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Research Update:

Allied Irish Banks 'BB/B' Ratings Affirmed As Progress Made On Rebalancing Funding; Outlook Remains Negative

Primary Credit Analyst:
Alexandre Birry, London (44) 20-7176-7108; alexandre.birry@standardandpoors.com

Secondary Contact:
Dhruv Roy, London (44) 20-7176-6709; dhruv.roy@standardandpoors.com

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Overview

- We consider that Allied Irish Banks PLC (AIB) has made significant progress in rebalancing its funding and liquidity profiles. The bank also reported first-half 2014 results that exceeded our expectations and should support its return to normal access to funding markets.
- We have therefore revised upward the bank's stand-alone credit profile to 'bb-' from 'b+'.
- However, the rating remains constrained by our view that the likelihood of extraordinary government support being available to AIB's senior unsecured bondholders will probably diminish over the next two years.
- We are affirming our 'BB/B' long- and short-term counterparty credit ratings on AIB.
- The negative outlook continues to reflect the possible removal of government support by year-end 2015 and what we see as the lack of certainty on the scale and timing of a potential recovery in AIB's capitalization, by our measures.

Rating Action

On Aug. 5, 2014, Standard & Poor's Ratings Services affirmed its 'BB/B' counterparty credit ratings on Allied Irish Banks PLC (AIB). The outlook is negative.

Rationale

AIB has made further significant progress in rebalancing its funding and liquidity profiles, in our view, and has shown a stronger return to profitability than we anticipated, which we believe should support the bank's return to normal access to funding markets. We have revised its stand-alone credit profile (SACP) upward to 'bb-' from 'b+'. However, the rating is constrained by our belief that the likelihood of extraordinary government support available to AIB's senior unsecured bondholders will likely diminish over the next two years. The ratings affirmation reflects our balanced view of these factors.

AIB reported a profit before tax of €437 million for the first half of 2014--its first profit since 2008 and a sharp rise from a loss of €838 million in the first half of 2013. This performance was well ahead of our forecast of a return to modest profitability in 2014. The results were driven by improvements in all major items, including revenues, due to a continued widening of the net interest margin, and a fall in expenses and loan impairment charges. The remarkable reduction in the loan impairment charge to €92 million from €744 million year-on-year was due largely to improving economic conditions, particularly rising house prices, leading to a reduction in impaired loans and in collective provisions. AIB's lower collective provisions were largely attributable to the bank's revision of its peak-to-trough house price reduction assumption to 52% from 55% in the first half of the year.

While we anticipate that the bank should remain profitable for the rest of the year, we do not expect the loan impairment charges to remain at the exceptionally low level they reached in the first half of the year. This is partly because household debt in the system is still elevated, and because there remains a significant stock of nonperforming assets that AIB and other banks have to work through. AIB's gross nonperforming assets still exceeded 30% of customer loans at end-June 2014.

We have revised upward our liquidity assessment of AIB to "adequate" from "moderate." As a result, our combined funding and liquidity assessment is now a neutral factor for the ratings. We believe AIB has made substantial progress in rebalancing its funding and liquidity profile. In particular, we note the reduction in its reliance on funding from monetary authorities to around €4 billion at end-June 2014, from €22 billion at end-2012, and recent issues on both a secured and unsecured basis. While some uncertainties remain around the conversion of the government preference shares, and possibly the European Central Bank's comprehensive assessment, we believe that the rebound in performance represents a key milestone that should support AIB's gradual return to normalized access to funding. We expect that its funding and liquidity metrics will demonstrate stability going forward.

We estimate that the bank's ratio of broad liquid assets to short-term wholesale funding, as we measure it, was comfortably in excess of 1x at end-June 2014. Although we do not adjust this metric for the asset encumbrance of some of the bank's liquidity portfolio, it nevertheless suggests that AIB has adequate liquidity to manage without access to the wholesale funding markets for a year. Our stable funding ratio is in excess of 100%, also suggesting that the bank's liabilities have a sound maturity profile. AIB reported a 96% loan-to-deposit ratio at end-June 2014, down from 168% at end-2010 and 115% at end-2012.

Despite the return to profitability in the first half of the year, our measure of the bank's capital remains a ratings weakness. We estimate that AIB's risk-adjusted capital (RAC) ratio was about 2.7% at June 30, 2014, slightly up from 2.4% at end-2013. The increase is due to a moderate increase in total adjusted capital, the sale of insurance subsidiary Ark Life, and a further decrease in credit risk-weighted assets during the period. We have revised our projected RAC range for 2015 to slightly above 3%--our threshold for a "weak" capital and earnings assessment-by the end of 2015--from under 3% in our previous forecast.

This revised projection is based on our expectation that the return to profitability will be sustained, despite an increase in loan impairment charges to 80-100 basis points (bps) of average customer loans in the second half of 2014 and in 2015 (from the exceptionally low level of around 20 bps in the first half of 2014). We expect a continued widening in the net interest margin during the period, with the loan book returning to modest growth from 2015.

We note the bank's statement that it is in discussions with the Department of Finance in relation to the possible conversion of some or all of the €3.5 billion preference shares into ordinary shares. We understand that the timing of any agreement will take into consideration the ongoing comprehensive assessment by the European Central Bank. Barring any distribution from the bank to the state, the conversion of all of the government preference shares to common equity would lift the mid-2014 pro forma RAC ratio to around 6%.

We have incorporated a one-notch negative adjustment into our rating on AIB, offsetting the higher SACP. This adjustment reflects our view that the rating is constrained by the likelihood that extraordinary government support available to AIB's senior unsecured bondholders will diminish over the next two years. After this adjustment, the rating incorporates one notch of uplift to reflect our view that AIB is of "high" systemic importance to Ireland, which we view as "supportive" of private-sector commercial banks. However, we could reduce or remove this uplift shortly before the January 2016 introduction of the EU Bank Recovery and Resolution Directive's bail-in powers for senior unsecured liabilities. These rules indicate to us that EU governments will be much less able to support senior unsecured bank creditors, even though it may take several more years to eliminate concerns about financial stability and the resolvability of systemically important banks. As a result of AIB's higher SACP, we do not anticipate a reduction in government support to have more than a one-notch impact on the rating on AIB, assuming no changes to our stand-alone assessment of the bank.

Outlook

The negative outlook 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 one notch if we consider that extraordinary government support is less predictable under the new EU legislative framework.

The negative outlook also reflects what we see as the lack of certainty on 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 to move sustainably to above 3% in the next 18 months. We would most likely reflect this projection in a downward revision of our capital and earnings assessment to "very weak" from "weak."

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. A revision to stable might also follow if we believed that any steps AIB might take that provide substantial additional flexibility to absorb losses while a going concern fully offset increased bail-in risks; or in the event of a strengthening of its SACP, possibly on the back of an improving RAC projection to closer to 5%.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BB/Negative/B	BB/Negative/B
SACP	bb-	b+
Anchor	bb	bb
Business Position	Adequate (0)	Adequate (0)
Capital and Earnings	Weak (-1)	Weak (-1)*
Risk Position	Adequate (0)	Adequate (0)
Funding and Liquidity	Average and Adequate (0)	Average and Moderate (-1)
Support	+2	+2
GRE Support	0	0
Group Support	0	0
Sovereign Support	+2	+2
Additional Factors	-1	0

*When a bank's anchor SACP, derived from our Banking Industry Country Risk Assessment (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

- Group Rating Methodology, Nov. 19, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Ireland Upgraded To 'A-' On Improved Domestic Prospects; Outlook Positive, June 6, 2014
- Most Irish Bank Ratings Affirmed On Stable Banking Industry Trends, June 10, 2014
- Banking Industry Country Risk Assessment: Ireland, June 10, 2014
- Allied Irish Banks 'BB/B' Ratings Affirmed Following Government Support Review; Outlook Remains Negative, April 30, 2014

Ratings List

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*	B
Commercial Paper*	BB

*Guaranteed by Allied Irish Banks PLC.

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com