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Bank of Ireland

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Bank of Ireland

SACP	bb	+	Support	+1	+	Additional Factors	0

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

GRE Support	0
Group Support	0
Sovereign Support	+1

Issuer Credit Rating

BB+/Negative/B

Major Rating Factors

Strengths:	Weaknesses:
• Stable franchise in Ireland with high market share across business lines, and better international business diversity than Irish peers. • Relative asset quality performance has proven to be, and we expect it to remain, better than Irish peers. • Stable deposit base characterized by very low concentration risks and a relatively low proportion of corporate deposits.	• We expect capitalization will remain weak, by our measures. • Declining net loan balances affecting future pre-provision earning prospects. • High stock of nonperforming assets.

Outlook: Negative

The negative outlook indicates that we may lower the ratings on Bank of Ireland (BOI) by year-end 2015 if we believe there is a greater likelihood that senior unsecured liabilities may incur losses if the bank fails. Specifically, we may lower the long-term counterparty credit rating by one notch if we consider that extraordinary government support is less predictable under the new EU legislative framework.

We could revise the outlook back to stable if we consider that potential extraordinary government support for BOI's senior creditors is unchanged in practice, despite the introduction of bail-in powers and international efforts to increase banks' resolvability; or if we believe that other rating factors, such as a stronger SACP or a large buffer of subordinated instruments, fully offset increased bail-in risks.

We could revise the SACP upward, and therefore potentially raise the ratings, if BOI outperforms our expectations and achieves a RAC ratio comfortably above the 5% threshold that we ascribe to a "moderate" capital and earnings assessment. We do not currently expect to lower BOI's SACP but this could occur, for example, if its earnings performance slips relative to Irish peers. We would reflect this by lowering its business position to "adequate" from "strong".

Our ratings on the Irish sovereign have a positive outlook. Under our criteria, if we raised the long-term sovereign rating by one notch to 'A', then BOI, as a "highly systemically important" bank, would be eligible for two notches of extraordinary government support rather than the current one notch. Given that there is at least a one-in-three probability that we could be removing all government support notches on systemically important European banks within 18 months, we do not currently expect to raise the ratings on BOI in this scenario. Instead, we would apply a negative adjustment of one notch to the counterparty rating.

Rationale

We base our ratings on BOI on the bank's "strong" business position, as defined by our criteria, due to its relative business stability in Ireland and its reasonably diversified revenue profile. We view capital and earnings as "weak," as we expect the bank's Standard & Poor's risk-adjusted (RAC) ratio to be 4.5%-5.0% by end-2015. Our assessment of the bank's risk position is "adequate," because we think that its risks are reasonably captured by the standard assumptions in our capital assessment. We view funding as "average" and liquidity as "adequate" noting that BOI has led the way among Irish banks in terms of re-establishing wholesale funding access, including senior unsecured issuance.

We assess BOI's stand-alone credit profile (SACP) as 'bb'. The issuer credit rating on BOI incorporates a one-notch uplift to reflect the bank's "high" systemic importance in Ireland, which takes into account its material market share in retail deposits in particular, and the potential for further extraordinary support from the Irish government.

Anchor: 'bb', reflecting weighted-average economic risk in countries of operation

The 'bb' anchor draws on our Banking Industry Country Risk Assessment (BICRA) methodology and our view of the weighted-average economic risk in the countries in which BOI operates, based on the geographic distribution of its net customer loan exposures, which at June 30, 2014, is about: Ireland (50%), U.K. (45%), and the rest of the world (5%). We view the weighted-average economic risk score for these countries as closer to '6' than '5' on a scale of 1-10 (where '1' is the lowest risk and '10' is the highest). We note the current downsizing of BOI's business and corporate banking franchises in Great Britain, which resulted from the finalization of its EU restructuring plan in 2013. We also note that a meaningful part of its U.K. exposure relates to Northern Ireland, where we consider that economic risks are typically higher than the U.K. average.

We view the Republic of Ireland's economic risk as high. Businesses, households, and government finances were all hit hard by the fallout from the collapse of property collateral values and the severe difficulties in the banking system, particularly during 2008-2011. We are now seeing clearer evidence that the Irish economy is recovering from its deep contraction, and that property prices are on an upward trend.

We still believe, however, that the Irish banking system continues to suffer as a result of these past events. In particular, the stock of nonperforming assets is high relative to higher-ranked banking systems and we expect its workout to take a while. We also assess Ireland's industry risk as high. While some Irish banks have re-established access to the wholesale funding market on the back of issuance by the Irish sovereign, and funding support from the European Central Bank (ECB) has reduced, we think that banks' funding profiles remain unbalanced. Moreover, income generated by Irish banks is quite modest and we believe that the Irish authorities have been relatively less proactive in forcing their banks to address the deficiencies in their capitalization exposed by fully loaded Basel III metrics.

Table 1

Bank of Ireland Key Figures					
		--Year-ended Dec. 31--			
(Mil. €)	**2014***	**2013**	**2012**	**2011**	**2010**
Adjusted assets	119,706	121,457	138,315	145,573	156,976
Customer loans (gross)	91,571	92,755	100,165	108,102	120,300
Adjusted common equity	4,246	4,079	4,413	7,070	4,789
Operating revenues	1,522	2,700	1,936	2,106	2,868
Noninterest expenses	813	1,581	1,608	1,644	1,785
Core earnings	289	(511)	(1,189)	(1,342)	(2,958)

*Data as of June 30.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Business position: Leading business position in Ireland

We assess BOI's business position as "strong." BOI has returned to pre-tax profitability in 2014, in part because in our view it has been better placed than other Irish banks to adjust its deposit pricing and increase new lending. We also believe that its U.K. business, which includes a useful source of customer deposits and allows for long-term growth potential, improves its diversity relative to Irish peers.

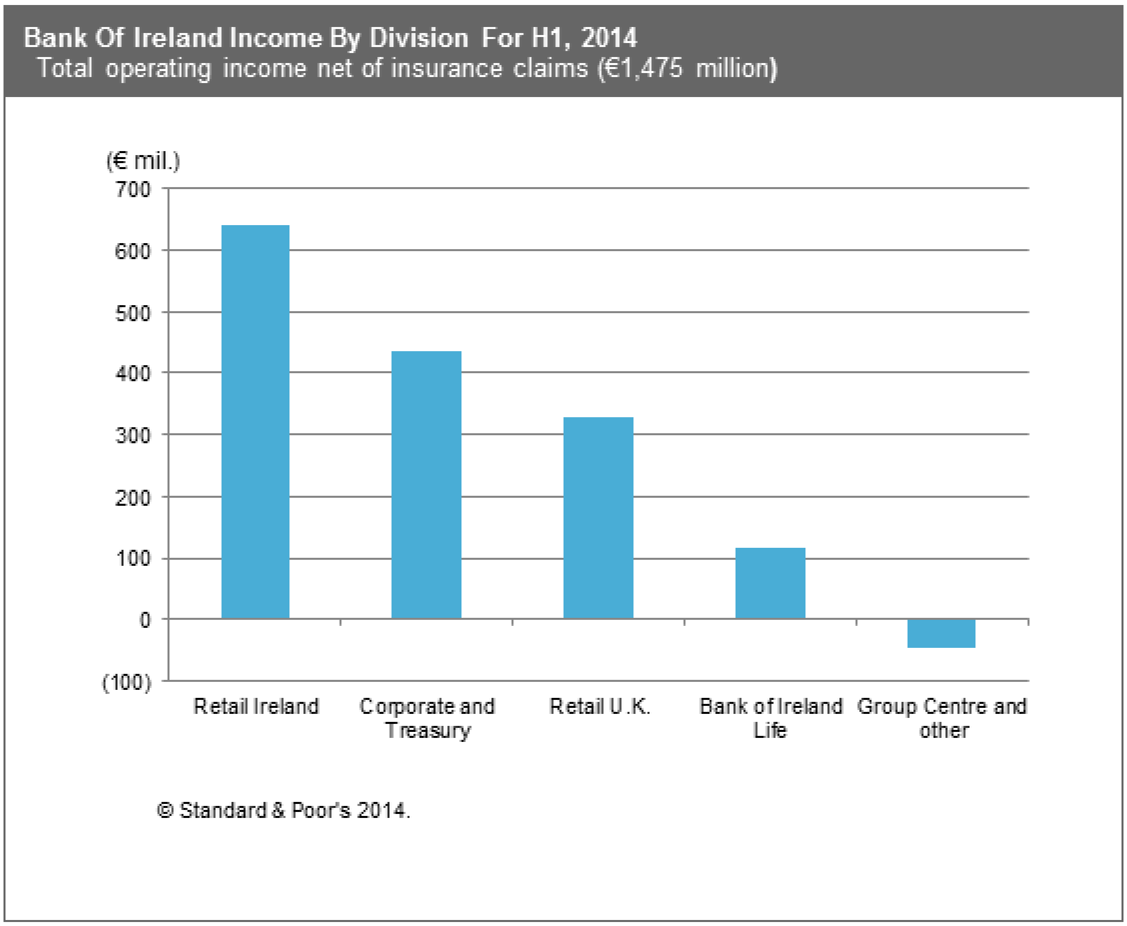
BOI's main rated peers active in the Irish banking industry include Allied Irish Banks PLC (AIB; BB/Negative/B) and Permanent TSB PLC (PTSB; B+/Negative/B), together referred to below as "domestic peers". They are both government-owned institutions. The broader "Irish peer" group includes foreign-owned banks KBC Bank Ireland PLC (BBB-/Negative/A-3) and Ulster Bank Ltd. (BBB+/Negative/A-2).

BOI has resilient franchises and high market shares across all retail and commercial banking lines in Ireland. We also note that the Irish government owns about 15% of BOI's ordinary shares, compared with more than 99% of domestic peers'.

We consider that BOI's domestic franchise has been enhanced by the significant shake-up of the Irish banking system over the past six years, which has led to a smaller number of market participants, including the withdrawal of some overseas lenders. In particular, the number of alternative personal current account or small business lending providers has diminished, enabling BOI to at least maintain its strong market shares.

Business activity is well spread by business line and we expect this to remain the case (see chart 1).

Chart 1



In our opinion, something that differentiates BOI's profile from its Irish peers is its useful U.K. franchise. While we consider this franchise to be less strong than most rated U.K. banks, it includes a joint venture with the U.K. Post Office, which gives BOI the option for potential long-term growth.

We recognize that BOI's management team, which has been more stable than most Irish peers throughout the Irish banking crisis, has now achieved its aim to return the bank to profitability. That said, reported net loans at June 30, 2014 were €83.4 billion, which is well below management's strategic target of €90 billion--on which its current cost base is predicated. Moreover, in the near term we expect credit demand in Ireland will remain muted across the retail and business sectors.

Capital and earnings: A long distance to travel to an "adequate" assessment

We view BOI's capital and earnings as "weak*." By our measures, BOI's capitalization is not as strong as that implied by a reported regulatory transitional common equity tier 1 (CET1) ratio of 13.2% at June 30, 2014. Through end-2015, we expect BOI's RAC ratio to be in the 4.5%-5.0% range. We do, however, assume that BOI's projected RAC ratio should remain comfortably above the 3% threshold, which we assign for a "very weak*" assessment.

*When a bank's anchor, derived from our 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, rather than two (see paragraph 88 of our bank criteria). The impact is minus two notches if we assign a "very weak" assessment, which includes a projected RAC ratio of less than 3%.

There are two primary reasons for the large difference between our capital analysis and BOI's regulatory capital. First, within our calculation of total adjusted capital, we exclude €1.3 billion of preference shares issued by BOI and we also exclude €1.6 billion of tax loss carry-forwards. On this basis, we estimate that total adjusted capital at June 30, 2014, was just under €4.3 billion (up from €4.1 billion at year-end due to retained earnings), which compares to reported regulatory transitional CET1 capital (before supervisory deductions) of €7.1 billion. Second, within our calculation of risk-weighted assets we apply more conservative risk weightings to reflect our view of economic risk within Ireland. As a result, we estimate that BOI's RAC was about 3.8% at this date (up from 3.6% at year-end). This improvement takes into account the first-half profit, plus our assumption that Standard & Poor's risk weighted assets (RWAs) declined by the same 2% as regulatory RWAs did in the first six months of the year.

Our forecast for BOI's projected RAC ratio of 4.5%-5.0% includes the following assumptions:

- Pre-provision earnings will improve by about 9% in 2014 compared with 2013, before rising by about 4% in 2015.
- Notwithstanding BOI's better-than-expected asset quality performance in the first half of 2014, our current forecast assumes a loan loss rate of about 100 bps in 2014, falling to less than 90 basis points in 2015.
- We assume that the negative impact of exceptional items will be low.
- Standard & Poor's RWA will fall by 5% in full-year 2014 and by a further 4% in 2015 because we assume that BOI's loan book will continue to reduce, before growing again in 2016.

The 2014 interim results highlighted to us that BOI should remain profitable henceforth. BOI reported a statutory profit before tax for the period of €399 million, which was its first period of solid earnings since the 2008 financial crisis. In particular, BOI reported that its net interest margin (before eligible liabilities guarantee fees, which now has a minor negative impact on revenues) improved to 2.05% from 1.65% a year before. This mainly reflected a combination of wider asset spreads, lower retail deposit costs, and reduced other funding costs. Growth in noninterest income was more modest. We expect future revenue growth to be primarily dependent on business growth because we believe that most of the drivers behind the recovery in net interest margins have now played out.

The other main driver behind the earnings recovery has been a sharp fall in loan impairment charges. In the first half of 2014, reported charges were €374 million, down from €780 million for the same period in 2013. In part this reflected the benefit of a €70 million write-back for Ireland's National Asset Management Agency (NAMA) subordinated bonds. Still, BOI reported lower impairment charges across all of its loan portfolios. We note that BOI's impairment charges have the potential to outperform our expectations if, for example, improved market conditions enable it to adjust its peak-to-trough fall in Irish house prices of 55% that it currently factors into its provisioning.

We consider the quality of capital to be a neutral factor. On the one hand, we believe that the bank now has few attractive assets that it may be able and willing to sell to raise funds. On the other hand, there are virtually no hybrid capital instruments included in total adjusted capital. BOI does have a degree of flexibility afforded by its remaining government preference shares.

Table 2

Bank of Ireland Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
S&P RAC ratio before diversification	N.A.	3.6	3.7	N.A.	N.A.
S&P RAC ratio after diversification	N.A.	3.7	3.8	N.A.	N.A.
Adjusted common equity/total adjusted capital	98.8	98.7	98.7	99.2	75.2
Net interest income/operating revenues	74.9	74.2	70.1	72.8	76.8
Fee income/operating revenues	10.9	11.1	15.5	19.9	13.1
Market-sensitive income/operating revenues	3.5	6.1	1.2	(1.7)	(4.4)
Noninterest expenses/operating revenues	53.4	58.6	83.1	78.1	62.2
Preprovision operating income/average assets	1.1	0.8	0.2	0.3	0.6
Core earnings/average managed assets	0.4	(0.4)	(0.8)	(0.8)	(1.7)

*Data as of June 30.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 3

Bank of Ireland RACF [Risk-Adjusted Capital Framework] Data

(Mil. €)	**Exposure***	**Basel II RWA**	**Average Basel II RW (%)**	**Standard & Poor's RWA**	**Average Standard & Poor's RW (%)**
Credit risk					
Government and central banks	19,029	38	0	3,320	17
Institutions	7,975	1,538	19	2,371	30
Corporate	34,317	28,438	83	48,098	140
Retail	54,847	15,338	28	36,879	67
Of which mortgage	48,975	11,650	24	29,004	59
Securitization§	594	350	59	2,561	431
Other assets	2,510	3,000	120	4,839	193
Total credit risk	119,272	48,700	41	98,068	82
Market risk					
Equity in the banking book†	209	0	0	2,613	1,250
Trading book market risk	--	1,213	--	1,819	--
Total market risk	--	1,213	--	4,431	--
Insurance risk					
Total insurance risk	--	--	--	8,438	--
Operational risk					
Total operational risk	--	3,525	--	4,556	--

Table 3

Bank of Ireland RACF [Risk-Adjusted Capital Framework] Data (cont.)				
(Mil. €)	**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments				
RWA before diversification	56,413		115,493	100
Total Diversification/Concentration Adjustments	--		(3,445)	(3)
RWA after diversification	56,413		112,048	97
(Mil. €)	**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio				
Capital ratio before adjustments	6,991	12.4	4,131	3.6
Capital ratio after adjustments‡	6,991	12.4	4,131	3.7

*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, 2013, Standard & Poor's.

Risk position: Still-elevated credit risk

In the context of peers with a similar economic risk and product mix (we can compare BOI with Portuguese banks, among others, as well as with Irish banks) our assessment of BOI's risk position is "adequate." We take into account BOI's more favorable overall loss experience than some Irish peers because it generally avoided the worst excesses of commercial property and other lending. Still, net nonperforming assets by our calculations remain high at over 10% and we expect credit costs to remain a drag on earnings this year and next.

Like Irish peers, BOI has materially reduced its balance sheet in recent years (and, like AIB, has benefited from being able to transfer a meaningful portion--€10 billion--of some of the worst parts of its loan book to NAMA during 2009-2011). Reported gross customer loans have reduced by about one-third to £91.6 property and construction loans has fallen to 18% from 27%.

BOI's impairment charges remain well in excess of our estimated normalized losses, a measure of the long-term average credit-losses derived from our risk-adjusted capital framework. However, we don't overly penalize BOI's risk position because the trend is similar to Irish peers'.

Over the five years to 2013, we calculate by our measures that the average of BOI's ratio of new loan loss provisions to average loans was about 2.5%, compared to more than 4.0% across the Irish peer group. In the first half of 2014, we calculate that BOI's loss rate was 81 bps (but that the differential with peers is narrowing). The main areas of concern in BOI's loan portfolio, in our view, relate to Irish mortgages, small and midsize enterprises (SMEs), and commercial real estate lending.

BOI states that its stock of nonperforming loans is steadily declining. Nonperforming loans were €16.7 billion at June 30, 2014, down from a peak of €18.3 billion at June 30, 2013. We assume that this trend will continue, albeit slowly.

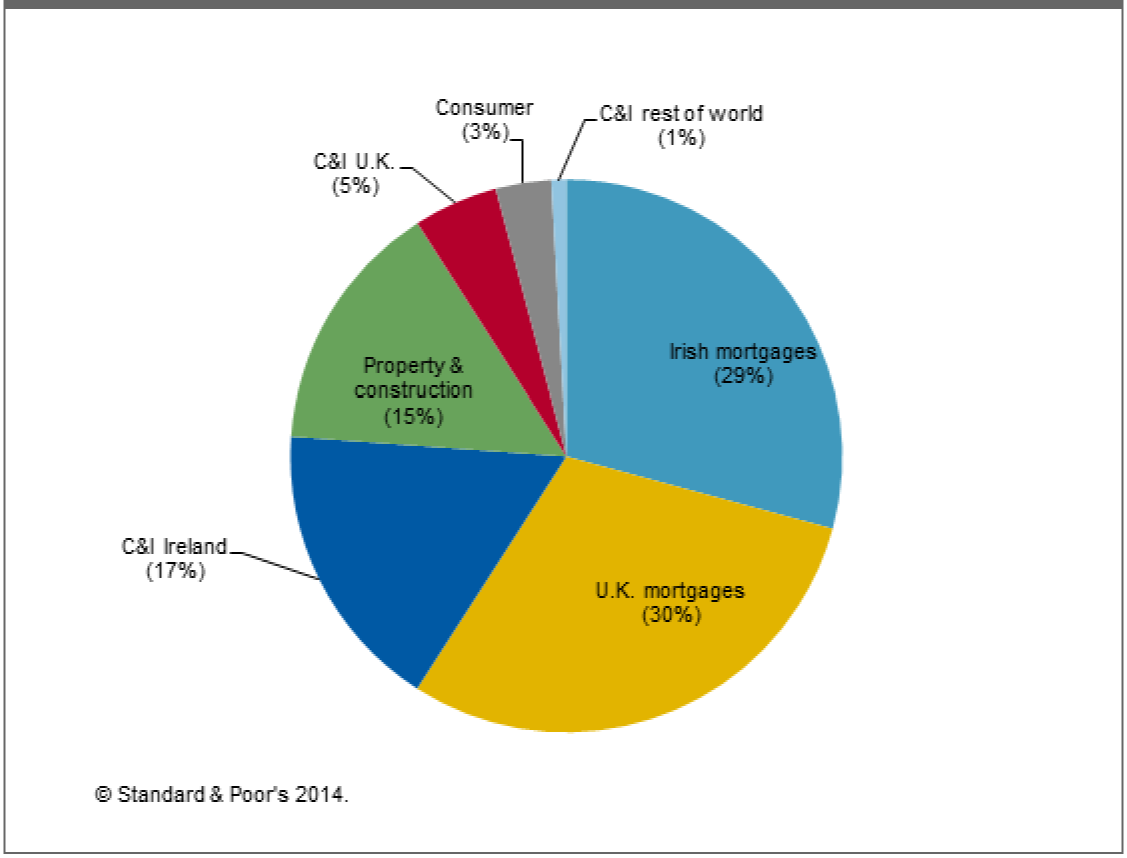
Residential mortgages account for a fairly high 59% of the net loan book and are split equally between Irish and U.K.

mortgages (see chart 2). While the profile of BOI's domestic mortgage book is broadly in line with the industry (for example BOI reports that 43% of this book was in negative equity at June 30, 2014), its arrears and forbearance rates are better than the industry average. Its vintage profile is a little better, too. BOI stated that 14.1% of its Irish mortgage book was nonperforming at June 30, 2014. While a very weak performance, this is better than Irish peers. The coverage of such loans improved to 51% at June 30, 2014, from 49% at year-end 2013.

In stark contrast, the asset quality of its large U.K. mortgage book appears to be holding up quite well. BOI's states that at June 30, 2.3% of its U.K. mortgages were nonperforming, which is broadly in line with the U.K. industry average. Provision coverage appears to be adequate at 22%.

Chart 2

Bank of Ireland Net Loan Book At June 30, 2014 (€83.4 Billion)



The 3% RAC framework diversification benefit gives some indication of the geographic diversity of BOI's activities. The RAC framework does, however, understate the risk weights for Irish buy-to-let mortgages (23% of BOI's gross domestic mortgage book at June 30, 2014), where arrears are higher. The RAC framework also understates the risk weights for BOI's Northern Ireland exposures, which attract a lower U.K. economic risk weight, but these exposures are not large in a group context.

Table 4

Bank of Ireland Risk Position					
		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Growth in customer loans	(2.6)	(7.4)	(7.3)	(10.1)	(10.7)
Total diversification adjustment / S&P RWA before diversification	N.A.	(3.0)	(3.0)	N.A.	N.A.
Total managed assets/adjusted common equity (x)	30.8	32.4	33.6	21.9	35.0
New loan loss provisions/average customer loans	0.8	1.7	1.7	1.7	3.5
Net charge-offs/average customer loans	1.0	1.1	0.7	0.5	0.6
Gross nonperforming assets/customer loans + other real estate owned	18.5	18.5	17.7	14.3	10.7
Loan loss reserves/gross nonperforming assets	49.3	48.1	42.6	41.2	39.3

*Data as of June 30.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Funding and liquidity: Trends are more favorable

We regard BOI's funding as "average" and its liquidity as "adequate." We believe that BOI has made good progress in recent years to better align its funding and liquidity profiles and that it has led the way among Irish banks in terms of re-establishing wholesale funding access, including senior unsecured issuance, and deposit pricing. We expect greater stability in funding and liquidity metrics.

BOI's reported loan-to-deposit ratio was 112% at June 30, 2014. This represents a meaningful improvement from the 175% reported at Dec. 31, 2010. BOI has a stated net loan book target of about €90 billion, but had dropped below that level to €83 billion at June 30, 2014. We believe that domestic credit demand remains muted and we don't expect loan balances to grow in the short term. Customer deposits are stable and therefore we expect little change in BOI's loan deposit ratio over the next two years. Customer deposits are largely sourced from retail customers, and are granular in nature. We also note that short-term senior unsecured debt maturities are small. U.K. Post Office balances, which are less seasoned, are about 23% of the total. Overall, BOI's funding profile compares quite well to the domestic industry average but is not materially superior, in our view. Our assessment of BOI's stable funding metric of 97% at Dec. 31, 2013, supports this view.

Borrowings from monetary authorities continue to fall. BOI reported that such funding was €6 billion at June 30, down from €8 billion at year-end 2013, and that about one-half of this total is used to fund NAMA senior bonds. Otherwise, short-term wholesale funding requirements appear modest and reported liquid assets are stable. Our metric of broad liquid assets to short-term wholesale funding was 1.4x at Dec. 31, 2013 (though this measure is slightly overstated due to asset encumbrance) and we expect this to remain comfortably over 1x.

Table 6

Bank of Ireland Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Core deposits/funding base	73.4	71.2	63.8	57.5	47.6
Customer loans (net)/customer deposits	113.0	115.2	124.9	144.3	176.1
Long term funding ratio	90.4	85.3	79.0	76.8	67.7

Table 6

Bank of Ireland Funding And Liquidity (cont.)					
Stable funding ratio	102.0	97.4	93.1	88.6	74.8
Short-term wholesale funding/funding base	10.3	15.6	22.2	24.7	34.1
Broad liquid assets/short-term wholesale funding (x)	2.2	1.4	1.1	0.9	0.4
Net broad liquid assets/short-term customer deposits	17.5	10.1	4.8	(4.9)	(43.2)
Short-term wholesale funding/total wholesale funding	38.6	54.2	61.3	58.1	63.0
Narrow liquid assets/3-month wholesale funding (x)	5.1	2.2	1.4	0.9	N/A

*Data as of June 30.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

External support: High systemic importance in Ireland

The long-term counterparty credit rating is one notch higher than the SACP, reflecting our view that BOI has high systemic importance in Ireland and the Irish government is "supportive" of the banking sector, as defined by our criteria.

We observe that European authorities are taking steps to increase the resolvability of banks and require creditors rather than taxpayers to bear the burden of the costs of failure. From January 2016, the Bank Recovery and Resolution Directive is set to introduce the mandatory bail-in of a minimum amount of eligible liabilities, potentially including certain senior unsecured obligations, before governments could provide solvency support.

Additional rating factors: None

No additional factors affect this rating.

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 August 15, 2014)	
Bank of Ireland	
Counterparty Credit Rating	BB+/Negative/B
Certificate Of Deposit	BB+/B
Junior Subordinated	B-

Ratings Detail (As Of August 15, 2014) (cont.)	
Preference Stock	B-
Senior Unsecured	B
Senior Unsecured	BB+
Subordinated	B
Counterparty Credit Ratings History	
29-Apr-2014	BB+/Negative/B
16-Jul-2013	BB+/Stable/B
20-Jan-2012	BB+/Negative/B
08-Dec-2011	BB+/Watch Neg/B
11-Jul-2011	BB+/Negative/B
02-Feb-2011	BB+/Watch Neg/B
26-Nov-2010	BBB+/Watch Neg/A-2
14-Sep-2010	A-/Negative/A-2
26-Jan-2010	A-/Stable/A-2
Sovereign Rating	
Ireland (Republic of)	A-/Positive/A-2

*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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