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Irish Banks Affirmed On Improving Credit Fundamentals Against A Backdrop Of Post-Brexit Uncertainty

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- Improving macroeconomic conditions are translating into low credit losses, ongoing private sector leverage reduction, and progress on reducing the high stock of non-performing loans. The effects of the U.K.'s vote to leave the EU (Brexit) will likely be negative for the Irish economy but of uncertain magnitude and mixed across sectors.
- Notwithstanding the uncertain effects of Brexit, we maintain the positive trend on our assessment of economic risk. This reflects our base-case scenario that Brexit may slow the pace of recovery and result in an uptick in credit losses in 2017, but will not fundamentally alter the banking system's path to a more sustainable credit profile.
- Based on these factors, we are affirming our ratings on Bank of Ireland (BOI), Allied Irish Banks (AIB), and Permanent TSB (PTSB). The outlooks on BOI and AIB are positive. The outlook on PTSB is stable.

LONDON (S&P Global Ratings) Aug. 2, 2016--S&P Global Ratings today affirmed its ratings on the three domestic Irish banks. Specifically, we affirmed the ratings on:

- Bank of Ireland (BOI) at 'BBB-/A-3'. The outlook is positive.
- Allied Irish Banks PLC (AIB) at 'BB+/B'. The outlook is positive.
- Permanent TSB PLC (PTSB) at 'BB-/B'. The outlook is stable.

We affirmed our ratings on KBC Bank Ireland on June 28, 2016 (see "KBC Bank Ireland 'BBB-/A-3' Ratings Affirmed On Improved Capitalization; Outlook

Stable," on RatingsDirect).

The affirmations reflect our expectation that Ireland's macroeconomic recovery will remain largely supportive of banking system profitability and financial profiles despite the uncertainty following the U.K.'s vote to leave the EU (Brexit), a prolonged low interest rate environment, and the overhang of legacy issues.

Ireland's real GDP grew at a robust rate in 2015 even adjusting for technical accounting effects related to Ireland's large export sector that inflated the official headline growth rate of 26.3%. Absent Brexit, our base-line expectation was that Ireland would record real GDP growth of 3%-4% annually over the next three years and unemployment would decline further to around 7.5% by 2017. Although the negative effects of Brexit are uncertain at this early stage, in our view, it is reasonable to assume that real GDP growth will be modestly lower than our central expectation before the referendum. Following the referendum, we revised down our 2017 growth forecast to 3.2% from 3.8%. Although direct trade links with the U.K. have reduced over the years (see "Brexit Has No Immediate Impact On Republic of Ireland Sovereign Ratings," published June 24, 2016), we consider that small and midsize enterprises (SMEs) in labor intensive sectors such as agriculture, food processing, and tourism are substantially reliant on U.K. trade. The sharp depreciation of the pound sterling will make Irish exports less competitive.

Nationally, house prices rose by 6.6% over the past 12 months as of June 2016. Although house price increases have moderated in the past few months, in part due to the central bank's macroprudential measures, we expect the gap between demand and supply of new housing to persist. Against this favorable backdrop, we expect credit losses to remain exceptionally low. This will be due to a combination of further provision releases (albeit not to the same extent as in 2015) and declining inflows into new defaults. Low interest rates will also support affordability. We now expect domestic systemwide credit losses to average around 30 basis points (bps) over 2016 and 2017 (compared with a net systemwide provision release of around 55-60 bps in 2015). Notwithstanding low loan losses, the structural supply shortages in the housing market due to low building activity, low levels of mortgage demand, and overall muted credit growth suggest that the unwinding of pre-crisis economic imbalances is still a work-in-progress.

Private sector deleveraging increasingly supports our assessment of credit risk in the economy. We estimate that private sector credit (we calculate this as loans to the household sector and domestic non-financial corporations by credit institutions as per central bank data) to GDP at end-2015 was 81%, representing a continuation of the deleveraging trend over the past few years. That said, we consider that household indebtedness in Ireland remains high compared with peers. For example, the household debt-to-disposable income ratio was 168% at year-end 2015. This compares to 127% for the U.K. and 64% for Italy.

The banking system's large stock of nonperforming loans (NPLs; we define these as impaired loans plus loans that are 90 days past due but not impaired) and still-high level of mortgage arrears (including very long term of 720 days plus arrears) are some of the most significant challenges facing the industry, in our view. We estimate that NPLs were a high 20% of systemwide loans at end-2015 (down from 28% at end-2014) although provision coverage of NPLs at around 51% remains adequate, in our base-case view of macroeconomic fundamentals. While we view this level of provision as satisfactory, a persistently high stock of NPLs does represent tail risk and poses a drag on a return to a normalized credit profile for Irish banks. For example, we could see a rise in re-default rates for restructured loans if sharper-than-expected deterioration in the post-Brexit macroeconomic environment puts pressure on more vulnerable borrowers such as SMEs linked to U.K. trade.

We expect further declines in NPLs to be gradual partly because the remaining stock represents the more difficult cases. Furthermore, legal bottlenecks and the slow process of creditors being able to recover collateral act as significant hurdles to rapid reductions in NPLs.

AIB and BOI performed poorly in the adverse stress scenario of the EBA's EU-wide stress test. AIB's fully loaded common equity Tier 1 (CET1) ratio in 2018 fell to 4.3%, from a starting point of 13.1% at year-end 2015. This makes AIB the second-worst performer in the stress test, after Italian bank Banca Monte dei Paschi di Siena (MPS, not rated). BOI's fully loaded CET1 ratio in 2018 fell to 6.2% from a starting point of 11.3%, making it the fourth-worst performer in the stress test.

The main reason for this poor performance was weak asset quality and losses on defaulted loans. The stress test makes certain simplifying assumptions to promote comparability, such as a static balance sheet position. In addition to a sharp rise in defaulted loans, this assumption is particularly punitive for Irish banks as low-yielding tracker mortgages and expensive liabilities that mature during the exercise are assumed to be replaced with similar assets and liabilities. That said, the results are consistent with our view that, while Irish banks have made substantial progress in reducing the stock of NPLs and strengthening their credit fundamentals, they remain vulnerable to a sharp downturn.

Although there has been a significant improvement in the pre-provision profitability and earnings capacity of most Irish banks over the past few reporting periods, we believe further material improvements are unlikely excluding one-off factors. Improving net interest margins (NIM) has primarily been due to deposit repricing, a decline in other funding costs (partly due to redemption of expensive legacy instruments), and better margins on new lending. We do not expect further material increases in NIM in part because deposit re-pricing in the domestic Irish market has largely run its course for now, with the possible exception of PTSB and to a lesser extent AIB. The large portfolios of tracker mortgages will continue to weigh on margins as long as low interest rates persist. In addition, banks are coming under some public and political pressure to reduce mortgage rates. Finally, we expect net loan growth to remain muted over the next few years. The central bank's industrywide investigation into documentation and disclosure on legacy tracker mortgages will take some time but could result in customer redress charges for some banks.

Although wholly or partially government-owned institutions continue to dominate the Irish banking system, we expect this ownership to be temporary (although complete divestment will likely take a few years). The government reduced its stake in PTSB to 75% in 2015 following its successful capital raise. In the post-Brexit environment and the more difficult market sentiment toward European banks in general, we now expect a delay in the sale of a first tranche of AIB shares.

OUTLOOK

BOI

We have raised BOI's stand-alone credit profile (SACP) to 'bbb' from 'bbb-' reflecting our view that capitalization, as indicated by the risk-adjusted capital (RAC) ratio, is comfortably and sustainably above 7%. It was 7.3% at year-end 2015 and we expect it to be 8.5%-9.0% by end-2017. The RAC ratio could further benefit from an improvement in our view of macroeconomic risks that BOI faces, which in turn would lower the S&P Global Ratings risk weights we apply to its exposures.

At the same time, we have applied a negative notch of adjustment in the rating to reflect BOI's high stock of NPLs relative to peers in other countries and its exposure to post Brexit macroeconomic uncertainties. BOI's NPL ratio of 11.6% at end-2015 remains higher than peers with similar SACPs despite good progress in reducing the stock of defaulted loans. Furthermore, with approximately 45% of its loan portfolio in the U.K., BOI is exposed to a macroeconomic slowdown and falling asset prices in the region--including in Northern Ireland where economic conditions are weaker than the average for the U.K. We currently ascribe a negative trend to our view of U.K. economic risk.

The positive outlook on BOI indicates that we may raise the ratings on the bank over the next one-to-two years if we perceived that the negative impacts of Brexit on BOI's earnings profile were manageable and the group had made further progress on reducing NPLs. We would reflect this by removing the negative notch of adjustment.

An upgrade might also follow if we included a notch of support for additional loss-absorbing capacity (ALAC) if we deemed that BOI's subordinated buffers would exceed our 4.75% ALAC threshold over a two-year horizon, or potentially longer, in response to clear regulatory requirements.

We could revise the outlook back to stable if we perceived that BOI's dividend policy, risk appetite, and earnings predictability did not warrant an upward revision of the bank's issuer credit rating.

AIB

The positive outlook reflects our view that, in the coming 12-18 months, we could revise upward our anchor for commercial banks in Ireland, including AIB, to reflect the decreasing macroeconomic risks that they face in their domestic market. This would follow an improvement of our economic risk assessment for Ireland under our Banking Industry Country Risk Assessment methodology.

Although less likely at this stage, an upgrade could arise if we included one notch of ALAC support into our long-term rating on AIB. The bank's ALAC buffer would need to increase substantially to exceed the required thresholds (4% if the anchor remains at 'bb+', 5% if it improves to 'bbb-').

We could revise the outlook to stable if we observed that economic recovery had stalled, indicating that the economic risks faced by Irish banks were not declining, as well as if Brexit had adverse effects on AIB's earnings profile and its ability to reduce NPLs.

The stable outlook on AIB UK reflects our view of its steady intrinsic creditworthiness.

PTSB
The stable outlook on PTSB reflects S&P Global Ratings' view that PTSB's capitalization and earnings capacity will remain commensurate with our expectations at this rating level over the next 12-18 months. The stable outlook also reflects that an improvement in our view of Irish economic risk is unlikely, in itself, to lead us to upgrade PTSB. This is because we continue to believe that PTSB lags its peers in the path to recovery and sustainable profitability.

We would lower the ratings if PTSB's path to earnings recovery were to stall or if we observed setbacks in the execution of its restructuring plan in the uncertain post-Brexit environment. We could also lower the rating if we perceived that PTSB's franchise had been negatively affected by its prolonged restructuring, indicated by reducing market shares and weak profitability in its core banking proposition.

We would raise the ratings if we perceived that PTSB's earnings capacity and profitability materially outperformed our expectations, such that capitalization (as measured by our RAC ratio) improved sustainably above 10%. This would depend on us taking a more favorable view of our combined assessment of PTSB's capitalization and risk profile. An upgrade could also follow if we perceived a clear path to building ALAC buffers over our two-to-four-year projection period.

RATINGS SCORE SNAPSHOTS

BOI

	To	From
Issuer Credit Rating	BBB-/Positive/A-3	BBB-/Positive/A-3
SACP	bbb	bbb-

Anchor	bbb-	bbb-
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Adequate (0)	Moderate (-1)
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	0	0
ALAC Support	0	0
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0
Additional Factors	-1	0

AIB

Issuer Credit Rating	BB+/Positive/B
SACP	bb+
Anchor	bb+
Business Position	Adequate (0)
Capital and Earnings	Adequate (0)
Risk Position	Adequate (0)
Funding and Liquidity	Average and Adequate (0)
Support	0
ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0
Additional Factors	0

PTSB

Issuer Credit Rating	BB-/Stable/B
SACP	bb-
Anchor	bb+
Business Position	Moderate (-1)
Capital and Earnings	Adequate (0)
Risk Position	Adequate (0)
Funding and Liquidity	Below Average and Moderate (-1)
Support	0
ALAC Support	0
GRE Support	0

Group Support	0	
Sovereign Support	0	
Additional Factors	0	

BICRA SCORE SNAPSHOT*

IRELAND

	To	From
BICRA Group	6	6
Economic risk	6	6
Economic resilience	Low risk	Low risk
Economic imbalances	High risk	High risk
Credit risk in the economy	Very high risk	Very high risk
Industry risk	6	6
Institutional framework	High risk	High risk
Competitive dynamics	Intermediate risk	Intermediate
Systemwide funding	High risk	High risk
Trends		
Economic risk trend	Positive	Positive
Industry risk trend	Stable	Stable

*BICRA--Banking Industry Country Risk Assessment economic risk and industry risk scores are on a scale from '1' (lowest risk) to '10' (highest risk). For more details on our BICRA scores on banking industries across the globe, please see "Banking Industry Country Risk Assessment Update" published monthly on RatingsDirect.

RELATED CRITERIA AND RESEARCH

Related criteria

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Group Rating Methodology, Nov. 19, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Commercial Paper I: Banks, March 23, 2004
- Use of 'C' and 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments, October 24, 2013

- Guarantee Criteria--Structured Finance, May 7, 2013

Related research
- Brexit Has No Immediate Impact On Republic of Ireland Sovereign Ratings, June 24, 2016
- Republic of Ireland 'A+/A-1' Ratings Affirmed; Outlook Stable, June 3, 2016

RATINGS LIST

************************** Allied Irish Banks PLC **************************

Ratings Affirmed

Allied Irish Banks PLC	
Counterparty Credit Rating	BB+/Positive/B
AIB Group (U.K.) PLC	
Counterparty Credit Rating	BB+/Stable/B
Allied Irish Banks PLC	
Senior Unsecured	BB+
Subordinated	B+
Subordinated	D
Commercial Paper	B
Allied Irish Banks N.A. Inc.	
Commercial Paper*	B
Commercial Paper*	BB+

*Guaranteed by Allied Irish Banks PLC.

***************************** Bank of Ireland ****************************

Ratings Affirmed

Bank of Ireland	
Counterparty Credit Rating	BBB-/Positive/A-3
Certificate Of Deposit	BBB-/A-3
Bank of Ireland	
Senior Unsecured	BBB-
Subordinated	BB
Junior Subordinated	B+
Preference Stock	B+
Commercial Paper	A-3
Bank of Ireland U.K. Holdings PLC	
Junior Subordinated*	B+

*Guaranteed by Bank of Ireland.

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*************************** Permanent TSB PLC **************************

Ratings Affirmed

Permanent TSB PLC
 Counterparty Credit Rating             BB-/Stable/B
 Certificate Of Deposit                 BB-/B

Permanent TSB PLC
 Senior Unsecured                       BB-
 Senior Unsecured                       BB-/B
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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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at 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.