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Summary:
Bank of Ireland

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Summary:

Bank of Ireland

Credit Rating: A+/Negative/A-1

Rationale

The ratings on Bank of Ireland (the trading name of the Governor and Company of the Bank of Ireland; BOI) are supported by its strong domestic market position, good business diversity, and sound track record. The negative outlook reflects our increasingly pessimistic expectations for the likely progression of asset quality, particularly in the property and construction (P&C) portfolio, given the continued weakening of the Irish and U.K. economic environment.

P&C lending represented about 26% of total loans at Sept. 30, 2008, of which 35% related to development lending, split fairly evenly between Ireland and the U.K. While this is less concentrated than Irish peers, it compares unfavorably with international peers. Development lending in particular is exerting downward pressure on asset quality. The continuing deterioration in operating conditions makes it more likely that deteriorating asset quality will have a material impact on profitability in the coming years.

Mortgages represent about 45% of BOI's loan portfolio, with U.K. specialist residential mortgages--self certified and buy to let--representing over one-quarter of the mortgage portfolio. Mortgages continue to perform well, but we note that a material proportion of originations up to 2007 were undertaken at high loan to values. The continuing decline of the Irish and U.K. property markets combined with the ongoing economic slowdown make the outlook for this portfolio increasingly uncertain.

The Irish government provided extraordinary support to its domestic banking system when it guaranteed most liabilities of many domestic banks on Sept. 30, 2008. The guarantee--which covers retail, corporate and interbank deposits, senior unsecured debt, covered bonds, and dated subordinated debt--extends to Sept. 29, 2010. Standard & Poor's has equalized the ratings on those BOI issues that mature within the life of the guarantee with the sovereign ratings of the Republic of Ireland (AAA/Stable/A-1+). We consider BOI to be a highly systemically important bank in the Irish banking sector, but do not currently factor in any extraordinary support into the counterparty credit ratings. As a result of its participation in the scheme, BOI's funding is well supported, but it is now subject to increased government control and regulatory oversight.

BOI's capitalization is adequate, but nevertheless relatively weak compared with peers, with a core Tier 1 ratio of 6% (on a Basel II basis) expected at Sept. 30, 2008. We expect that, as a result of BOI's participation in the Irish guarantee scheme, BOI will further increase its focus on internal capital generation and may well not distribute earnings to shareholders this year. This would offset the expected fall in profitability and help it meet likely higher regulatory capital requirements over the medium term.

Outlook

The challenging operating environment will lead to pressure spreading from Irish property development lending to most segments of BOI's loan book. As a result of these higher credit costs, profitability will be materially diminished in the coming couple of years. Capitalization remains a relative weakness, and we expect capital ratios to increase through earnings retention or other sources over the coming two years.

The negative outlook reflects our increasingly pessimistic expectations about the Irish economy and the associated downside risks to BOI's asset quality and profitability. Negative rating action could result if BOI's earnings appear likely to be even more materially reduced. We would consider a material reduction to be the result of impairment costs that are materially beyond the top end of management's current estimate of 90 basis points in the year to March 31 2010. The outlook could be revised to stable if BOI's asset quality and the resultant impact on profitability appear likely to outperform our expectations over the next two years.

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