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Research Update:

Ireland-Based AIB Group Outlook Revised To Negative On Sharp Economic Contraction; Ratings Affirmed

April 28, 2020

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Overview

- Despite governments' measures to contain the COVID-19 pandemic, European economies, including that of Ireland, face an unprecedented challenge to manage the slowdown in economic activities and global trade.
- In this context, we believe that downside risks for Irish banks and AIB Group PLC (AIB) are material, taking into account the structural profitability challenges that the local banking sector faces and the bank's exposure to domestic corporates and small and midsize enterprises (SMEs).
- As such, we are revising the outlook on AIB to negative from stable and affirming the 'BBB-/A-3' ratings.
- The negative outlook reflects our view that the economic contraction could impair the bank's asset quality, earnings, and capitalization at a time when the sector is experiencing some structural issues related to profitability.

Rating Action

On April 28, 2020, S&P Global Ratings revised its outlook on Ireland-based nonoperating holding company (NOHC) AIB Group PLC to negative from stable. At the same time, we affirmed the 'BBB-/A-3' long- and short-term issuer credit ratings.

We also revised the outlook to negative from stable on the main bank, Allied Irish Banks PLC, and affirmed the 'BBB+/A-2' ratings. We also affirmed our 'A-/A-2' resolution counterparty rating on Allied Irish Banks PLC.

Finally, we revised the outlook to negative from stable on U.K.-based subsidiary, AIB Group (U.K.) PLC, and affirmed the 'BBB/A-2' ratings.

Rationale

The outlook revision reflects the sharp reduction in economic activity we anticipate for U.K. and eurozone economies in 2020, including Ireland, and our view that there are downside risks to the ratings given the material uncertainties associated with the COVID-19 pandemic. The bank's structural exposures to local corporates and SMEs--including retail/wholesale distribution services, which we see as more vulnerable in the current context--pose asset quality risks for AIB, like for other domestic banks. We believe that banks would be better placed to absorb those risks if the Irish banking sector, and AIB as the second-largest domestic bank, were not also suffering from structural profitability issues, which rising credit losses may exacerbate.

With isolation strategies still very much in force, our economists expect sharp economic contraction in the second quarter of 2020, followed by a rebound starting in the third quarter. However, they are now more cautious on the strength of recovery through end-2020 and into 2021, envisaging 5.5% real GDP contraction in Ireland this year (6.5% in the U.K.), to be followed by 5.5% growth in 2021 (6.0% in the U.K.). Even under this base case, the effects of COVID-19 will be evident for long after the crisis subsides.

The ratings affirmation reflects our expectation that AIB will be able to withstand the negative effects of a shock to the economy and private sector in the first quarters of this year, while remaining committed to its medium-term business plan, in particular cost discipline and asset quality performance. The bank's strong capital position provides some buffer to absorb unexpected losses.

Still, we believe that margin pressure in Ireland due to low interest rates and heightened competition, and banks' relatively high costs bases, will continue to weigh on Irish banks' profitability in the foreseeable future. This leaves little room to contain the inevitable rise in the cost of risk, which is structurally higher in Ireland than other countries like the U.K., France, Belgium, or The Netherlands. Therefore, we consider that the likely deterioration in AIB's return on equity--well below 5% in 2020--is equally due to modest pre-provision income and rising loan losses, as well as when the recognition of credit losses occurs.

Under the above assumption, we forecast that AIB's risk-adjusted capital will remain above 10% over the next two years.

The affirmation reflects several supporting factors. First, authorities in Ireland and the U.K. have delivered unprecedented policy responses in the form of monetary, fiscal, and regulatory support to the economy. Second, the group's decade-long deleveraging and focus on improving risk-management place the bank in a better position to withstand an economic shock.

We are acutely mindful that this base case remains subject to significant downside risks, however. Even under our economic base case, the policy responses taken in Ireland may be less than totally successful in avoiding permanent economic damage later (see "COVID-19 Deals A Larger, Longer Hit To Global GDP," published April 16, 2020). We also note that a significant component of the fiscal support package comprises additional indebtedness--for the sovereign, some households, and many businesses. The longer the delay in the recovery of economic activity, the less sustainable this extra debt will be.

The negative outlook on U.K.-incorporated AIB Group (U.K.) PLC (AIB UK) reflects that on its ultimate parent, Ireland-based AIB Group PLC (AIB). We consider AIB UK to be strategically important to its parent. As such, we cap the ratings at one notch below our 'bbb+' group credit profile (GCP) on AIB. This means that we could lower the ratings on the U.K.-based subsidiary following a similar action on its parent over the next 18-24 months. We could also lower the ratings if we perceived a weakening in the importance of AIB UK to the group's strategy.

Outlook

AIB Group PLC (nonoperating holding company)

The negative outlook on AIB primarily reflects our view that the economic contraction in the areas in which the bank operates could impair its asset quality, earnings generation capacity, and capitalization, while some structural profitability challenges generally faced by the local banking sector will persist.

Consequently, we would most likely lower the ratings over the next 18-24 months if we observed that profitability substantially and sustainably falls from the level reached at end-2019. This could happen if nonperforming exposures and credit losses were rising faster, entailing a material impact on AIB's earnings generation capacity and capitalization, or if margin pressure intensifies. This may occur following a material deterioration in economic and operating conditions, either because the downturn is deeper and longer, or the recovery weaker, than we currently anticipate.

We could revise the outlook back to stable if we considered that economic and operating conditions had stabilized and that cost discipline allows the bank to sustain preprovision income.

Allied Irish Banks PLC (operating company)

The negative outlook reflects that on AIB Group PLC.

We could lower the ratings if the additional loss-absorbing capacity (ALAC) buffer protecting senior creditors were to fall short of our expectation that it will remain above 5.0% of S&P Global Ratings' risk-weighted assets over the outlook horizon. This could happen, for example, because of the group's impaired access to capital markets or a more aggressive capital policy than we currently expect.

AIB UK PLC (operating company)

The negative outlook on the U.K. subsidiary of AIB reflects that on AIB Group PLC, and will continue to do so as long as we view the bank as a strategical subsidiary.

Therefore, any positive or negative action on the group will result in the similar action on AIB UK. Downside pressure could also come from underperformance from AIB UK compared with the group's expectations.

Ratings Score Snapshot

Allied Irish Banks PLC

Operating company

Issuer Credit Rating	BBB+/Negative/A-2
Group SACP	bbb
Anchor	bbb

Allied Irish Banks PLC (cont.)

Business Position	Adequate (0)
Capital and Earnings	Strong (+1)
Risk Position	Moderate (-1)
Funding and	Average and (0)
Liquidity	Adequate
Support	(+1)
ALAC Support	(+1)
GRE Support	0
Group Support	0
Sovereign Support	0
Additional Factors	0
AIB Group PLC	
(nonoperating holding company)	
Issuer Credit Rating	BBB-/Negative/A-3

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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: Guarantee Criteria, Oct. 21, 2016
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, Oct. 24, 2013
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Outlooks Revised On Three Irish Banks On Deepening COVID-19 Downside Risks, April 28, 2020
- Outlooks Revised On Six U.K. Banks On Deepening COVID-19 Downside Risks, April 23, 2020
- Europe's AT1 Market Faces The COVID-19 Test: Bend, Not Break, April 22, 2020
- How COVID-19 Is Affecting Bank Ratings, Apr 22, 2020
- Europe Braces For A Deeper Recession In 2020, April 20, 2020
- European Banks' First-Quarter Results: Many COVID-19 Questions, Few Conclusive Answers, April 1, 2020
- COVID-19: The Steepening Cost To The Eurozone And U.K. Economies, March 26, 2020
- COVID-19 Countermeasures May Contain Damage To Europe's Financial Institutions For Now, March 13, 2020
- The Coronavirus Will Shave 50 Basis Points Off Eurozone Growth, March 4, 2020
- AIB Group PLC, Feb. 18, 2020
- AIB Group's Additional €300 Million Tracker Mortgage Provision Is Manageable As A One-Off Event, Feb. 5, 2020