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Research Update:

Allied Irish Banks Long-Term Rating Raised To 'BB+' On Reducing Industry Risks In Ireland; Outlook Stable

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

Secondary Contact:
Sadat Preteni, London (44) 20-7176-7560; sadat.preteni@standardandpoors.com

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Overview

- Preprovision profitability for Irish banks has improved on the back of expanding net interest margins.
- We view the post-crisis structure of the industry as stable with relatively few, mostly domestically focused, players.
- A significant improvement in Irish macroeconomic fundamentals and the ongoing property price recovery have supported a sharp decline in credit losses across the banking system, leading to net reversals for Allied Irish Banks in 2014 and early 2015.
- We are therefore raising our long-term ratings on Allied Irish Banks (AIB) and its wholly owned subsidiary AIB Group (U.K.) PLC to 'BB+' from 'BB', and affirming the 'B' short-term ratings.
- The stable outlook on the rating on AIB reflects our view that the improving macroeconomic environment and possible capital strengthening offset the risk that we may remove the uplift for potential extraordinary government support that we currently incorporate in the rating.

Rating Action

On July 20, 2015, Standard & Poor's Ratings Services raised its long-term counterparty credit ratings on Allied Irish Banks PLC (AIB) and its wholly owned U.K. subsidiary, AIB Group (U.K.) PLC (AIB UK), to 'BB+' from 'BB', and affirmed the 'B' short-term ratings. The outlook is stable.

Rationale

The rating action largely reflects our view that industry risks have decreased for Irish banks, and that improvements in banking system profitability and the lower risk appetite will prove enduring (see "Various Rating Actions Taken On Irish Banks Due To Improving Industry Profitability," published today on RatingsDirect). In addition, we believe that the structure of the industry will remain broadly stable with relatively few players and a primary focus on domestic retail and business banking. As a result, we expect the industry's existing competitive landscape to remain supportive of a more rational risk-return profile than before the crisis. These positive developments should, in turn, benefit our long-term view of AIB's creditworthiness.

We see a positive trend in our assessment of economic risk for Ireland. The

Irish macroeconomic recovery has provided an increasingly supportive backdrop for the banking system. We expect real GDP growth of 4.2% in 2015 and 3.8% in 2016--levels that are likely to be ahead of Continental European peers (see " Ireland Long-Term Rating Raised To 'A+' On Government Debt Reduction; Outlook Stable," published June 5, 2015). We expect the unemployment rate to also gradually trend down to 8.0% by end-2016 from 11.4% at end-2014. Nationally, house prices have increased by 13.8% over the past 12 months as of May 2015. Although house price increases have moderated in the past few months, we expect the gap between demand and supply of new housing to persist. Against this favorable backdrop, we expect credit losses to remain exceptionally low. This will be due to a combination of provision releases (both due to progress on restructuring nonperforming loans and changes in peak-to-trough house price assumptions in provisioning models) and declining inflows into new defaults.

Our view of the improved industry risk in the Republic of Ireland has led us to raise the anchor--the starting point in assigning an issuer credit rating to a bank--for most Irish banks (including AIB) to 'bb+' from 'bb'. Our view of AIB's stand-alone credit factors remains unchanged. We have therefore revised up our view of the bank's stand-alone credit profile (SACP) to 'bb' from 'bb-'.

We have maintained our projected risk-adjusted capital (RAC) range for end-2016 at 4.3%-4.8%, still short of the 5% minimum threshold we ascribe to a "moderate" assessment. 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. The above-mentioned RAC forecast does not incorporate any conversion. Barring any distribution from the bank to the state, the conversion of about one-third of the preference shares would be sufficient to lift our projected RAC ratio at end-2016 to materially above 5%; the conversion of at least two-thirds would raise it to above 7%, everything else being equal.

Our forecast of a RAC ratio of between 4.3%-4.8% at end-2016--in the absence of any conversion of the government preference shares--is based on our expectation of:

- A continued widening--albeit gradually slowing--in the net interest margin, combined with the resumption of modest single-digit growth in net lending.
- Broadly flat operating expenses over 2015-2016 as a result of the cost initiatives of the past few years offset by an increase in activity levels and investments.
- Marginal loan impairment charges for the full-year 2015 after a net €300 million writeback in the first quarter, and then a gradual increase to around 40 basis points (bps) of average customer loans in 2016, reflecting a progressive normalization of the cost of risk.
- Low-single-digit growth in risk-weighted assets according to our RAC framework as positive net new lending resumes.

We believe that the likelihood of extraordinary government support available to the senior unsecured bondholders may diminish by the end of the year. We therefore continue to incorporate a negative adjustment in the rating, thereby reducing the uplift of the ratings to one notch rather than two.

We view AIB UK as a "strategic" subsidiary of AIB under our criteria. The subsidiary's long-term counterparty credit rating is based on its SACP, which is at the same level as the parent's group credit profile.

Outlook

The stable outlook on the rating on AIB reflects our view that the improving macroeconomic environment and possible capital strengthening offset the risk that we may remove the uplift for potential extraordinary government support that we currently incorporate in our long-term counterparty credit rating.

More specifically, we believe that our assessment of the economic risks that Irish banks face could improve within the next year or two. This could lead to a higher anchor for Irish banks. In addition, ahead of AIB's privatization, we believe that part of the government preferred shares could be converted into equity, which could materially enhance our assessment of the bank's capitalization. We expect a conversion into equity of €1 billion of the €3.5 billion would be sufficient to push our projected RAC ratio beyond 5%, and lead to an increase in the SACP. Therefore, we consider it likely that an improvement in our stand-alone assessment on the bank would offset the potential removal of the one notch of uplift in the issuer credit rating above the SACP.

We could lower our long-term rating on AIB if we remove the uplift that we factor into the rating for government support, and if this removal was not offset by an improved view of the economic risks that Irish banks face, or an improvement in our assessment of the bank's capitalization.

Even if we decide to remove any uplift for government support, we could raise the long- and short-term ratings in the next two years if our assessment of economic risk improves--leading to a higher anchor for Irish banks--and if we also expect the bank's RAC ratio to durably exceed 7%. The latter could be triggered by a conversion of at least two-thirds of the government preference shares. It could also occur if only one of the above possible improvements in the bank's SACP materializes, and if we include a notch of uplift in the ratings for additional loss-absorbing capacity (ALAC)--provided that we deem the Irish resolution regime as effective at that point and that the bank's ALAC buffer increases substantially to exceed the required thresholds.

The stable outlook on the rating on AIB UK reflects that on the rating on AIB and our stable view of the subsidiary's stand-alone creditworthiness. We could lower the ratings on AIB UK if we lower the ratings on AIB or if we revise down its SACP, for instance based on a reducing franchise or a reduction in its capitalization to below 10%, as measured by our RAC framework. We see little upside potential to AIB UK's ratings at this juncture.

Ratings Score Snapshot

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

*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

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Group Rating Methodology, Nov. 19, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- 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
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010

Related Research

- Ireland Long-Term Rating Raised To 'A+' On Government Debt Reduction; Outlook Stable, June 5, 2015

Ratings List

Upgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Allied Irish Banks PLC		
AIB Group (U.K.) PLC		
Counterparty Credit Rating	BB+/Stable/B	BB/Negative/B

Upgraded

	To	From
Allied Irish Banks PLC		
Senior Unsecured	BB+	BB
Allied Irish Banks N.A. Inc.		
Commercial Paper*	BB+/B	BB/B

Ratings Affirmed

Allied Irish Banks PLC	
Commercial Paper	B
Subordinated	D

*Guaranteed by Allied Irish Banks PLC.

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

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