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Irish BICRA Changed To Group 3 From Group 2 On Heightened Industry Risk

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LONDON (Standard & Poor's) March 16, 2009--Standard & Poor's Ratings Services said today that it revised downward its Banking Industry Country Risk Assessment (BICRA) on the Republic of Ireland (AAA/Negative/A-1+) to Group 3 from Group 2. We had previously changed the BICRA to Group 2 from Group 1 on Dec. 10, 2008 (for more information, see "S&P Changes Ireland BICRA To Group 2 From Group 1 On Economic And Structural Vulnerabilities").

Standard & Poor's BICRA rankings integrate our view of the strengths and weaknesses of a country's banking system compared with those of other countries. The scale ranges from Group 1 (strongest) to Group 10 (weakest). Banking systems ranking similarly to Ireland in Group 3 include Portugal, Austria, and Japan.

The BICRA change principally reflects our changed view of industry risk in Ireland, in particular the reputational fallout from the events at Anglo Irish Bank Corp. Ltd. (Anglo; A-/Watch Neg/A-1), and what we see as weakened investor confidence in the framework of bank regulation. We also consider there to have been a further weakening in the near- and medium-term Irish economic prospects since our action in December. The shift to Group 3 has no direct impact, in and of itself, on our ratings on the Irish banks.

In our opinion, the reputation of Irish banking with the public and the investor community has suffered in recent months. The nationalization of Anglo

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was precipitated by reports of alleged manipulation of directors' loans to avoid public disclosure. The authorities have reportedly started investigations into an alleged scheme to overstate the strength of Anglo's customer deposit base and allegations that Anglo lent money to key clients so that those could buy Anglo's shares. Overall, we consider that the regulator has shown some reluctance to intervene, particularly in Anglo's case.

In our view, the timing of these revelations is harmful to the strength of the banking system overall, coming at a point when investor confidence is already low. The Irish government has said that it plans to create a new central banking commission that incorporates the functions of the Central Bank and the Financial Regulator, but with increased powers. We consider that this could be a positive development, although it will likely take time to take effect.

Despite reduced public confidence in the banking sector, we expect to see the dominant market positions of the two major players, Allied Irish Banks PLC (AIB; A/Stable/A-1) and Bank of Ireland (BOI; A/Stable/A-1), to be maintained and perhaps even strengthened. We expect some competitors, particularly those that are foreign owned, will likely reduce their lending over the coming year and that AIB and BOI could grasp this opportunity by refocusing their lending capacity from their overseas to their domestic franchises. The potential drawback of this strategy, however, is reduced diversification of earnings and a risk of gradual weakening of those overseas franchises.

In our opinion, the Irish government has shown significant support to the domestic banking sector--evidenced by the nationalization of Anglo in January, the recapitalization of AIB and BOI in February, and the intention to extend the bank liability guarantee scheme beyond September 2010. Indeed, our ratings on all the domestically owned Irish banks now explicitly include notches of support above the banks' stand-alone credit strengths. This support, however, bears with it the prospect of rising interference or direction.

We consider that all Irish banks face major near-term challenges from the economic downturn. In our view, the adverse economic environment has led to a very weak outlook for asset quality. We had expected to see robustness in earnings capacity to offset some of the expected material loan losses. We now expect the banks' revenues to be pressured by a combination of the low interest rate environment, an inability to fully pass on higher funding costs to borrowers (particularly mortgagees), much lower transaction volumes, rising prevalence of nonperforming loans, and low (or even negative) net lending. Furthermore, while we consider that the banks typically benefit from quite good efficiency (when compared with European peers), we think that public and government expectations of the banks leave only modest flexibility to materially reduce headcount, if this were needed.

We recently revised down our forecast for Irish economic growth, and now expect a faster rise in unemployment and falling GDP in all three years to end 2010. (See "European Economic Forecast: The Recession Of A Lifetime," published Feb. 17, 2009, for more details.) In our opinion, this downward revision reflects an incremental, as opposed to fundamental, deterioration in these near-term metrics from our previous forecast. In our view, the recession will seriously affect the whole economy, and we do not expect to see a rebound in activity until the second half of 2010. We therefore expect to see asset quality deterioration right across Irish bank loan books. We consider that unemployment will be the main determinant of the amplitude of credit losses on banks' mortgage and personal unsecured portfolios. While the near term will, we think, be difficult, we continue to consider that Ireland has good longer-term economic prospects, underpinned by the flexibility of its economy, high per capita income, and a favorable demographic structure.

Under a reasonable worst-case economic scenario, we now estimate the Irish banking system's level of gross problematic assets (GPAs) as a percentage of private sector credit to be in the range of 10%-20%. We had previously placed Irish system GPAs in the highest category (5%-15%). This change reflects our present view that, in a reasonable worst-case economic scenario, GPAs could rise to between 15% and 20%. This outturn would reflect a significant deterioration from our current expectations for Irish bank credit quality, however. For a more detailed discussion of BICRA methodology, see "S&P's Banking Industry Country Risk Assessments: Global Annual Roundup," published on Aug. 9, 2007.

In our view, an upward revision of the Irish BICRA to Group 2 is unlikely in the medium term. If this were to happen, it would likely follow radically improved prospects for the economy and bank earnings, and renewed confidence in the regulatory framework. A further downward revision would most likely be driven by significantly weaker long-term prospects for the Irish economy and could pressure our ratings on the individual Irish banks.

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