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Research Update:

Allied Irish Banks 'BB/B' Ratings Affirmed On Stable Irish Banking Industry Risk; Outlook Remains Negative

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Overview

- We consider that economic and industry risks, as they affect the Irish banking system, remain high.
- In particular, we do not anticipate seeing meaningful improvement in the very poor asset quality of Irish banks' loan books over the coming year, and underlying income growth prospects appear modest.
- Despite our improving view of the creditworthiness of the Irish sovereign, we continue to see a stable trend for Irish banking industry risk.
- We are affirming our 'BB/B' counterparty credit ratings on Allied Irish Banks PLC.
- The negative outlook continues to reflect what we see as the lack of certainty about the scale and timing of a potential recovery in AIB's capitalization, by our measures, and the possible removal of government support by year-end 2015.

Rating Action

On June 10, 2014, Standard & Poor's Ratings Services affirmed its 'BB/B' counterparty credit ratings on Allied Irish Banks PLC (AIB). The outlook is negative.

Rationale

The affirmation reflects our view that the Irish banking industry is making slow, but steady, progress to improve its balance sheet profile and achieve positive earnings after six years of balance-sheet instability and pretax losses. As demonstrated by our recent rating action on Ireland, in which we raised the long-term sovereign credit rating to 'A-' and maintained the positive outlook, we consider that the Irish economy as a whole is recovering more quickly than its banking sector.

We anticipate that Ireland will sustain its economic growth. Unemployment levels are declining and property prices are increasing across Ireland. However, household debt is still elevated, the stock of nonperforming assets is significant, and we expect credit losses across most asset classes to continue to dampen bank earnings over the next two years.

In our view, pre-provision operating income growth is likely to be modest across the system this year and next because of limited underlying revenue growth (excluding the recovery in net interest margins that has arisen from certain structural factors).

We recognize that systemwide funding risks have fallen, but the turnaround remains incomplete. In our view, the Irish authorities could have more actively forced banks to address the deficiencies in their capitalization that were exposed by fully loaded Basel III metrics.

We would need to observe a better-than-expected reduction in both credit losses and household debt, or stronger balance sheets, for us to reclassify Ireland's banking system to a stronger BICRA group.

Over and above AIB's 'bb' anchor--the starting point for our assessment of AIB's 'b+' stand-alone credit profile (SACP)--our view of AIB's other stand-alone credit factors remains unchanged.

In particular, in the absence of a conversion of the preference shares held by the Irish government into common equity, we could lower our assessment of the bank's capital and earnings position. As a result of its 2013 pretax loss of €1.7 billion, we calculate that AIB's risk-adjusted capital (RAC) ratio decreased to 2.4% during the year, well below the 3% threshold to which we ascribe a "weak" capital and earnings assessment. However, our current assessment considers the financial flexibility afforded by these instruments. We also note the bank's statement that discussions with the Department of Finance have commenced in relation to the possible conversion of some or all of the €3.5 billion preference shares into ordinary shares. We understand that the bank hopes to reach an agreement during the second half of 2014.

We expect AIB to return to modest profitability in 2014 and its performance to improve further in 2015. However, in the absence of a conversion of the preference shares, we don't expect retained earnings and the slowing reduction in risk-weighted exposures to be enough to lift the ratio back to 3% or above at end-2015. Barring any distribution from the bank to the state, the conversion of all of the government preference shares to common equity would lift the end-2013 pro forma RAC ratio to around 5.5%.

We believe AIB has made material progress in rebalancing its funding and liquidity profile. In particular, we note the reduction in its reliance on funding from monetary authorities to €9 billion at end-March 2014, from €22 billion at end-2012, and recent issues on both a secured and unsecured basis. We expect that we could revise upward our liquidity assessment of AIB to "adequate" from "moderate"--possibly toward the end of 2014--once any uncertainties around the conversion of the government preference shares, and possibly the European Central Bank's comprehensive assessment, are lifted. We regard these events as important milestones for the bank's sustainable return to normal access to funding.

Given the two notches of government support that we currently factor into our ratings on AIB, and our view of decreasing potential extraordinary government support for European banks, an improvement in the bank's SACP by one or two notches would be unlikely to lead us to raise the issuer credit rating. Rather, we would likely apply a negative adjustment of one or two notches to reflect the possible removal of government support from our ratings on AIB.

Outlook

The negative outlook reflects what we see as the lack of certainty about the scale and timing of a potential recovery in AIB's capitalization, by our measures. We could lower the ratings if we do not project AIB's RAC ratio will be above 3% by year-end 2014. We would most likely reflect this projection in a downward revision of our capital and earnings assessment to "very weak" from "weak."

The negative outlook also indicates that we may lower the ratings on AIB by year-end 2015 if we believe there is a greater likelihood that senior unsecured liabilities may incur losses if the bank fails. Specifically, we may lower the long-term counterparty credit rating by up to two notches if we consider that extraordinary government support is less predictable under the new EU legislative framework.

In addition to potential changes in the SACP and government support, we will review other relevant rating factors when taking any rating actions. These could include any steps AIB might take to mitigate bail-in risks to senior unsecured creditors, such as building a large buffer of subordinated debt instruments.

We could revise the outlook back to stable if we consider that potential extraordinary government support for AIB's senior unsecured creditors is unchanged in practice, despite the introduction of bail-in powers and international efforts to increase banks' resolvability; or if we believe that other rating factors, such as a stronger SACP or a large buffer of subordinated debt instruments, fully offset increased bail-in risks. In particular, we could change the outlook to stable if we were to improve both our capital and earnings, and funding and liquidity assessments.

Ratings Score Snapshot

Issuer Credit Rating	BB/Negative/B
SACP	b+
Anchor	bb
Business Position	Adequate (0)
Capital and Earnings	Weak (-1)*
Risk Position	Adequate (0)
Funding and Liquidity	Average and Moderate (-1)

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Support                      +2
  GRE Support                0
  Group Support              0
  Sovereign Support          +2

Additional Factors           0
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*When a bank's anchor SACP, derived from our BICRA methodology, is in the 'bb' category and its common equity regulatory Tier 1 ratio is greater than the local regulatory requirements, a "weak" assessment of capital and earnings has a minus one-notch impact on the SACP (see paragraph 88 of our bank criteria).

Related Criteria And Research

Related Criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research

- Most Irish Bank Ratings Affirmed On Stable Banking Industry Trends, June 10, 2014
- Banking Industry Country Risk Assessment: Ireland, June 10, 2014
- Ireland Upgraded To 'A-' On Improved Domestic Prospects; Outlook Positive, June 6, 2014
- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014

Ratings List

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Ratings Affirmed

Allied Irish Banks PLC
 Counterparty Credit Rating             BB/Negative/B
  Senior Unsecured                      BB
 Subordinated                           D
 Commercial Paper                       B

Allied Irish Banks N.A. Inc.
 Commercial Paper*                      BB
 Commercial Paper*                      B

*Guaranteed by Allied Irish Banks PLC.
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Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.