

# Ratings On Irish Banks Affirmed Amid Ongoing Profitability Pressure; Most Outlooks Still Negative

June 24, 2021

- Despite Ireland's anticipated economic recovery, banks' earnings and profitability remain under pressure due to modest growth opportunities, significant cost bases, high capital requirements, in particular for mortgage loans, and still low revenue diversification.
- Banks have started taking steps to widen their product offerings and diversify their revenue streams, but this has not yet had a noticeable impact on profitability.
- We therefore still see a negative industry risk trend for Ireland's banks and affirmed our ratings on three Irish banks, while maintaining our negative outlooks.
- We have revised to positive from stable our outlooks on Allied Irish Banks PLC (AIB) and its U.K.-based subsidiary AIB Group (UK) PLC due to the potential buildup of additional loss-absorbing capacity (ALAC).

## PRIMARY CREDIT ANALYSTS

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DUBLIN (S&P Global Ratings) June 24, 2021--S&P Global Ratings today affirmed its ratings on Irish banks (see Ratings List below).

**Webinar:** S&P Global Ratings will be hosting a live webinar on June 29, 2021 (9:00 a.m. EDT; 2:00 p.m. BST; 3:00 p.m. CEST) to discuss our views on European Banks. For more details, please visit:

<https://event.on24.com/wcc/r/3252634/C509A2EA04B74CFC5B846E025A448F8D?partnerref=GMR>

## Rationale

### **Profitability challenges Irish bank faced before the pandemic have not eased, in our view.**

Ireland is poised for an economic recovery. However, the flat interest rate yield curve, negative policy rates that cannot be fully passed on to depositors, a lack of business diversity, and modest growth opportunities in the relatively small domestic economy are increasingly weighing on net interest income. What's more, structural issues constraining banks' profitability persist. These include large cost bases together with continuous investment in business transformation and digital capabilities, and higher capital requirements than in other European countries for mortgage loans. The planned exit of international players like NatWest Group and KBC Group from the Irish market, announced earlier this year, underscores the tough operating environment and weak profitability prospects. Moreover, we see increasing risks for domestic banks from digital disruption, since the impact of COVID-19 has accelerated innovation and digitalization in many banking markets, including Ireland. So far, we see limited offerings from fintech companies in Ireland. However, in the longer term, potential changes in digital technologies could have a

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profound impact on intermediation between savers and investors, which could further affect our view of competitive dynamics in the banking industry.

**Cost reduction and revenue diversification are critical for Ireland's banking sector to prevent profitability erosion.** Irish banks, like their peers in many other jurisdictions, face the challenge of implementing remedies to achieve lasting efficiency gains and reverse the sluggish trend in top-line revenue. Banks' cost-to-income ratios remain stubbornly high, surpassing 70%. Irish banks' managements have shown their commitment to reducing the absolute amount of operating costs, such as staff and property expenses. However, a significant reduction is hard to achieve amid rising regulatory costs and digital transformation plans that require large investments to improve profitability. Therefore, we expect that cost discipline won't completely offset revenue pressure over the coming years. Dependence on lending activity (with mortgage loans dominating banks' loan portfolios) also limits banks' revenue generation capacity. We observe that banks are taking steps to widen their product offerings and diversify their revenue streams, but these efforts are still at an early stage, so there is as yet no noticeable impact on profitability. Irish banks' ability to deliver on their cost-cutting and returns strategy, and demonstrate top-line growth beyond the one-off improvement that could come after the exit of NatWest and KBC, would be critical to our further assessment of industry risks in Ireland.

**We estimate that the impact of credit losses and nonperforming loans (NPLs) should be manageable for Irish banks.** Irish banks entered the pandemic with healthy capitalizations and robust liquidity profiles, owing to residents' large savings. This allowed them to set aside large provisions in 2020 for future defaults, but this also led to reported losses. So far, we have not observed significant deterioration of asset quality, but we expect NPLs to rise over 2021-2022 as government support to households and businesses unwinds. However, we think last year's provisioning already provides a sufficient buffer for potential losses; therefore we project new provisions to be much lower this year and next, at between 30 basis points (bps) and 45 bps. Lower credit provisions will support profitability improvements, but not enough for returns to reach prepandemic levels. Moreover, average systemwide returns in Ireland are likely to lag those of peers.

**Systemwide funding has improved, in our view.** This is based on our estimate that core deposits (our measure includes 100% of retail deposits and 50% of corporate deposits) will cover more than 100% of systemwide domestic loans over the next several years. Moreover, access to capital markets remains good for Irish banks and they were among the first to tap the capital markets last year.

**Generally, our negative outlooks indicate that we could lower our ratings if Irish banks are unable to resolve current weaknesses in profitability.** In particular, we will look at how preprovision income evolves, apart from the potential one-off benefits from acquiring NatWest and KBC's portfolios. We overlay this broad assessment with our view on the idiosyncratic features of individual banks, reflecting other positive and negative rating pressures, their asset and funding profiles, and our view of their earnings' capacity to absorb potential setbacks and so avoid significant capital erosion.

## OUTLOOKS

## Allied Irish Banks

Primary analyst: Letizia Conversano

### AIB Group PLC

The negative outlook on AIB Group PLC (AIB) reflects our view that structural profitability issues--namely high costs and still significant dependence on net interest income--will continue to constrain AIB's earnings generation capacity over the next 18-24 months, while it implements its new business plan. This could make the bank more vulnerable to the persistent low-interest-rate environment than other more diversified and digitally advanced international peers.

**Downside scenario:** We could consider lowering our ratings on AIB over the next 18-24 months if the group were unable to reduce costs and diversify revenues, as per its new business plan, and we forecast persistently weak returns over that period.

**Upside scenario:** We could revise our outlook to stable over the next 18-24 months if we saw tangible signs that the bank is delivering on its cost-cutting, revenue-diversification, and digital transformation plans, while maintaining sound asset quality and good capital buffers.

### Allied Irish Banks PLC (operating company)

The positive outlook indicates the possibility of an upgrade over the next 18-24 months if the ALAC buffer protecting senior creditors increases sustainably beyond 8.0% of S&P Global Ratings' risk-weighted assets (RWA) through 2023, making the bank eligible for a two-notch rating uplift.

### AIB UK

The positive outlook on U.K.-incorporated AIB Group (U.K.) PLC (AIB UK) reflects that on its parent, Ireland-based Allied Irish Banks (AIB). We consider AIB UK strategically important to its parent, so we cap the ratings at one notch below our 'bbb+' group credit profile on AIB. Therefore, any positive or negative rating action on the bank will result in a similar action on AIB UK.

**Upside scenario:** We could raise our ratings on AIB UK over the next 18-24 months, following a similar action on the operating parent company. We could also consider an upgrade if we see tangible signs that AIB UK's importance within the AIB Group is increasing.

**Downside scenario:** Rating pressure could come from a material underperformance of AIB UK compared with our base-case scenario, or from a weakening of AIB UK's strategic importance within the group.

### Bank of Ireland Group (BOI Group)

Primary analyst: Anastasia Turdyeva

## **Bank of Ireland Group PLC**

The negative outlook reflects our view that structural profitability issues--such as modest growth opportunities, persistently high costs, high capital requirements, and low revenue diversification--will continue weighing on the bank's creditworthiness over the next 18-24 months, despite our expectation of an economic rebound.

**Downside scenario:** We could lower the ratings if, despite committed cost discipline and investment in digitalization, the group's returns remain weak over the next two years, with profitability metrics that are not in line with peers'.

**Upside scenario:** We could revise the outlook to stable if economic and operating conditions stabilize, while cost discipline allows the bank to sustain preprovision income.

## **Bank of Ireland**

The negative outlook on Bank of Ireland (BOI), the main operating bank, mirrors that on the BOI Group.

**Downside scenario:** We could lower the ratings on BOI if we lower the ratings on BOI Group PLC. We could also lower the ratings on BOI if the buffer of bailinable debt protecting senior creditors does not stay at or above 8.0% our RWA metric and is no longer commensurate with a two-notch rating uplift. This could happen because of a less conservative capital policy than we currently expect or due to inflation of the risk-asset base.

**Upside scenario:** We could revise the outlook to stable if we see stabilization in the operating environment and we also revise our outlook on BOI Group to stable.

## **Permanent TSB Group (PTSB Group)**

Primary analyst: Anastasia Turdyeva

## **Permanent TSB Holdings Group PLC (nonoperating holding company)**

The negative outlook on PTSB Group primarily reflects our view that, despite an anticipated economic recovery, the operating environment in Ireland will remain challenging, leading to weaker business and profitability prospects over the next 12-18 months. We see PTSB group's profitability as being under greater pressure than that of large domestic players due to its lack of scale and diversification. Consequently, we expect it to remain weak over the next 12-18 months except in the event that the group can benefit from external growth, for example via a one-off purchase of portfolios from banks exiting the Irish market.

**Downside scenario:** We would lower the ratings over the next 18-24 months if PTSB Group's strategy to diversify and improve profitability is significantly behind schedule, and we see little signs of recovery of profitability, indicating inability to expand successfully. We could also downgrade the bank if we observed more aggressive capital management, with our forecast RAC ratio falling below 10%.

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**Upside scenario:** We could revise the outlook to stable if economic and operating conditions stabilize, while cost discipline and business diversification allow the bank to sustain preprovision income.

### Permanent TSB PLC (operating company)

The negative outlook on Permanent TSB PLC mirrors that on PTSB Group.

**Downside scenario:** We could lower the rating on the operating company if the bank is unable to sustain profitability in the difficult operating environment, or if we forecast the ALAC buffer protecting senior creditors to fall below 6.0% of our RWA metric over the next two years.

**Upside scenario:** We could revise the outlook to stable if the operating environment normalizes and we revise the outlook on PTSB Group to stable.

## BICRA Score Snapshot

### Ireland

|                            | To                | From              |
|----------------------------|-------------------|-------------------|
| BICRA group                | 4                 | 4                 |
| Economic risk              | 5                 | 5                 |
| Economic resilience        | Low risk          | Low risk          |
| Economic imbalances        | High risk         | High risk         |
| Credit risk in the economy | High risk         | High risk         |
| Economic risk trend        | Positive          | Stable            |
| Industry risk              | 4                 | 4                 |
| Institutional framework    | Intermediate risk | Intermediate risk |
| Competitive dynamics       | High risk         | Intermediate risk |
| Systemwide funding         | Low risk          | Intermediate risk |
| Industry risk trend        | Negative          | Negative          |

### Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- 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

## Ratings On Irish Banks Affirmed Amid Ongoing Profitability Pressure; Most Outlooks Still Negative

- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

## Related Research

- Economic Outlook Europe Q3 2021: The Grand Reopening, June 24, 2021
- The European Speculative-Grade Corporate Default Rate Could Fall To 5.25% By March 2022, May 26, 2021
- Diverse Rating Actions On European Banks Highlight The Importance Of Robust Business Models To Long-Term Resilience, Feb. 26, 2021
- Capital Resilience Alone Won't Stabilize European Bank Ratings In 2021, Feb. 3, 2021
- Low-For-Even-Longer Interest Rates Maintain Margin Pressure On European Banks, Feb. 2, 2021
- Lower And Later: The Shifting Horizon For Bank Credit Losses, Feb. 2, 2021

## Ratings List

\*\*\*\*\* AIB Group PLC \*\*\*\*\*

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### Ratings Affirmed

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#### AIB Group PLC

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|                      |                   |
|----------------------|-------------------|
| Issuer Credit Rating | BBB-/Negative/A-3 |
|----------------------|-------------------|

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### Ratings Affirmed; Outlook Action

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|  | To | From |
|--|----|------|
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#### AIB Group (U.K.) PLC

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|----------------------|------------------|------------------|
| Issuer Credit Rating | BBB/Positive/A-2 | BBB/Negative/A-2 |
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#### Allied Irish Banks PLC

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|----------------------|-------------------|-------------------|
| Issuer Credit Rating | BBB+/Positive/A-2 | BBB+/Negative/A-2 |
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\*\*\*\*\* Bank of Ireland Group PLC \*\*\*\*\*

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### Ratings Affirmed

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#### Bank of Ireland Group PLC

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|                      |                   |
|----------------------|-------------------|
| Issuer Credit Rating | BBB-/Negative/A-3 |
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## Ratings On Irish Banks Affirmed Amid Ongoing Profitability Pressure; Most Outlooks Still Negative

### Bank of Ireland

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|----------------------|-----------------|
| Issuer Credit Rating | A-/Negative/A-2 |
|----------------------|-----------------|

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\*\*\*\*\* Permanent TSB Group Holdings PLC \*\*\*\*\*

### Ratings Affirmed

#### Permanent TSB Group Holdings PLC

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|                      |                |
|----------------------|----------------|
| Issuer Credit Rating | BB-/Negative/B |
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#### Permanent TSB PLC

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|----------------------|-------------------|
| Issuer Credit Rating | BBB-/Negative/A-3 |
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceld/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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