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Merely A Win, No Grand Slam Glory For Irish Banks

March 26, 2018

Ireland may be basking in recent Rugby Union Grand Slam glory but banks in the Republic of Ireland have only achieved one victory, in rating terms, over the past year. The 2017 results recently published by rated banks in Ireland reinforce our view that the country's banking system is steadily rebuilding its creditworthiness. We believe that its industry risk profile has the potential to be less of a negative outlier relative to other eurozone banking systems.

Even so, we believe that Irish banks are still not back to "business as usual". The 2017 results highlight that Irish banks continue to work through legacy problems while new challenges are emerging. The principal legacy issue remains the workout of their large stock of nonperforming loans (NPLs) through a combination of cures, restructures, write-offs, and selective portfolio sales.

However, deleveraging on its own cannot lead to glory. As banks seek to grow their balance sheets and garner new business, they also have to adapt to the changed world of banking that has emerged while they were tied up dealing with their past mistakes. These challenges include more demanding requirements from customers and regulators, and the need for an enhanced digital capability. Operating in a small market, Irish banks will have to work extra hard to better adapt their cost base in a low interest rate environment.

We reflected our expectation of improved financial performance in our Dec. 12, 2017 rating action on the two largest banking groups, AIB and Bank of Ireland, at which time we revised our outlooks on them to positive from stable. We also improved and then ascribed a positive trend to our view of industry risk, which if it materializes, would lead us to revise upward our anchor, the starting point for rating a typical Irish bank, to 'bbb' from 'bbb-' currently. Indicative of the brisk pace of recovery in the creditworthiness of Irish banks, we raised this anchor to 'bbb-' from 'bb+' in January 2017.

Key Takeaways

- Full-year 2017 results reinforced our view that the Irish banking system is steadily rebuilding its creditworthiness.
- NPL ratios continue to decline but will remain relatively high, absent more significant work-out or portfolio sales.
- Selected upgrades may arise from further industrywide improvements; some operating bank ratings may be raised if minimum requirement for own funds and eligible liabilities (MREL) issuance progresses sufficiently for us to incorporate a notch of additional loss absorbing capacity (ALAC) uplift into those ratings.

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Buoyant Economy Could Give Banks An Advantage In 2018-2019

We think that the scope for further net interest margin (NIM) improvement has now passed and, in most cases, doubt that provision releases will continue to support earnings. We expect all of the banks to make good progress toward meeting their nonperforming exposure (NPE) targets, as set by their regulator, although the scale of the effect on their capitalization, if any, is unclear. Increased capital distributions may also temper further improvements in our risk-adjusted capital metrics. We regard capitalization as either credit neutral or credit negative in our rating assessment, as we temper the banks' strong risk-adjusted capital (RAC) ratios with our view of their high stock of NPLs, among other factors.

Irish banks' high NPL levels remains a key relative weak spot despite good progress in 2017, in which total NPLs reduced by almost one quarter, by our calculations. Still, we estimate that about 21% of domestic loans were nonperforming at end-2017 by our measures, albeit down from around 26% at end-2016. Forecasting the pace of reductions in 2018 is especially hard given that several banks have announced planned portfolio sales. Supportive factors for these sales is the still buoyant Irish economic recovery--we assume real Irish GDP growth will be 2.6% in 2018--and the strengthening property market--we assume nominal house price inflation of 8.5%. That said, current data implies a risk of a more rapid acceleration, which could be a cause for concern. Finally, the multi-year decline in total credit balances seems to have reached an end-point toward the start of 2018. As the year progresses, we assume positive total credit growth for the first time since the 2008 global financial crisis.

Creditworthiness Lagging Eurozone Peers

Debt issuance for MREL purposes may pick up now that non- operating holding companies (NOHC) have been established by AIB and Bank of Ireland. Indeed, Bank of Ireland Group PLC issued two MREL instruments in September 2017, and in March 2018, AIB Group PLC issued the first Irish NOHC issue. None of the banks rated by S&P Global Ratings currently benefit from ALAC uplift, in part, because we seek greater confidence in their issuance capability and overall creditworthiness. We would only apply a positive adjustment notch for ALAC to the ratings on the operating banks, which undertake the systemically important operations. We would not take this approach to rating NOHCs as we think they are more likely to default in a resolution scenario.

Debt issuance for MREL purposes may pick up now that NOHCs have been established by AIB and Bank of Ireland.

Compared with its eurozone peers, Irish banks still lag most in terms of creditworthiness. The anchors for Western European banks in the eurozone typically range from 'bbb+' to 'a-'. The exceptions, in addition to Ireland, are Spain (with a 'bbb-' anchor), Italy ('bbb-') and Portugal ('bb'). In our view, risks to Irish banks remain unchanged, namely that the seemingly robust domestic economic outlook will be challenged by the U.K. exiting the EU, given the strong direct trade relationships. Additionally, the low interest rate/low credit growth environment is very unlikely to support good bank earnings.

An improvement in our anchor assessment would require the banking system to demonstrate that it is able to maintain a retail funding profile as lending growth recovers, and if we see further evidence of wide, affordable access to the wholesale markets. We would also need to gain confidence that the ongoing recovery in pre-provision profitability will not reverse.

Profitability Becoming The Norm

The latest results from Irish banks show that nearly all were profitable in 2017. Common themes in the year's results were: improved NIMs but generally flat pre-provision income; very low loan impairment charges or, in some cases, provision releases; and statutory profit being typically weighed down by exceptional charges in relation to the Central Bank of Ireland's (CBI) Tracker Mortgage Examination. In terms of the balance sheet, loan books and total assets continued to decline; regulatory capital ratios typically improved despite dividend payments; and funding metrics improved (see table 1).

Loan books and total assets continued to decline while regulatory capital ratios and funding metrics improved.

For the purpose of this report, we have excluded the financials of the sixth rated bank, Barclays Bank Ireland PLC (BBI), a small bank that remained profitable throughout the financial crisis and remains so. We consider BBI to be core subsidiary of ultimate parent Barclays and we therefore equalize the ratings on BBI with other core operating companies of the group, including Barclays Bank PLC.

Table 1

Results Summary for 2017

(Mil. €)	AIB	BOI	PTSB	Ulster
Total assets (reported)	90,062	122,554	22,773	30,248
% change v 2016	(5.8)	(0.1)	(3.5)	(1.5)
Operating revenues	2,940	3,007	444	608
% change v 2016	10.1	(5.1)	2.3	(7.9)
Preprovision operating income	1,490	923	124	117
Pretax profit	1,306	852	52	(168)
S&P Global Ratings core earnings	1,386	734	60	28
Net interest income/average earnings assets (%)	2.60	2.25	1.64	1.56
Noninterest expense/revenues (%)	49	69	72	81
New loan loss provisions/average customer loans (%)	(0.19)	0.02	0.23	0.29
Texas ratio* (%)	81	85	157	56
S&P Global Ratings core earnings/revenues (%)	47.2	24.4	13.5	4.6
Net income/average assets (%)	1.20	0.56	0.17	(0.53)
Customer loans (net)/customer deposits (%)	93.0	100.5	108.1	110.8
Reported common equity Tier 1 (%)-fully loaded	17.5	13.8	15.0	31.2

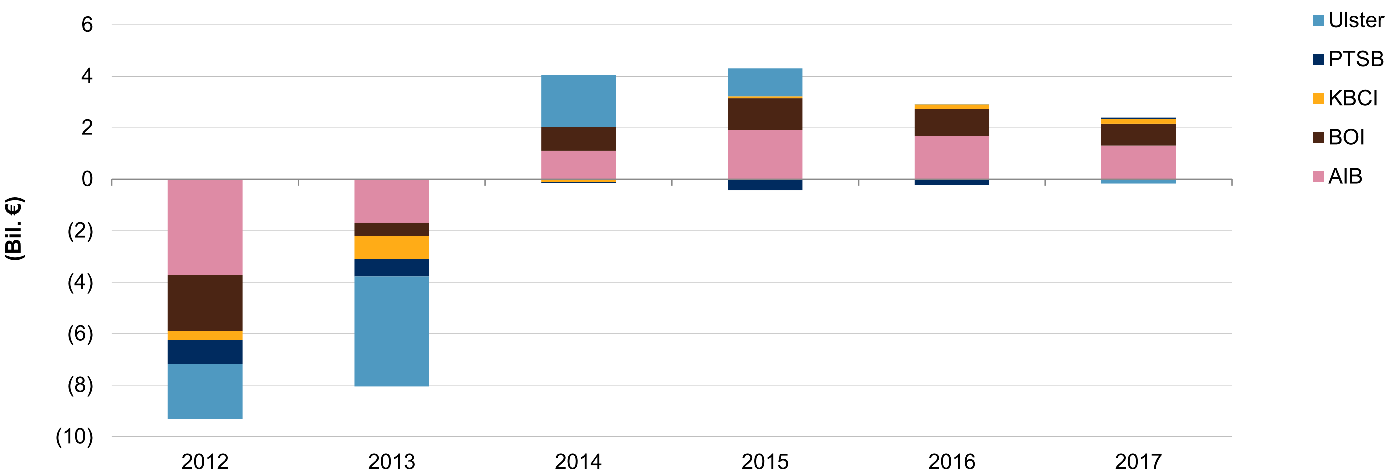
Source: S&P Global Ratings database. *Texas ratio is computed as gross nonperforming loans to loan loss reserves plus tangible common equity. Note: Sufficient KBCI data has yet to be published.

Ulster Bank Ireland DAC was the only bank to report a statutory loss for 2017. This was largely due to a conduct charge of €192 million, of which €87 million was directly related to the CBI's Tracker Mortgage Examination. Among the other banks, KBC Bank Ireland, which has yet to publish its full statutory accounts, reported an exceptional provision of €116 million in relation to the Tracker Mortgage Examination but was able to report a net profit of €183 million following large loan impairment releases. Bank of Ireland incurred a tracker charge of €170 million; AIB and PTSB had booked large provisions in prior years.

Of note, PTSB reported its first statutory pre-tax profit in 10 years. The system's profit trend since the nadir of the banking system in 2011 has been mixed, with trends distorted by the timing of provision releases (see chart 1). Leaving aside the tracker charges, we think that banks' 2017 earnings performance is broadly indicative of the likely performance over the next two years.

Chart 1

Reported Statutory Profit Before Tax (PBT)

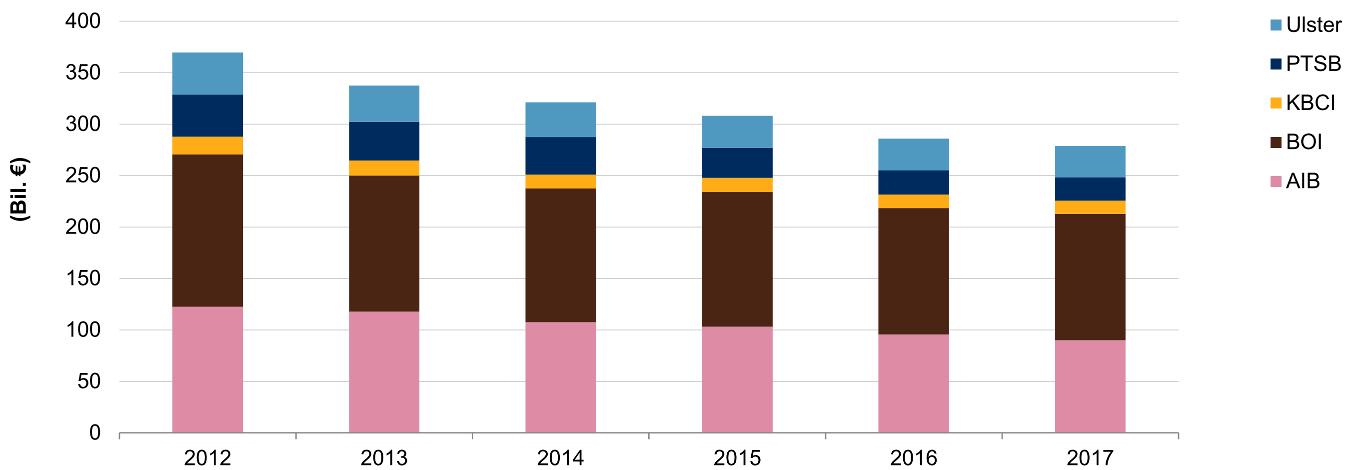


Source: S&P Global Database. KBCI 2017 data is based on reported net income.

We consider that a material improvement in earnings will be difficult to achieve because balance sheets have shrunk (see chart 2). Since 2012, the peer group's total assets have shrunk by one-quarter. More recently, the pace of asset decline has slowed and we assume a gradual increase henceforth, notwithstanding possible NPL portfolio sales. Combined with the low interest rate environment--and the large low-margin tracker mortgage portfolios are a particular pain-point in this respect--it will be hard to imagine much net interest income growth absent a stronger pick-up in interest earnings assets. Margins will also be hit as Irish banks gradually build up their MREL stack.

Chart 2

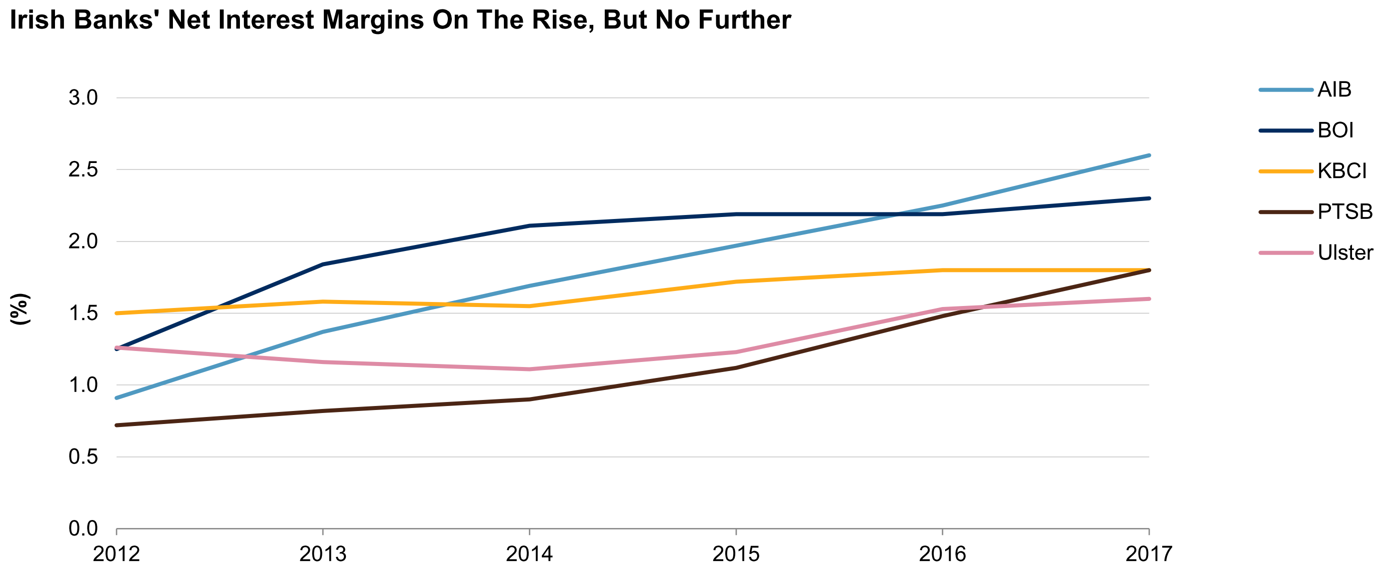
Steady Decline In Irish Banks' Total Assets



Source: S&P Global Database. KBCI 2017 data based upon our estimate.

Reported NIMs have increased every year since 2012, mainly due to sharp reductions in the cost of funds. We see little scope for cost of funds to reduce further and future widening of asset spreads looks tough to achieve; for example, new mortgage lending competition has been heating up and both AIB and Bank of Ireland have signaled a slight softening in their NIM outlook.

Chart 3



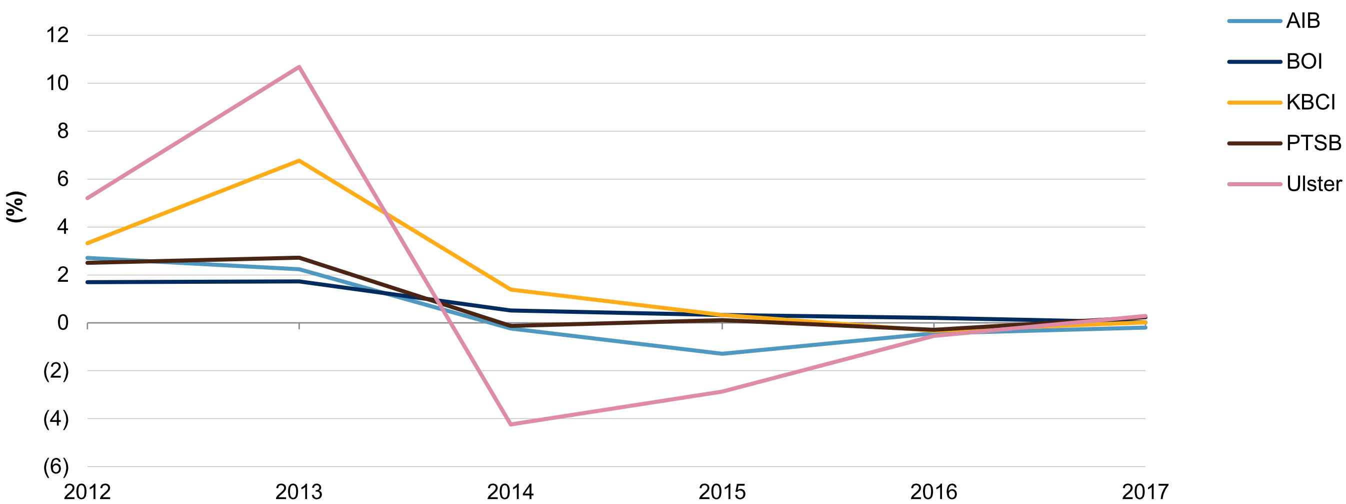
Source: Company accounts. Excludes the negative impact of the Eligible Liabilities Guarantee Scheme (ELG). Note: KBCI and Ulster do not state their net interest margins. We have input our calculation as per our database. KBCI's 2017 ratio is derived from quarterly disclosures.

Smaller balance sheets also have implications for the cost base. Irish banks have become well versed in managing their cost base since 2008 and are making strides to invest in their systems and customer propositions. Even so, measured by noninterest expense to average assets, Irish banks lag stronger peer systems. In 2017, this metric ranged from 1.4% to 1.9% across the four largest banks, and in each case is higher than it was in 2013. In contrast, and indicative of the journey still to be traveled by Irish banks, the mean for selected Swedish, U.K., and Dutch banks is about 0.9%, 1.0%, and 1.3%, respectively.

The year 2017 was the fourth consecutive one with either net provision releases or low credit losses, as a result of provision write-backs and limited needs for new provisions (see chart 4). We calculate that the industrywide loan-loss rate on domestic lending in 2017 was about a mere 2 basis points (bps). This is a bit lower than our estimate of 20 bps in our "Banking Industry Country Risk Assessment: Ireland" report published on Dec. 12, 2017 partly due to good performance in consumer credit portfolios. We continue to assume an industrywide loss rate of about 20 bps for 2018 and 30 bps for 2019, on the assumption that further net provision write-backs have largely run their course.

Chart 4

Loan Loss Rates Set To Rise



Source: S&P Global Ratings database. Loan loss rates are computed as new loan loss provisions to average loans. KBCI has yet to publish its 2017 statutory accounts. The 2017 data in this chart is based upon the Ireland division within KBC Group's results and may not be fully comparable to previous years.

Domestic Economy Still Propping Up Bank Earnings

The gradual recovery in bank creditworthiness has principally been supported by the recovery in the Irish economy and the related rise in employment levels and property prices, as opposed to significant intrinsic improvements by the banks.

Recent data published by the Central Statistics Office (CSO) suggests that Irish GDP rose by a high 7.8% in 2017. Irish data does demonstrate volatility and the CSO has produced an alternate measure to estimate the size of annual economic output that would exclude activities with limited domestic links. This measure is a modified gross national income, denoted as "GNI*", which was first published in mid-2017. GNI*, which will be published annually, is reported to be about two-thirds the size of reported GDP. The latest monthly unemployment rate is 6.0%, down from 7.3% a year before, and has reduced significantly from the peak of over 15% in 2012.

In a similar vein, the latest reported annual house price growth is high at 12.5% and prices have increased by 73% since the 2013 trough. That said, the national index is still 22% lower than its 2007 peak. We view the Irish housing market as still being in recovery mode and note that it is not a credit-fueled bubble. The property price recovery has largely been the result of a large gap between demand and supply, in our view, and there is scant evidence of a meaningful pick up in housing completions. As a result, a continuation of house price appreciation seems likely in the short term, although we assume this will peter out--we estimate nominal growth of 6% in 2019--whereas sustained growth above 10% could be a cause for concern in our banking industry country risk assessment.

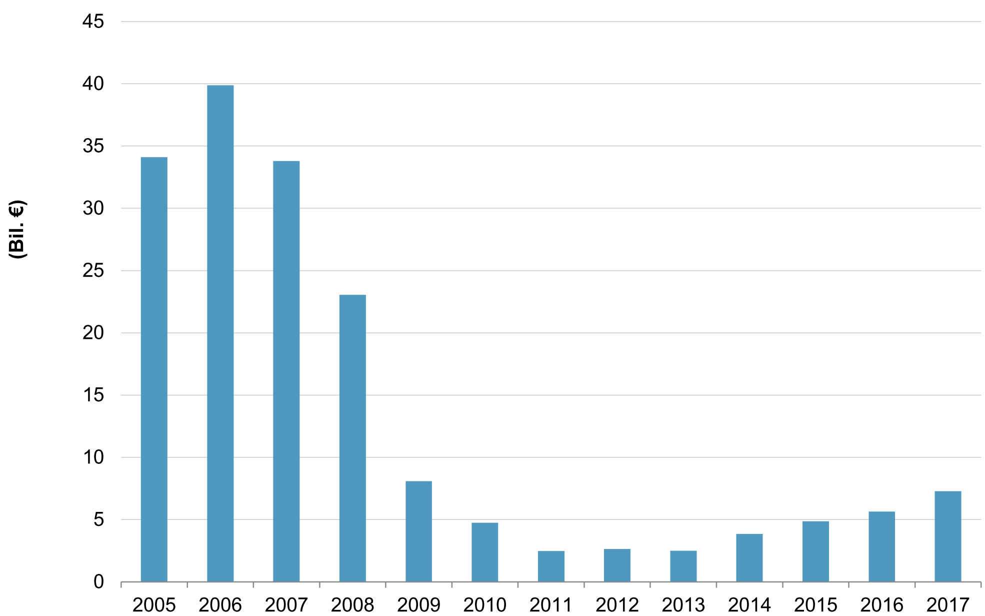
The Irish housing market is still in recovery mode and we note that it is not a credit-fueled bubble.

Domestic loan books continued to contract in 2017. According to CBI data, as of early 2018, residential mortgage book credit growth has been flat year-on-year, and remains in positive territory for the smaller consumer credit portfolios. Lending data for non-financial corporations will always be more volatile but there are tentative signs of growth. We expect total credit growth to continue throughout 2018.

Illustrative of the gradual recovery in lending was the 29% increase in gross mortgage volumes in 2017 versus 2016. That said, the 2017 volume of €7.3 billion remains well-below the figures reported prior to 2009 (see chart 5).

Chart 5

Gross Residential Mortgage Lending Slowly Recovering

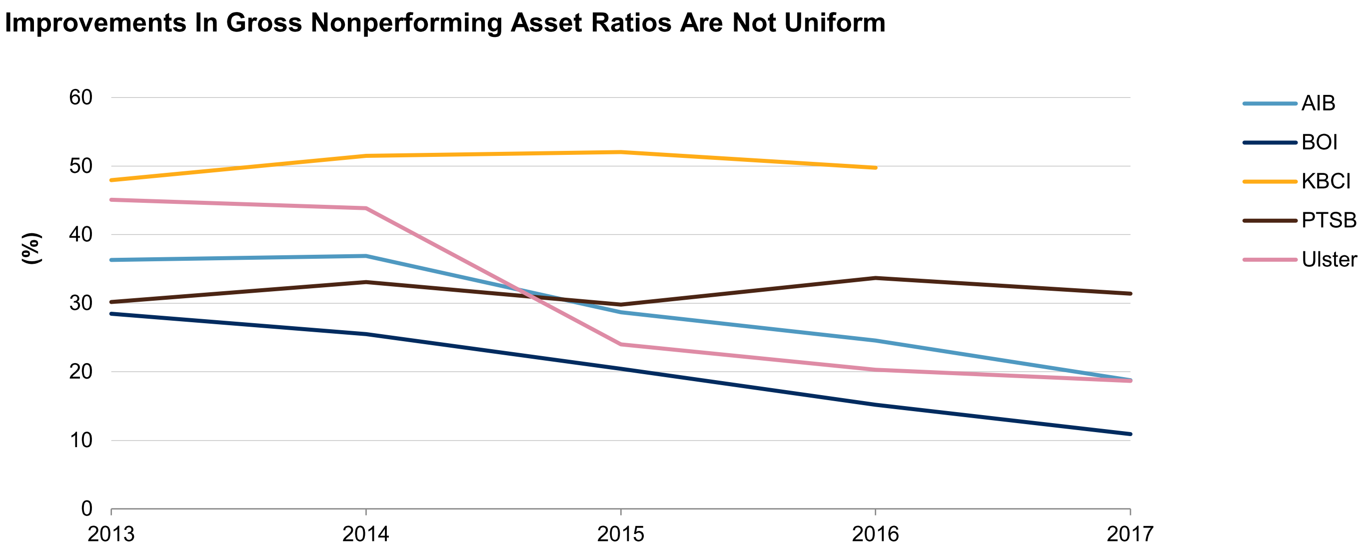


Source: Banking & Payments Federation Ireland

Asset Quality Improvement Still Some Way From The Touch-Line

Notwithstanding four years of improving asset quality, Irish banks' stock of domestic NPLs remains an ongoing credit concern, being one of the higher levels among European banking systems. Individual bank NPL ratios remain high (see chart 6).

Chart 6



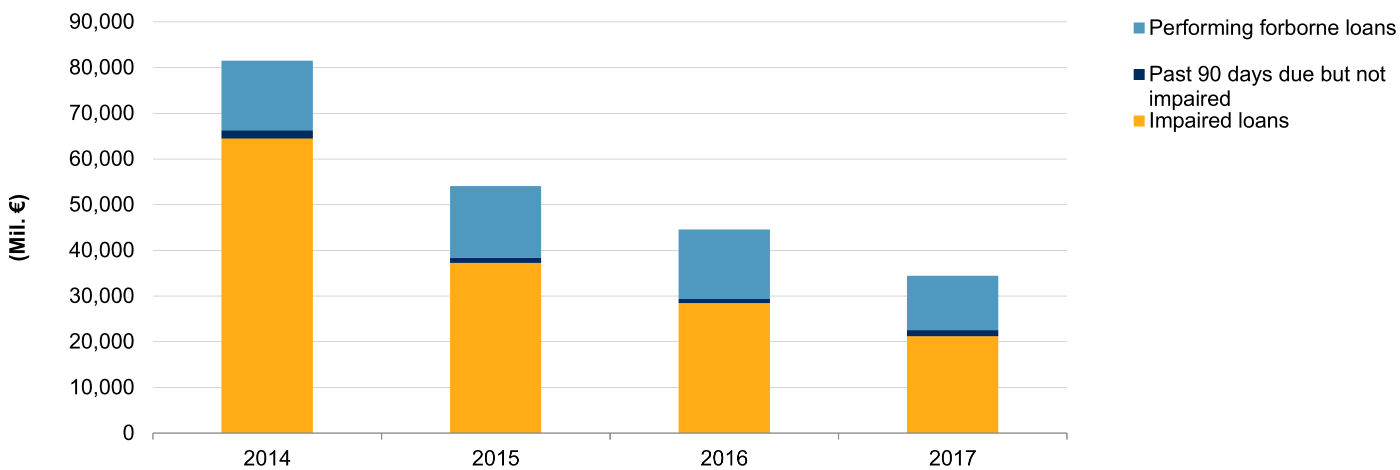
Source: S&P Global Ratings database. KBCI has yet to publish its 2017 statutory accounts.

S&P Global Ratings' NPL measure comprises impaired loans, loans over 90 days due, and performing forborne loans. This measure is slightly more conservative than the reported NPE regulatory measure. The significance of performing forborne loans is a material one for Irish banks, being over one-third of NPLs by our measures. We estimate systemwide coverage at about 27%, or about 40% excluding performing forborne loans, which appears reasonably satisfactory.

The stock of NPLs has reduced markedly (see chart 7). However, given the aforementioned reduction of balance sheets, NPL ratio declines have been slower.

Chart 7

Construction Of Domestic Nonperforming Loans



Source: S&P Global database.

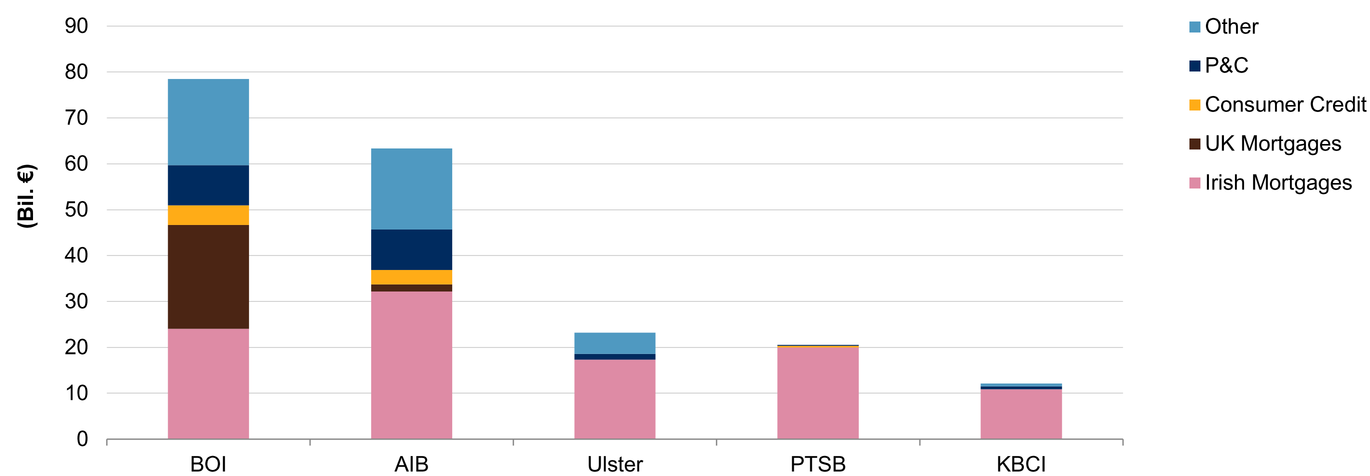
Irish loan books are heavily weighted toward residential mortgages. Ordinarily this would be a positive for credit quality. However, in the case of Ireland, residential mortgages remain a weak asset class and, by our calculations, we estimate that they represent almost two-thirds of domestic NPLs.

Mortgages represent more than half of the gross loan book for all five rated banks (see chart 8). In the case of AIB and Bank of Ireland, whose total loan books include international lending, Irish mortgages represent 63% and 56% of their gross Irish loan books, respectively.

In contrast, the weighting of property and construction loans (P&C) continues to fall. For example, AIB has reduced the P&C weighting of its total loan book to 14% from 36% as of Dec. 31, 2008; Bank of Ireland has reduced its weighting to 11% from 25% over a similar timeframe. Overall, we consider that Bank of Ireland's loan book is the most diverse of the Irish banks, with the U.K. loans being about 40% of gross loans (based on the geographic location of the customer), and a lower relative role for Irish mortgages. By comparison, Irish lending represents 80% of AIB's total loan book, while the other Irish banks are solely domestic focused.

Chart 8

Mortgages Make Up The Majority Of Irish Banks' Loan Books



Source: Company Accounts. KBCI has yet to publish its 2017 statutory accounts. The 2017 data in this table is based upon the Ireland division within KBC Group's results.

The quality of disclosure of Irish mortgage books is good (see table 2). The annual report data highlights the weak vintage profile and the high weighting of low-yielding tracker mortgages. The data also supports our view that Bank of Ireland's mortgage book has a superior profile compared with its domestic peers.

Table 2

Irish Mortgage Book, 2017

(%)	Gross loans (Mil. €)	WALTV (%)	BTL (%)	% book negative equity	pre-2009 vintage	Tracker book	Impaired	OO Arrears	BTL arrears
AIB	32,200	64	12.0	10	65.4	33	9.8	4.9	14.8
BOI	24,069	63	16.2	7	65.1	46	4.7	2.3	5.1
KBCI	12,128	N.A.	17.3	N.A.	N.A.	N.A.	28.0	N.A.	N.A.
PTSB	19,990	84	24.8	29	85.0	63	21.7	N.A.	N.A.
Ulster	17,317	69	N.A.	N.A.	N.A.	62	18.7	N.A.	N.A.

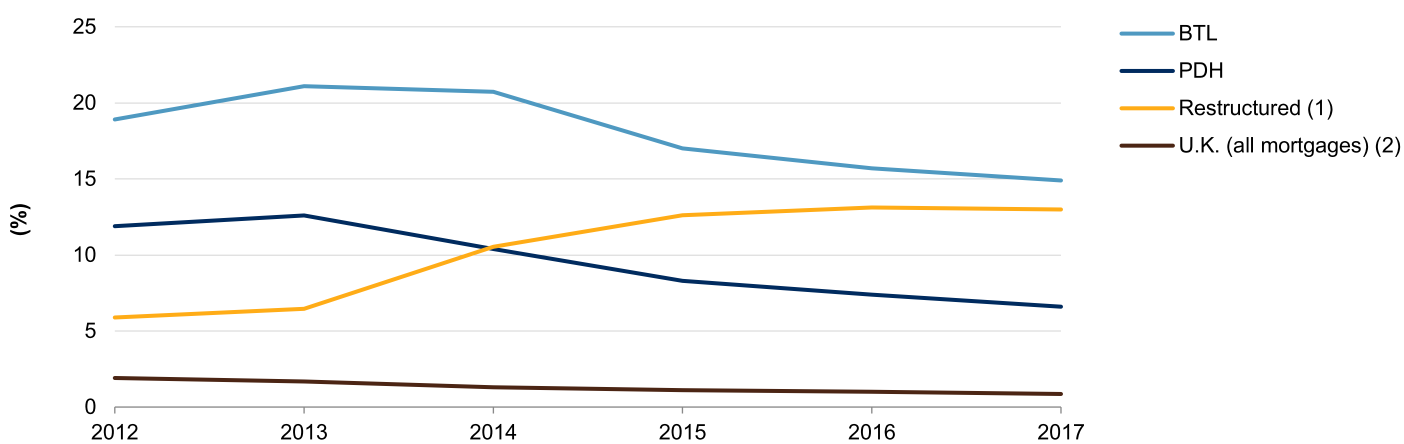
WALTV--Weighted-average loan-to-value (stock). OO--Owner-Occupier. BTL--Buy-to-let. N.A.--Not available. Source: Company Accounts. Impaired loans as reported. Arrears are more than 90 days past due by number of accounts. KBCI has yet to publish its 2017 statutory accounts. The 2017 data in this table is based upon the Ireland division within KBC Group's results.

Industry mortgage arrears are high, although there is evidence of a steady reduction. According to CBI data, as of Dec 31, 2017, 6.6% of all home-owner mortgage accounts were more than 90 days past due, down from a peak of 12.9% in 2013 (see chart 9). The equivalent for buy-to-let mortgages (14% of all mortgage accounts) was a high 14.9%, and the pace of reduction is slower. We note, in addition to the data shown in chart 9, that a reported 7% of total Irish mortgage accounts (and a bit higher by balances) are held by non-bank entities, of which 49% of those accounts are more than 90 days in arrears. Thus, 10.6% of total Irish mortgage accounts are more than 90 days past due--compared to the U.K. industry average of around 0.9%, for example. This shows starkly why we expect the Irish mortgage book to remain a drag on banks' creditworthiness for several years.

One of the difficult unresolved problems facing the Irish banking industry is the issue of very long-term arrears (more than 720 days). This segment constitutes 41% of all residential home-owner mortgage accounts in arrears (the equivalent figure is 58% for BTL mortgages). Banks have employed a range of forbearance solutions to restructure accounts in arrears. Around 17% of all mortgage accounts held by banks are currently classified as restructured. Of these, 87% are defined as meeting the terms of their arrangement.

Chart 9

The Owner-Occupier Mortgage Arrears Rate Has Nearly Halved Since 2013



Source: Central Bank of Ireland. Based on number of cases of arrears over 90 days due. PDH--Primary dwelling or owner occupier. BTL--Buy-to-let. (1) Restructured mortgages, and not in arrears, as a percentage of total number of mortgage a/c outstanding (both BTL & PDH). (2) Estimate based on UK banks' results.

Some Obstructions To Regulatory Capitalization

Irish bank capitalization appears comfortable, with relatively high regulatory ratios, and S&P Global Ratings' RAC measure being in the strong category. Indicative of their growing confidence, several of the Irish banks are now paying dividends. In addition to AIB, which resumed dividend payments last year, Bank of Ireland has announced its first dividend payment since 2008. Moreover, after its financial year-end, Ulster Bank Ireland announced its second large €1.5 billion dividend to its parent, Royal Bank of Scotland, following a similar announcement in November 2016. Both AIB and Bank of Ireland have signaled a progressive dividend policy.

Possible obstacles to the pace and scale of capital distributions include the Targeted Review of Internal Models (TRIM) being undertaken by the European Central Bank in systemically important banks with a view to harmonizing the approach across the EU. Others include International

Financial Reporting Standards (IFRS)9 and the NPE strategy implementation. Bank of Ireland has stated that TRIM could reduce its Common Equity Tier ratio by 50bps, whereas Permanent TSB (PTSB) has indicated a much larger 250bps potential impact. Irish banks have also disclosed the first-time effect of IFRS9, with the fully loaded impact being 20bps at Bank of Ireland, 70bps at AIB, and 107bp at PTSB. We note, however, that the negative impact on regulatory capital will be tempered by the transitional arrangement, which means the effect can be drawn out over five years. Finally, as discussed earlier, for some banks, the regulatory requirement to implement NPE strategies may result in a capital hit if write-downs on portfolio sales are greater than the capital required to manage NPL's internally.

For the rated Irish banks, we consider our combined view of capital and earnings and risk position to be either credit neutral or credit negative (see table 3). At the time of writing, we have yet to calculate our end-2017 RAC ratios. However, our existing strong capital assessments will likely be reinforced by the movement in 2017 of exposure at default and our total adjusted capital measure.

Debt Issuance Set To Rise

The many years of deleveraging has resulted in reduced wholesale funding balances and improved funding metrics. For AIB, Bank of Ireland, PTSB, and Ulster Bank at end-2017:

- Our loan-deposit ratio ranges from 93% to 111%.
- Our stable funding ratio ranges from 106% to 120%.
- Our ratio of customer deposits to the funding base ranges from 83% to 87%.
- Our broad liquid assets to short-term wholesale funding ratio is comfortably above 1.5x.

For Irish banks, we understand that the chosen resolution strategy is through a single point of entry via a NOHC, similar to the U.K. and Swiss systems, for example. The current stack of MREL eligible instruments is fairly limited, and each affected banking group has indicated their planned issuance over the next few years, which, in absolute terms, appears manageable. However, we do not currently include any notches of ALAC uplift in the ratings of Irish banks until we garner greater confidence in their issuance capability and overall creditworthiness. For the three foreign-owned banks--Ulster Bank, KBCI, and BBI--we reflect ALAC through our view of their group support, as appropriate.

We do not currently include any notches of ALAC uplift in the ratings of Irish banks until we garner greater confidence in their issuance capability and overall creditworthiness.

Table 3

Ratings Components For Rated Irish Banks/Banking Groups

Bank or banking group	NOHC Long-term ICR/Outlook	Opco Long-term ICR/Outlook	Business position	Capital & Earnings	Risk position	Funding & Liquidity	SACP / UGCP	Type of support	No. of notches of support
AIB Group PLC	BB+/Positive	Allied Irish Banks PLC: BBB-/Positive	Adequate	Strong	Moderate	Avg/Adequate	bbb-	None	0
Bank of Ireland Group PLC	BBB-/Positive	Bank of Ireland: BBB/Positive	Strong	Strong	Moderate	Avg/Adequate	bbb	None	0
Barclays Bank Ireland PLC	N/A	A/Stable	N.A.	N.A.	N.A.	N.A.	N.A.	Group	N.A.

Table 3

Ratings Components For Rated Irish Banks/Banking Groups (cont.)

Bank or banking group	NOHC Long-term ICR/Outlook	Opco Long-term ICR/Outlook	Business position	Capital & Earnings	Risk position	Funding & Liquidity	SACP / UGCP	Type of support	No. of notches of support
KBC Bank Ireland PLC	N/A	BBB-/Positive	Moderate	Strong	Weak	Avg/Adequate	bb	Group	3
Permanent TSB Group Holdings PLC	B+/Positive	Permanent TSB PLC: BB/Positive	Moderate	Strong	Weak	Avg/Adequate	bb	None	0
Ulster Bank Ireland DAC	N/A	BBB/Positive	Moderate	Strong	Moderate	Avg/Adequate	bb+	Group	2

ICR--Issuer credit rating. SACP--Stand-alone credit profile. UGCP--Unsupported Group Credit Profile.

In summary, the operating environment for Irish banks continues to be supportive and they have made progress rebuilding their NIMs, reducing their stock of NPLs, and making a start to address their future operational demands. In the near term, however, any further improvement in ratings is more likely to result from operating bank-specific ALAC support, rather than an improvement in our view of the Irish banking system or improvements in intrinsic creditworthiness.

Related Research

- AIB Group PLC Assigned 'BB+/B' Ratings; Outlook Positive, March 12, 2018
- Europe's Housing Markets: Soft Landing In Sight, Feb. 7 2018
- Banking Industry Country Risk Assessment: Ireland, Dec. 12, 2017
- Various Positive Rating Actions Taken On Irish Banks On Improving Industry Credit Profile, Dec. 12, 2017
- Republic of Ireland Ratings Affirmed At 'A+/A-1'; Outlook Stable, Dec. 1, 2017