In November 2018, KBCI completed the sale of a loan portfolio of approximately €1.9 billion to entities established and financed by Goldman Sachs, composed of performing and nonperforming U.K. buy-to-let mortgage loans and nonperforming corporate book and Irish buy-to-let mortgage loans. This transaction reflects a shift toward accelerating the reduction of NPLs. KCBI states that its NPL ratio on a pro forma basis will be about 25% compared with its reported ratio of 35.6% as of June 30, 2018.

As of Sept. 30, 2018, KBCI's €12.3 billion gross loan book was focused on residential mortgages (€11.2 billion or 90% of total loans), with corporate lending (most of it small and midsize enterprises and real estate-related) accounting for about 10% of balances (see chart 2). This chart does not capture the impact of the recently completed portfolio sale, which will reduce the loan book for FY2018.

Chart 2

KBC Bank Ireland PLC Gross Loans As Of September 2018 (€12.3 bil.)



Source: S&P Global Ratings.

We expect the bank will continue to gradually deleverage in the coming two years given its focus on winding down its €1.1 billion corporate book. However, we believe this will be increasingly counterbalanced by new lending in mortgages and, to a lesser extent, consumer finance.

Table 4

KBC Bank Ireland--Risk Position					
	--Year ended Dec. 31--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	(7.7)	(6.0)	(3.8)	(3.8)	(5.1)
Total diversification adjustment/S&P Global Ratings' RWA before diversification	38.7	40.4	24.4	21.4	21.0
Total managed assets/adjusted common equity (x)	13.6	13.8	18.0	27.3	27.7
New loan loss provisions/average customer loans	(1.7)	(0.3)	0.3	1.3	6.8
Net charge-offs/average customer loans	5.7	1.6	0.9	0.0	0.3
Gross nonperforming assets/customer loans + other real estate owned	40.7	49.7	52.0	54.1	50.0
Loan loss reserves/gross nonperforming assets	31.2	37.9	38.2	36.7	35.7

Funding and liquidity: Supported by the demonstrated stability of parent funding

We believe support from KBC will continue to allow KBCI to deal with any refinancing risk despite the modest nature of its own deposit-taking franchise. We expect our funding and liquidity assessment to remain at this level over our outlook horizon. At year-end 2017, core deposits as a proportion of total funding stood at about 46%, materially weaker than domestic peers.

KBCI's funding position remains underpinned by KBC. Parent funding--sourced directly from the head office and via customer deposits placed with KBC's Dublin branch and on-lent to KBCI--has long accounted for the majority of the bank's funding base. It represented 55% of total funding at year-end 2017. The S&P Global Ratings stable funding ratio of about 71% at year-end 2017, up from around 30% in 2012, remains relatively weak because we classify group funding as wholesale and it is largely short term. KBCI's 0.41x liquidity ratio, as measured by our broad liquid assets to short-term wholesale-funding ratio, is similarly negatively affected. However, our overall funding and liquidity assessment includes a qualitative overlay reflecting the demonstrated stability of parent funding.

Over the past three or four years, group-sourced funding, including deposits from KBC Dublin branch, has been generally reducing in absolute terms due to extensive deleveraging and because KBCI is increasing customer deposits. Between year-end 2015 and year-end 2017, group funding reduced by about €1.4 billion. Over the same period, customer deposits increased by 8% to €5.4 billion.

We consider the development of a stronger, retail-focused deposit franchise to be a ratings support generally. However, we give the most analytical weight to franchise-based insured deposits that are granular and balanced between current and savings accounts, as these tend to be stickier. While we expect growth of the customer deposit base to be modest, in part because of the ongoing deleveraging, we see deposit quality as a longer-term development.

We consider the bank's pool of eurozone government securities and its ability to generate collateral from its mortgage book to support its liquidity because these can provide access to secured funding, such as covered bonds, or contingent external sources such as monetary authorities. Unencumbered collateral was €4.3 billion at year-end 2017. We understand that the group also remains willing to provide liquidity to the bank if needed.

Table 5

KBC Bank Ireland--Funding and Liquidity

	--Year ended Dec. 31--				
(%)	**2017**	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	46.1	43.4	42.8	33.9	25.9
Customer loans (net)/customer deposits	198.4	215.8	219.7	278.3	357.4
Long-term funding ratio	61.7	57.4	51.7	41.8	32.6
Stable funding ratio	71.5	66.4	58.5	46.4	36.9
Short-term wholesale funding/funding base	42.5	47.5	52.8	62.2	71.9
Broad liquid assets/short-term wholesale funding (x)	0.4	0.3	0.3	0.2	0.2
Net broad liquid assets/short-term customer deposits	(56.1)	(130.9)	(100.8)	(313.1)	(264.2)
Short-term wholesale funding/total wholesale funding	78.9	83.9	88.7	91.0	94.3
Narrow liquid assets/3-month wholesale funding (x)	0.5	0.4	0.6	0.2	0.2

Support: Ratings benefit from continued strong KBC support

We apply a three-notch upward adjustment to KBCI's 'bb' stand-alone credit profile, reflecting our view that KBCI is strategically important to parent KBC. However, while KBC announced Ireland is a core market for the group and it remains highly supportive of its Irish subsidiary--including in the current phase of investment--we note that KBCI remains an underperformer in the context of the wider peer group. We do not currently consider KBCI to be integral to the group's long-term strategy. That said, we believe it is becoming increasingly important especially given that much of the group's digital investment is being channelled through KBCI. We therefore think that a potential sale is unlikely within the two-year outlook horizon--supported by KBCI's funding reliance on KBC--and we expect that KBC will continue to provide operational, capital, and funding and liquidity support to KBCI.

Related Criteria

- Criteria - Financial Institutions - General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- Banking Industry Country Risk Assessment: Ireland, Dec. 17, 2018
- Various Positive Rating Actions Taken On Irish Banks On Improving Funding Profile, Dec. 17, 2018
- KBC Group N.V., July 31, 2018

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 January 11, 2019)

KBC Bank Ireland PLC	
Issuer Credit Rating	BBB/Stable/A-2
Resolution Counterparty Rating	BBB+/--/A-2
Issuer Credit Ratings History	
17-Dec-2018	BBB/Stable/A-2
08-Nov-2017	BBB-/Positive/A-3
20-Jul-2015	BBB-/Stable/A-3
Sovereign Rating	
Ireland	A+/Stable/A-1
Related Entities	
Ceskoslovenska Obchodni Banka A.S.	
Issuer Credit Rating	A+/Stable/A-1
Resolution Counterparty Rating	AA-/--/A-1+
KBC Bank N.V.	
Issuer Credit Rating	A+/Stable/A-1
Resolution Counterparty Rating	AA-/--/A-1+
Certificate Of Deposit	A-1
Commercial Paper	
Foreign Currency	A-1
Junior Subordinated	BBB-
KBC Group N.V.	
Issuer Credit Rating	A-/Stable/A-2
Junior Subordinated	BB+
Senior Unsecured	A-
Short-Term Debt	A-2
Subordinated	BBB

Ratings Detail (As Of January 11, 2019) (cont.)	
KBC Group Re S.A.	
Financial Strength Rating	
Local Currency	A/Stable/--
Issuer Credit Rating	
Local Currency	A/Stable/--
KBC Insurance N.V.	
Financial Strength Rating	
Local Currency	A/Stable/--
Issuer Credit Rating	
Local Currency	A/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.