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Ratings

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Various Positive Rating Actions Taken On Irish Banks On Reduced Economic Risk

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OVERVIEW

- Brisk economic growth and the sustained recovery in property prices are, in our opinion, starting to feed through to the creditworthiness of the Irish banks in a more meaningful way.
- As a result, we have improved our assessment of economic risk, and the starting point or anchor for rating Irish banks.
- We see a stable trend for both economic risk and industry risk.
- We are therefore raising the ratings on Bank of Ireland, Allied Irish Banks, and Permanent TSB. The outlook on each bank is stable.
- We are affirming the ratings on foreign-owned Ulster Bank Ireland and KBC Bank Ireland. The outlook on each bank is stable.

RATING ACTIONS

On Jan. 13, 2017, S&P Global Ratings took various rating actions on Irish banks. Specifically, we:

- Raised the long- and short-term counterparty credit ratings on Bank of Ireland (BOI) to 'BBB/A-2' from 'BBB-/A-3'. The outlook is stable.
- Raised the ratings on Allied Irish Banks PLC (AIB) to 'BBB-/A-3' from 'BB+/B'. The outlook is stable.
- Raised the ratings on Permanent TSB PLC (PTSB) to 'BB/B' from 'BB-/B'. The outlook is stable.
- Affirmed the 'BBB/A-2' ratings on Ulster Bank Ireland DAC (UBI). The outlook remains stable.

- Affirmed the 'BBB-/A-3' ratings on KBC Bank Ireland PLC (KBCI). The outlook remains stable.

RATIONALE

The rating actions reflect our view that economic risks have decreased for Irish banks, as we believe that brisk economic growth and the sustained recovery in property prices are helping to reduce the negative impact of past economic imbalances.

As a result we have raised the anchor, the starting point for rating a typical Irish bank, to 'bbb-' from 'bb+'. An improved economic risk score also reduces the risk-weightings for Irish exposures within our risk-adjusted capital (RAC) framework. For example, the risk weighting for Irish mortgages reduces to 45% from 54%. We have incorporated these revised assumptions into our ratings on the five rated Irish banks, as explained further below.

We now believe that the Irish economy is in an "expansionary phase" in contrast to our previous view of a "correction phase". Over the next two-to-three years we assume relatively brisk economic growth and continued property price inflation. We also believe that 2016 was the last year of material loan book deleveraging, and assume that total loan growth will turn positive by 2018.

We assume that Ireland's real GDP will have increased by about 3.5% in 2016. We forecast a real GDP growth rate of 3.0% in 2017-2019. We will continue to keep a close eye on any impact on the Irish economy following the U.K.'s referendum vote to leave the EU. While its exact form remains unknown, Brexit could have a notable negative effect on Ireland's economic and fiscal performance over the medium term.

Nationally, house prices rose by 7.1% over the 12 months to October 2016 according to official data, maintaining the steady recovery since the trough in early 2013. Commercial property capital values have also improved, and office vacancy rates have fallen. This sector remains a risk for the Irish banking system given our estimate that about 14% of loans are construction and property loans and around 15%-20% of these are riskier land and development books, which we believe is a high proportion.

We assume flat total credit growth in 2017, rising to about 1% in 2018. Credit growth has been negative in Ireland since the financial crisis. In recent months, however, we have observed positive credit growth in consumer credit. Mortgage loans, which account for the vast majority of household debt, continued to decrease during 2016, as has lending to non-financial corporations. We expect business lending in particular, however, to pick up, as long as the brisk pace of economic growth is maintained.

Against this favorable backdrop we assume domestic system-wide credit losses to have been exceptionally low in full-year 2016, with net provision releases for the third straight year. This compares with our assumption in our August

2016 Banking Industry Country Risk Assessment (BICRA) publication of 25 basis points (bps) of credit losses in 2016. The minimal impact of Brexit, to date, helps to explain the difference. For 2017 and 2018 we maintain our view of a more normal level of around 30 bps credit losses.

The banking system's large stock of nonperforming loans (NPLs; defined as impaired loans plus loans that are 90 days past due but are not impaired) and still high level of mortgage arrears (including a resilient bunch of very long-term 720 days plus arrears) remain among the most significant challenges facing the industry. We estimate that NPLs will account for around 16% of domestic systemwide loans at end-2016 (down from a peak of around 35% at end-2013) although provision coverage of NPLs at around 50% appears satisfactory. While we expect further reduction in NPLs (we assume to about 12% by end-2018), a more material reduction appears unlikely 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 a hurdle to rapid reductions in NPLs.

Provision releases and a recovery in net interest margins (NIM) have helped most Irish banks to return to profitability at a satisfactory level. In our opinion, a number of factors may act as a brake on a further improvement in industry profitability henceforth:

- We expect future NIM expansion to be modest as long as interest rates remain low. Low interest rates make the large low margin tracker mortgage portfolios a particular pain point. In addition, we understand there is some public and political pressure on Irish banks to reduce pricing on standard variable rate mortgages and near-term net loan growth is expected to remain subdued.
- Margins will be impacted as Irish banks gradually build up their minimum requirement for own funds and eligible liability (MREL) requirements. Margins currently benefit from the relative absence of debt securities and subordinated instruments.
- While Irish banks have done much work to "right size" their operations for a smaller loan book and footprint, we believe that they will need to continue to invest in their digital capability and other operational requirements.
- There is the possibility of exceptional charges such as customer redress related to the Central Bank of Ireland's ongoing industrywide investigation on documentation and disclosure for legacy tracker mortgages.

Finally, we note that the Irish banking system is dominated by wholly or partly government-owned institutions and we expect this to remain the case for a few more years. The government has reduced its stake in PTSB to 75% following the successful capital raise in early 2015. Otherwise there has been little progress of note since the re-capitalization of the sector in 2011; in particular there is no clear evidence of when the sale of the first tranche of

AIB's shares will occur. That said, we acknowledge that 2016 was a difficult year for European banks' equity valuations in general.

OUTLOOKS

BOI

We have maintained our stand-alone credit profile (SACP) at 'bbb'. We have removed the one-notch negative adjustment within the counterparty credit rating, as we believe that the financial performance and prospects of the bank have normalized and are now in line with European peers rated at the same level.

The stable outlook on BOI reflects our expectation that the bank will continue to steadily reduce its NPL ratio to a mid-single-digit level over the two-year outlook timeframe, and that its relatively large U.K. business will not be a source of weakness for the group.

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

A lowering of the ratings is deemed relatively unlikely at this time but could arise if its business and earnings predictability falters.

AIB

We have raised AIB's SACP by one notch to 'bbb-' from 'bb+' to reflect the improvement in its anchor.

The stable outlook reflects our view of AIB's stable intrinsic creditworthiness and our expectation that it will continue making steady progress in reducing its stock of NPLs to levels more aligned with that of peers in the coming 18-24 months.

We could lower the ratings on AIB if we observed that the 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.

We could upgrade AIB if we observed that its capitalization, as measured by our RAC ratio, improved to a level sustainably above 10% and NPLs continued to reduce to levels more in line with those of peers, in particular domestic peer Bank of Ireland. Although less likely at this stage, an upgrade could also arise if we included one notch of ALAC support in our long-term rating on AIB. The bank's ALAC buffer would need to increase substantially to exceed the required thresholds (5% for a bank with an anchor of 'bbb-').

The stable outlook on AIB Group (U.K.) PLC (AIB UK), AIB's wholly owned subsidiary, continues to reflect our view of its consistent intrinsic creditworthiness.

PTSB

We have raised PTSB's SACP by one notch to 'bb' from 'bb-' to reflect an improvement in its anchor.

The stable outlook reflects our view that PTSB's operating performance and earnings capacity will gradually recover over the next 12-18 months.

We could raise the ratings if we observed an earlier return to statutory profitability and evidence of solid business generation, which would indicate that the bank's business model is sustainable, and if we observed improvements in its funding profile to a level sustainably closer to that of peers.

Although less likely, an upgrade could also follow if we perceived a clear path to the group building a sufficiently large ALAC buffer over our two-to-four-year projection period. This would only benefit the ratings on the operating company, PTSB, because ALAC support would not accrue to the non-operating holding company's creditors due to structural subordination.

We could lower the ratings if PTSB's path to earnings recovery became derailed, or if we perceived that PTSB's franchise had been negatively affected by its prolonged restructuring, indicated by reducing market shares and even weaker profitability in its core banking proposition.

UBI

We have affirmed our ratings on UBI and maintained the outlook as stable, based on our assessment of the entity's highly strategic importance to the Royal Bank of Scotland group. At the same time, we assess UBI's SACP as 'bb+'. The SACP reflects the entity's well established franchise as the third-largest bank in the Republic of Ireland; its strong capitalization balanced against some concentration in its exposures, particularly to tracker mortgages; and its sound funding and liquidity position.

The stable outlook on UBI reflects our stable view of the supported group credit profile (GCP) of the Royal Bank of Scotland PLC (RBS), UBI's ultimate parent. An upgrade or downgrade of RBS would result in a similar action on UBI.

We could also consider an upgrade if we revised UBI's group status to core from highly strategic, which would enable us to equalize the ratings on UBI with RBS. Such an assessment would primarily require UBI to demonstrate operating performance and a risk profile in line with that of the parent.

KBCI

KBCI's SACP remains unchanged at 'bb'.

The stable outlook on KBCI balances our view that, over the coming 18-24 months, it will remain profitable and its projected RAC ratio will remain above 7%, against the very large stock of NPAs.

We continue to view the bank as a strategically important subsidiary of Belgium bancassurance group KBC, while we understand that the group plans to publicly communicate its strategic plans for its Irish business in the first quarter of 2017.

While we view KBCI's strategy as logical, we still consider management's attempt to reposition the KBCI franchise as a work in progress. We could therefore lower the ratings if we believe that the bank is lagging behind its peers in terms of working through its large stock of NPLs, or if we consider that management is unlikely to develop KBCI into a retail-focused bank that can generate solid business while remaining profitable on a statutory basis.

We could also take a negative action if we observe that the links between KBCI and KBC are weakening and if KBC decides that Ireland is no longer a strategic priority, which could lead us to revise our group status assessment and the uplift for potential group support that we factor into our ratings on KBCI. Group support from KBC--both extraordinary and ongoing support--is key to KBCI's investment grade ratings.

Although less likely, we could raise the ratings on KBCI by removing the negative adjustment notch, if we see strong indications that the bank is making significant progress in working through its NPLs while generating recurring and sustainable profits, which would indicate the strategic repositioning is working successfully. We could also upgrade KBCI within the coming 18-24 months if we observe that capitalization, as measured by our RAC ratio is sustainably maintained at a level exceeding 10%.

BICRA SCORE SNAPSHOT*

Ireland	To	From
BICRA Group	5	6
Economic risk	5	6
Economic resilience	Low risk	Low risk
Economic imbalances	Intermediate 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 risk
Systemwide funding	High risk	High risk
Trends		
Economic risk trend	Stable	Stable
Industry risk trend	Stable	Stable

*Banking Industry Country Risk Assessment (BICRA) 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

- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments, Oct. 24, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

RELATED RESEARCH
- Banking Industry Country Risk Assessment: Ireland, Jan 13, 2017

Ratings List

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

Upgraded; CreditWatch/Outlook Action

	To	From
Allied Irish Banks PLC		
Counterparty Credit Rating	BBB-/Stable/A-3	BB+/Positive/B
Senior Unsecured	BBB-	BB+
Subordinated	BB	B+
Commercial Paper	A-3	B
Allied Irish Banks N.A. Inc.		
Commercial Paper*	A-3	B
Commercial Paper*	BBB-	BB+

Ratings Affirmed

AIB Group (U.K.) PLC	
Counterparty Credit Rating	BB+/Stable/B
Allied Irish Banks PLC	
Subordinated	D

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Upgraded; CreditWatch/Outlook Action

	To	From
Bank of Ireland		
Counterparty Credit Rating	BBB/Stable/A-2	BBB-/Positive/A-3
Certificate Of Deposit		
Local Currency	BBB	BBB-
Senior Unsecured	BBB	BBB-
Subordinated	BB+	BB
Junior Subordinated	BB-	B+
Preference Stock	BB-	B+
Commercial Paper	A-2	A-3
Bank of Ireland U.K. Holdings PLC		
Junior Subordinated	BB-	B+

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Ratings Affirmed

KBC Bank Ireland PLC	
Counterparty Credit Rating	BBB-/Stable/A-3
Commercial Paper**	A-1

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Upgraded; Ratings Affirmed

	To	From
Permanent TSB PLC		
Counterparty Credit Rating	BB/Stable/B	BB-/Stable/B
Certificate Of Deposit		
Local Currency	BB	BB-
Senior Unsecured	BB	BB-

Permanent TSB Group Holdings PLC		
Counterparty Credit Rating	B+/Stable/B	B/Stable/B

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Ratings Affirmed

Ulster Bank Ireland DAC	
Counterparty Credit Rating	BBB/Stable/A-2
Certificate Of Deposit	BBB/A-2

* Guaranteed by Allied Irish Banks PLC
** Guaranteed by KBC Bank N.V

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