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Research Update:

Outlook On Permanent TSB Group Holdings PLC To Positive On Prospect Of Stronger Balance Sheet; Ratings Affirmed

December 21, 2021

Overview

- On Dec. 17, 2021, Permanent TSB PLC (PTSB) signed binding agreements with NatWest Group PLC (NatWest) and Ulster Bank Ireland DAC (Ulster Bank) to acquire about €7.6 billion of Ulster Bank's loan portfolio in Ireland. The deal is expected to complete in the second half of 2022, subject to regulatory and shareholders' approval. It would also increase PTSB's loan portfolio by about half, improving its domestic market position and easing its structural profitability problem.
- The capital consumption of the Ulster deal will likely be modest. Completion of PTSB's sale of a portfolio of nonperforming loans (NPLs) in the first quarter of 2022 and the Ulster Bank deal structure, with new shares issue and recognition of an accounting gain, will together support PTSB's solid capital position.
- Against the background of an improving economic environment, the NPL sale would mark further material progress in PTSB's efforts to address its overhang of poor asset quality.
- We revised the outlook on Permanent TSB Group Holdings PLC and its operating entity PTSB to positive and affirmed our ratings on them.
- The positive outlook indicates that the group has made progress in cleaning up its legacy problematic assets. We could upgrade the bank and the holding company within the next 12-18 months if we consider the group's capital, set against its risks, was positive for its rating.

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Rating Action

On Dec. 21, 2021, S&P Global Ratings revised to positive from negative its outlook on Permanent TSB Group Holdings PLC and Permanent TSB PLC. We also affirmed our 'BB-/B' long- and short-term issuer credit ratings on the holding company; our 'BBB-/A-3' long- and short-term issuer credit ratings on Permanent TSB PLC; our 'BBB/A-2' resolution counterparty rating (RCR); and our issue ratings.

Rationale

In our view, the portfolio acquisition could be transformational for the PTSB group in the medium to long term. The group entered into a binding agreement to acquire some of Ulster Bank's retail, small and midsize enterprise (SME), and asset finance business in Ireland, subject to approval by the relevant authorities and shareholders. This is in line with PTSB's strategic focus on mortgages and the expansion into SME business that it started several years ago. If executed as anticipated, the deal will materially increase the group's scale; its loan portfolio would be about 50% larger than it was at the end of 2020. In addition, PTSB's share of the Irish mortgage market will rise to over 20%, from 15% at the end of 2020.

In the medium- to long-run, the increased scale should support the group's revenue generation and dilute the weight of the bank's high-cost base. That said, increased scale alone is not sufficient. Like other Irish banks, PTSB will need to successfully implement cost-cutting initiatives (including optimizing its branch network and staff) to achieve lasting efficiency improvements. Given the rising regulatory costs and digital transformation that PTSB is undergoing, which still require significant investments, we consider substantial cost reduction will be difficult to achieve in the next two to three years. Furthermore, once the Ulster Bank deal is completed, operational costs will rise by about €50 million a year. Thus, although the group has ambitious return on equity (ROE) targets, we anticipate that its ROE will only improve to a still-modest 2.5%-3.0% by 2023. As a result, we consider PTSB management's ability to deliver on cost discipline and its returns strategy while demonstrating good business volume and a growing top-line (beyond the one-off improvement that Ulster Bank deal brings) to be critical to our future assessment of the group's business position.

Transformational acquisitions carry inherent execution risks and the PTSB–Ulster Bank deal is no exception. PTSB has no direct experience with such deals. However, of the assets to be acquired, most are Irish mortgages, which is PTSB's core market. We think PTSB can manage the associated execution risks. The successful transfer of the SME and asset finance portfolio, while demonstrating good client relationship management, will be key to PTSB's developing franchise in these business lines. However, this portfolio is relatively modest in size and the staff involved in these businesses could also move to PTSB, which would mitigate the integration risk for the SME portfolio.

Given the current deal structure and the NPL portfolio sale scheduled for execution in the first quarter of 2022, we anticipate that the transaction's effect on PTSB's solid capital position will be manageable. In particular, we forecast that our risk-adjusted capital (RAC) ratio will decline only moderately to 11.0% by end-2023, compared with our 11.4% estimate at end-2021, supported by:

- An improvement of about 50 basis points (bps) in the RAC ratio after the NPL sale closes;
- An estimated accounting gain when the Ulster Bank transaction closes, as the portfolio will be purchased at a discount to fair value on the assets to be acquired; and
- The issuance of hybrid instruments to fulfil regulatory buckets in 2022.

We are also mindful that part of the deal will be financed with equity--NatWest will end up with a 16.66% stake in PTSB Group.

We anticipate that PTSB Group will continue to benefit from a cushion of bail-inable instruments large enough to protect senior bondholders in a resolution scenario. Our additional loss-absorbing capacity (ALAC) ratio stood at 5.25% at end-2020 (2.6% at end-2019) and we forecast that this ratio will remain sustainably above our 4% threshold to qualify for one notch of uplift to the ratings on the main operating bank. The buffer is likely to comprise only a limited number of instruments. Therefore, we apply a higher threshold to PTSB than our standard 3%.

We anticipate that PTSB's asset quality metrics will improve further over the course of the next year and the group will remain committed to reducing this ratio further over the medium term. The NPL portfolio sale that is to close by the end of the first quarter of 2022 has a gross balance sheet value of €390 million. The sale will improve PTSB's NPL ratio to about 5% of the gross loan portfolio from the current 6.9%. Furthermore, the performing assets acquired in the Ulster Bank deal will dilute the weight of the remaining legacy assets, reducing the NPL ratio to well below 5% of gross loans.

PTSB's newly generated portfolio largely comprises residential mortgages of robust asset quality. We have not observed any deterioration in underwriting standards over the past two years, despite concerns over COVID-19-related risks. The economic risk trend for the Irish banking sector is positive, which supports overall economic recovery and asset quality improvement in the system.

As the Ulster Bank deal closes, we expect current strong funding and liquidity metrics to move closer to peers' average level. For example, we expect the group's loan-to-deposit ratio to increase to around 100% from 77% at mid-2021. We anticipate that customer deposits will continue to grow but that the group will have to issue more than €1 billion in wholesale debt to fund the Ulster Bank transaction and meet its minimum required eligible liabilities (MREL) requirements.

Outlook

The positive outlook on Permanent TSB Group Holdings and Permanent TSB PLC, the main operating entity, primarily indicates that the group is continuing to make progress in reducing its NPLs. Combined with the manageable capital impact associating with acquiring Ulster Bank's portfolios, this could result in the group's risk-adjusted capital becoming a positive rating factor over the next 12-18 months.

The acquisition of Ulster Bank's portfolio will significantly strengthen the group's business and could improve its profitability. That said, returns will remain modest over the next couple of years--ROE will only reach 2.5%-3.0% by 2023.

Upside scenario

We could consider raising the rating over the next 12-18 months, on both the operating entity and the holding company, if the group's risk profile improved as expected and the group preserved its solid capital position.

Downside scenario

We could revise the outlook to stable if we foresee some deterioration in underwriting standards or the integration poses managerial challenges.

Ratings Score Snapshot

Permanent TSB PLC (operating entity)

Issuer credit rating: BBB-/Positive/A-3

Resolution counterparty rating: BBB/--/A-2

Permanent TSB Group Holdings PLC (HoldCo)

Issuer credit rating: BB-/Positive/B

Group stand-alone credit profile: bb+

Anchor: bbb

- Business position: Constrained (-2)
- Capital and earnings: Strong (+1)
- Risk position: Moderate (-1)
- Funding and liquidity: Adequate and adequate (0)
- Comparable rating analysis: 0

Support:+1

- ALAC support: 1
- GRE support: 0
- Group support: 0
- Sovereign support: 0

Related Criteria

- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019

- 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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Permanent TSB's Deal With NatWest Complements Its Growth And Diversification Strategy, July 23, 2021
- Ratings On Irish Banks Affirmed Amid Ongoing Profitability Pressure; Most Outlooks Still Negative, June 24, 2021

Ratings List

Ratings Affirmed		
Permanent TSB PLC		
Resolution Counterparty Rating	BBB/--/A-2	
Permanent TSB Group Holdings PLC		
Senior Unsecured	BB-	
Ratings Affirmed; Outlook Action		
	To	**From**
Permanent TSB Group Holdings PLC		
Issuer Credit Rating	BB-/Positive/B	BB-/Negative/B
Permanent TSB PLC		
Issuer Credit Rating	BBB-/Positive/A-3	BBB-/Negative/A-3

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. 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/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on 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.