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Research Update:

Bank of Ireland Outlook Revised To Positive On Reducing Economic Risks In Ireland; 'BB+/B' Ratings Affirmed

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Overview

- A significant improvement in Irish macroeconomic fundamentals and ongoing property price recovery have supported a sharp decline in credit losses across the banking system.
- We believe that domestic economic risks that Irish banks face have reduced, reflecting our view that banking system credit losses are declining and will pose less of a risk to sector profitability over the next two to three years than we had previously anticipated.
- In this context, we expect Bank of Ireland (BOI) to return to sustainable organic capital build through retained earnings from 2014 onward.
- We are therefore revising the outlook on BOI to positive from negative and affirming our 'BB+/B' long- and short-term counterparty credit ratings.
- The positive outlook reflects the possibility of an upgrade over the next one to two years if BOI's risk-adjusted capital (RAC) ratio improves to a level that is comfortably and sustainably above 5%.

Rating Action

On Dec. 9, 2014, Standard & Poor's Ratings Services revised the outlook on Bank of Ireland (BOI) to positive from negative. We also affirmed the 'BB+/B' counterparty credit ratings on the bank. At the same time, we raised the issue ratings on BOI's junior subordinated debt to 'B-' from 'CCC+' and on its nondeferrable subordinated debt to 'B+' from 'B'.

Rationale

The outlook revision reflects our view that the domestic economic risks that Irish banks face have reduced (see "Irish Bank Ratings Affirmed On Reducing Economic Risks," published today on RatingsDirect).

We have revised up our expectations for growth for Ireland and now expect real GDP growth of 4.5% in 2014 and 3.5% in 2015--levels that are likely to be ahead of Continental European peers (see "Ireland Upgraded To 'A/A-1' On Improved Growth And Fiscal Performance; Outlook Stable," published Dec. 5, 2014).

Against this more favorable macroeconomic backdrop, all the major Irish banks reported a sharp decline in loan impairment charges in the first half of 2014.

We expect this improving trend in loan impairments to continue for the second half of the year supported by provision releases (both as a result of changes in model assumptions and continued progress in restructuring impaired loans) and declining arrears (albeit from still high levels), including reduced inflows into early arrears.

The economic risk trend is stable, in our view, and incorporates still-high private sector leverage and the large stock of domestic nonperforming loans (NPLs; defined as impaired loans plus 90 days past due but not impaired) that the system has to work through. Although the stock of NPLs will reduce from a very high 35% of systemwide loans at end-2013, we expect progress to be gradual.

As a result of our view of reduced economic risks in the Republic of Ireland and consequently our view of BOI's domestic Irish exposures, we have revised upward our anchor--the starting point in assigning an issuer credit rating to a bank--for Irish banks to 'bb+' from 'bb'. BOI's anchor also benefits from its greater geographic diversification than Irish peers, with 42% of its gross loans and advances in the U.K., which we view as having a better economic risk profile than domestic Irish exposures. We have, therefore, revised upward the bank's stand-alone credit profile (SACP) to 'bb+' from 'bb'.

We believe that BOI's capitalization is on an improving trend, although we continue to regard it as "weak," as our criteria defines this term. We project that the bank's RAC ratio will increase to 5.5%-6.0% by end-2016--a range we typically ascribe to a "moderate" capital and earnings assessment. Nevertheless, we are taking a conservative stance on our assessment until BOI establishes a track record of maintaining capital well above 5%. The RAC ratio stood at 3.6% at end-2013. As a result of our improved view of economic risks in Ireland and lower risk weights we now apply to Irish exposures, the pro-forma RAC ratio at that date increased by about 30 basis points (bps). In addition to the impact of lower risk weights on Irish exposures, our updated forecast makes the following assumptions:

- The loan book continues to contract in 2014 and 2015 as redemptions outpace new lending along with some asset sales. We assume modest net loan growth in 2016.
- Revenues have benefited from substantial increases in net interest margin (NIM) over the past 12-18 months primarily due to the lower cost of deposits and declining ELG (Eligible Liabilities Guarantee) fees. Nevertheless, we expect only modest increases in NIM over the forecast horizon as deposit re-pricing has substantially run its course and some asset margin pressure will emerge, in our view.
- The loan impairment charge (defined as new loan loss provisions-to-average customer loans) declines to around 75bps in 2014 from 173bps in 2013. Our expectation assumes some provision releases in 2014 and 2015. We expect that credit losses will further decline toward 50bps by 2016.
- Standard & Poor's risk-weighted assets (RWAs) will decline in 2014 and 2015 with some growth in 2016, in line with the loan book.

- A modest dividend in 2016.

Our forecasts don't incorporate any potential capital transactions that could be positive for the RAC ratio.

The affirmation of the issuer credit rating, despite the upward revision of the SACP, reflects our view that the likelihood of extraordinary government support available to the senior unsecured bondholders will probably diminish within our rating horizon. We therefore incorporate a negative adjustment in the rating, thereby eliminating the uplift of the ratings attributable to extraordinary sovereign support.

Outlook

The positive outlook indicates that we may raise the ratings on BOI over the next one to two years if we expect that capitalization, as indicated by the RAC ratio, will be comfortably and sustainably above 5%. Although less likely, an upgrade could also follow if we consider that potential extraordinary government support for BOI's senior unsecured creditors is unchanged in practice, despite the introduction of bail-in powers and international efforts to increase banks' resolvability. An upgrade might also follow if we believed that any steps BOI might take that provide substantial additional flexibility to absorb losses while a going concern fully offset increased bail-in risks.

We could revise the outlook back to stable if we perceive that BOI's dividend policy, longer-term growth in Standard & Poor's RWAs, and risk appetite do not warrant an upward revision of our combined assessment of capital and risk.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BB+/Positive/B	BB+/Negative/B
SACP	bb+	bb
Anchor	bb+	bb
Business Position	Strong (+1)	Strong (+1)
Capital and Earnings	Weak (-1)*	Weak (-1)*
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	+1	+1
GRE Support	0	0
Group Support	0	0
Sovereign Support	+1	+1
Additional Factors	-1	0

*When a bank's anchor SACP, derived from our Banking Industry Country Risk

Assessment (BICRA) methodology, is in the 'bb' category and its common equity regulatory Tier 1 ratio is greater than the local regulatory requirements, a "weak" assessment of capital and earnings has a minus one-notch impact on the SACP (see paragraph 88 of our bank criteria).

Related Criteria And Research

Related criteria

- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Sept. 18, 2014
- Group Rating Methodology, Nov. 19, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related research

- Ireland Upgraded To 'A/A-1' On Improved Growth And Fiscal Performance; Outlook Stable, Dec. 5, 2014
- Irish Bank Ratings Affirmed On Reducing Economic Risks, Dec. 9, 2014
- Bank of Ireland, Aug. 15, 2014

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Bank of Ireland		
Counterparty Credit Rating	BB+/Positive/B	BB+/Negative/B

Upgraded

	To	From
Bank of Ireland		
Subordinated	B+	B
Preference Stock	B-	CCC+

Bank of Ireland U.K. Holdings PLC
Junior Subordinated*

B-	CCC+
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Ratings Affirmed

Bank of Ireland	
Senior Unsecured	BB+
Commercial Paper	B

*Guaranteed by Bank of Ireland.

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