

CORPORATE SECTORS: FINANCIAL INSTITUTIONS

Dissecting Irish Zombie Banks

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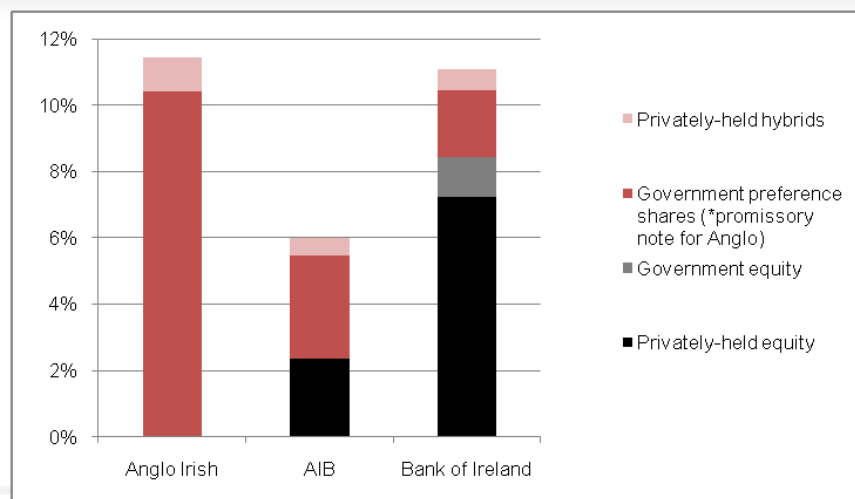
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- **The macroeconomic backdrop for Irish banks is weak at best, with risks to the downside.** RGE's forecast for real GDP growth in 2011 is 1.3%, 1pp below the IMF's WEO projections. Sovereign leverage remains high and unstable while policy tools are limited. Financial sector deleveraging will continue, placing downward pressure on available credit.
- **Liquidity is abundant but reliance on central banks is increasing.** NAMA transfers permanently reduce the amount of refinancing obligations and the banks safely passed September's refinancing hump. However, this rollover was matched by a €24bn (+25% m/m) increase in Irish central bank lending to credit institutions. Additionally, the major banks are reliant upon rate-sensitive deposits; maintaining those balances will further pressure funding costs and margins.
- **Post-NAMA transfers and disposals, banks still remain geared to real estate and are predominantly state-owned.** The big three banks will still hold approximately 30-45% of loans backed by Irish property. The proposed capital requirements reduced uncertainty of losses and future conversions/injections may suffice to maintain positive equity but regulatory forbearance will render capital ratios increasingly meaningless. Nevertheless, full conversion of the Government preference shares is likely under a 'stress' scenario, further diluting equity holders.
- **Hedge your bets and avoid subordinated risk as upside is limited and market risk is high. We unwind negative basis trades at a profit.** Tight and compressing margins coupled with a shrinking asset base and additional provisioning weigh on profitability. Official language has not shied away from burden-sharing with subordinated risk holders but protects senior debt. That said, debt and growth dynamics of the economy point to potential restructuring, meaning senior debt is not in the clear.

Figure 1: Capital Ratios as at end of June 2010



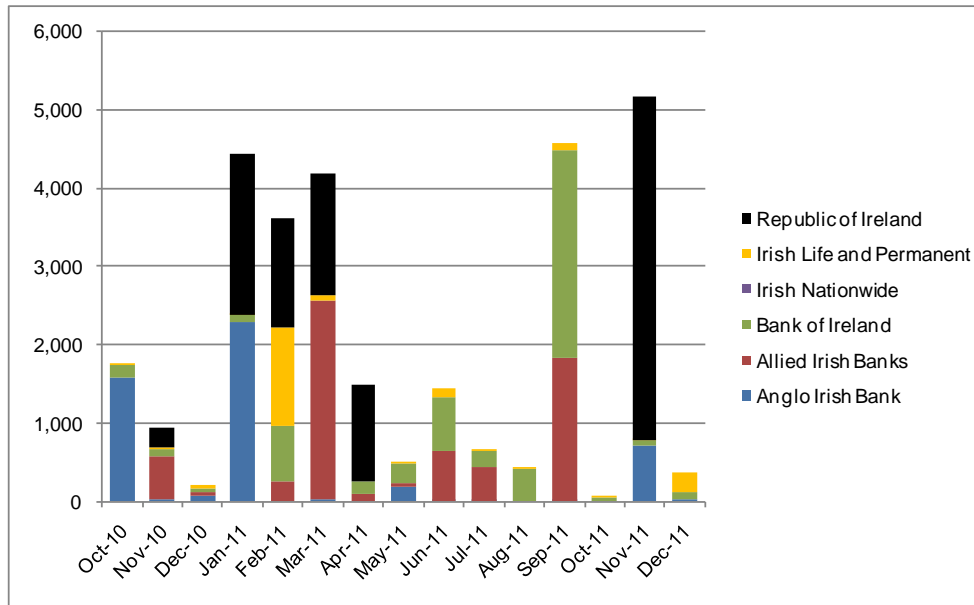
Source: Company reports, presentations, and RGE estimates

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Liquidity: The ECB Waits in the Wings

Figure 2: Monthly Refinancing Obligations Until the End of 2011



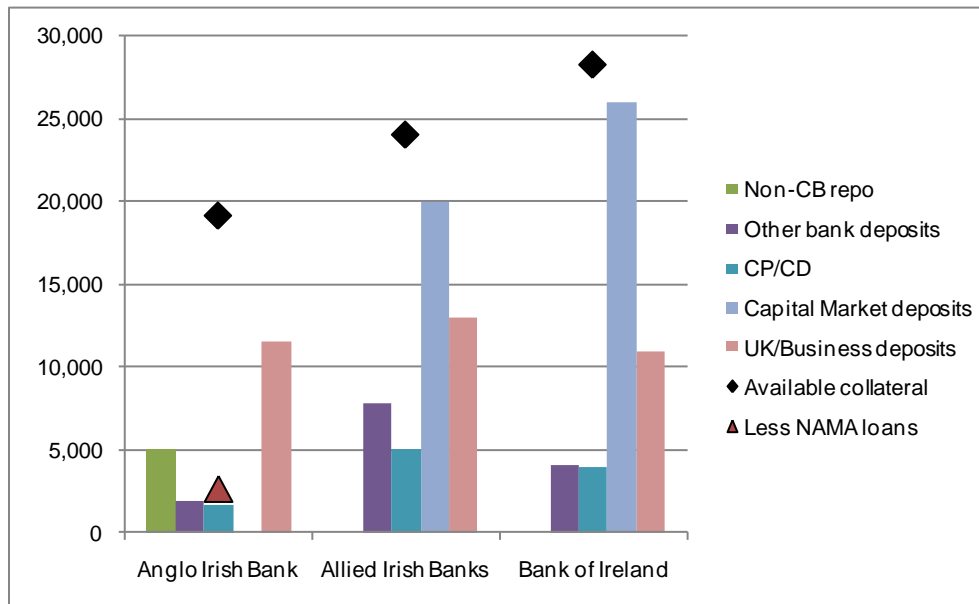
Source: Bloomberg (08 October 2010)

The final quarter of 2010 looks quiet for most Irish banks, with the exception of Anglo Irish which faces maturities totaling €1.6bn (**Figure 2**). However, €12bn of financial and sovereign debt falls due in the first quarter of 2011, with much of bank refi risk falling upon Anglo Irish and Allied Irish Banks (AIB). This maturity hurdle is significantly lower than the roughly €30bn of bank debt that came due in late September and is mitigated by the sovereign's €20bn in cash balances.

As of June 2010, AIB and Bank of Ireland had high levels of available collateral to refinance near-term debt maturities as well as a fair amount of outflows of less 'sticky' financing; commercial paper, corporate deposits, unsecured bank deposits, etc (**Figure 3**). However, the relative levels of capital market and business deposits reaffirm our view that in a period of intense distress, no amount of liquidity is sufficient. The sudden exit of these deposits, however, is a low probability event and is mitigated by the ECB's largesse, which was imposed upon again in September to the tune of €24bn. This has undoubtedly reduced unencumbered assets available to the banks as to repo collateral since the end of the interim.

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Figure 3: Liquidity and Available Collateral (as at End June 2010, EUR Millions)



Notes: Anglo (Estimated. Black marker assumes all NAMA loans HFS are repo-eligible; assumes SPV collateral meets 30% haircut; UK/business deposits are non-retail). AIB (Available collateral = reported cash value of liquidity buffer less reported pledged assets). Bank of Ireland (Available collateral = reported cash value of contingent liquidity buffer less repo transactions). Cash value incorporates haircuts, therefore, underlying collateral carrying value may be much higher

Source: Company reports and presentations

Anglo Irish did not explicitly report aggregate figures for liquidity buffers or pledged assets. We assumed that eligible assets included the promissory note from the Treasury (eligible at a significant discount with the National Central Bank), NAMA bonds, AFS assets, SPV-ready loans to customers, and loans held-for-sale to NAMA. The remainder of over €19bn is a significant amount but unlike AIB and Bank of Ireland, it does not incorporate haircuts demanded by counterparties. Additionally, if we assume that NAMA loans are not repo-eligible, a fair assumption given that past due and impaired loans run at over 90% of total loans, the total amount available drops down to €2.7bn, a razor-thin liquidity buffer. Government guarantees, significant regulatory forbearance and ECB life support are mitigants but given the sensitivity of the funding situation, it is likely we won't see clear details of the bank split until after completion.

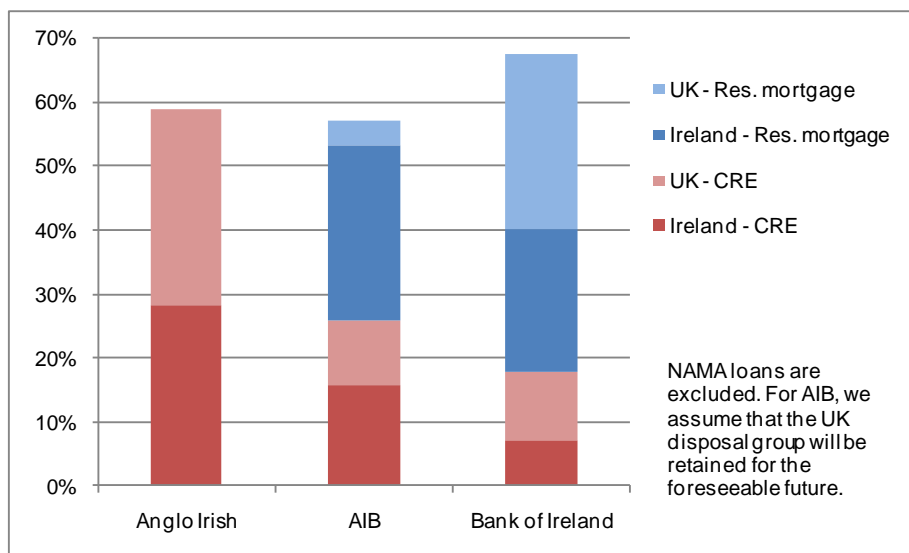
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Solvency Concerns Dominated by Property Exposure and Further Dilution

The balance sheets of the major Irish banks have been sliced and diced to reflect transfers to NAMA, disposal groups, and the longer term continuing business. While some of the worst property loans will ultimately be transferred to NAMA at a significant haircut, Irish banks will remain highly weighted towards UK and Irish property markets.

Figure 4: Irish and UK Property Exposure as Percentage of Continuing Loan Exposures



Source: Company statements and presentations, RGE estimates

If we assume that the second and third tranches are recognized in H2 accounts, and we apply the estimated haircuts provided in the Irish Minister of Finance's statement, we estimated H2 NAMA-related losses of €13.4bn for the largest three Irish banks, net of provisions. These losses alone represent 99%, 74%, and 14% of reported Tier 1 capital for Anglo Irish, AIB, and Bank of Ireland, respectively, at the end of June 2010 (i.e. before the additional capital from H2 capital raisings and disposals). If we stress the Irish and UK property portfolios (**Figure 5**) for AIB and Bank of Ireland, we generate additional losses of €5.1bn and €4.2bn, net of provisions. The potential losses for Anglo Irish appear to be well-covered by provisions but does not include stress on roughly €8bn of U.S. property loans.

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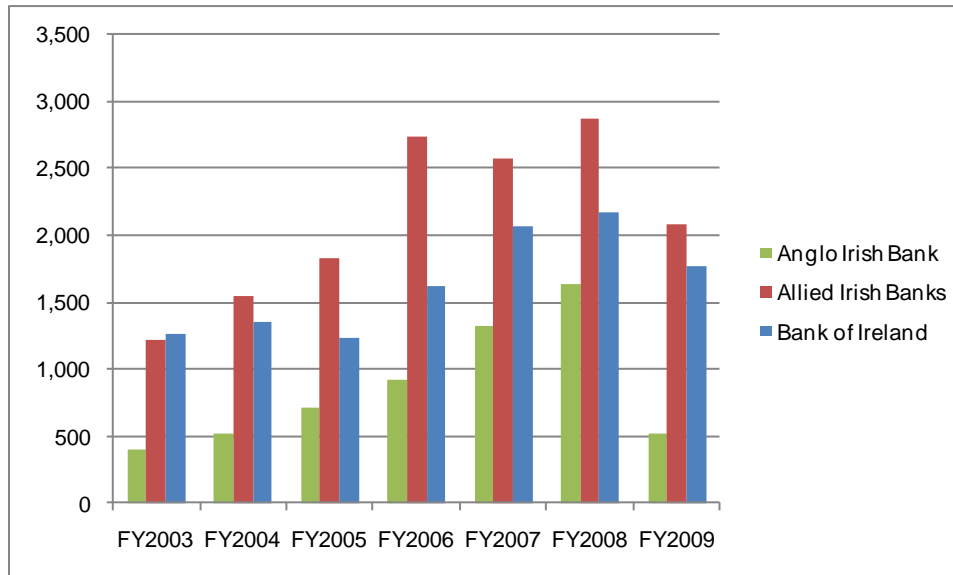
Figure 5: Stress Scenario Haircuts

	Ireland	UK
Property and Development	60%	35%
Property investment	20%	7%
Residential mortgage	5%	3%

Source: PCAR, RGE estimates in grey italics

Some of these losses will be absorbed by pre-provision operating profit (Figure 6) but this figure will continue to shrink as the asset base decreases from run-off or disposals, a low-rate environment and deposit competition continue to pressure margins, and the ability to cut operating costs hits a wall. Clearly, rehabilitation of the Irish banking model will be arduous.

Figure 6: Pre-Provision Operating Profit is Falling (EUR Millions)



Source: Capital IQ

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Regulatory solvency is particularly challenging to estimate due to deleveraging and derogations (i.e. regulatory forbearance) which distort Anglo's capital ratios. AIB will likely benefit from such forbearance—after the forthcoming share-raising it will be effectively nationalized. Under the stress scenario, we think both AIB and Bank of Ireland emerge with Tier 1 ratios above the 4% current regulatory minimum but below the 8.5% core Tier 1 minimum required by the Irish regulator by 2019.

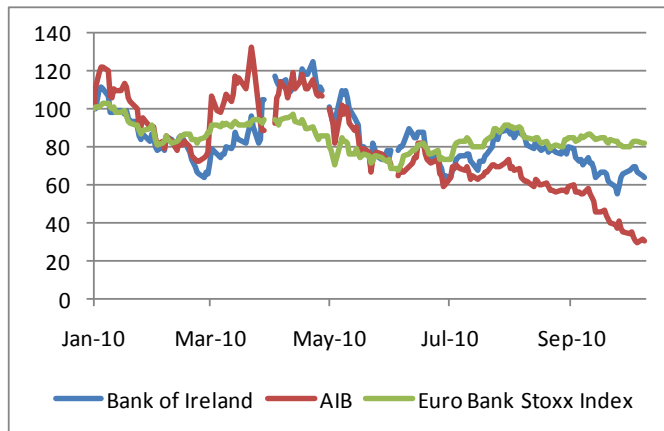
Additionally, a significant portion of post-stress Tier 1 capital will be in the form of non-core equity and therefore both entities may need to convert the remainder of the sovereign's preference shares into core equity further diluting existing shareholders. In the case of AIB, we assumed the €2.5bn, €900m and €3.7bn of new Tier 1 capital generated by the sale of the Polish operations, sale of M&T and government injection, respectively, are realized.

Recommendation: Avoid Un-Hedged Irish Exposure

Fair domestic stress test assumptions (complemented by RGE assumptions) and severe haircuts on NAMA means Irish banks—more specifically, Bank of Ireland—may be attractive to deep value investors with an extended time horizon. However, market risk remains high and near-term volatility will have a severe adverse effect on Irish names. Liquidity may be plentiful but margins are thin, interest-generating assets are shrinking, and regulatory solvency is increasingly meaningless amid regulatory forbearance and regulatory change. We have been Underweight periphery risk within the eurozone and remain so. As we have mentioned in the [Cross-Asset Monthly](#) and previous [strategy flashes](#), taxpayer fatigue and opposition parties may be on the cusp of a tipping point where further writedowns or a political landscape change may result in debt-for-equity swaps as a path to raising capital.

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Figure 7: Irish Bank Equities Have Significantly Underperformed YTD with Good Reason



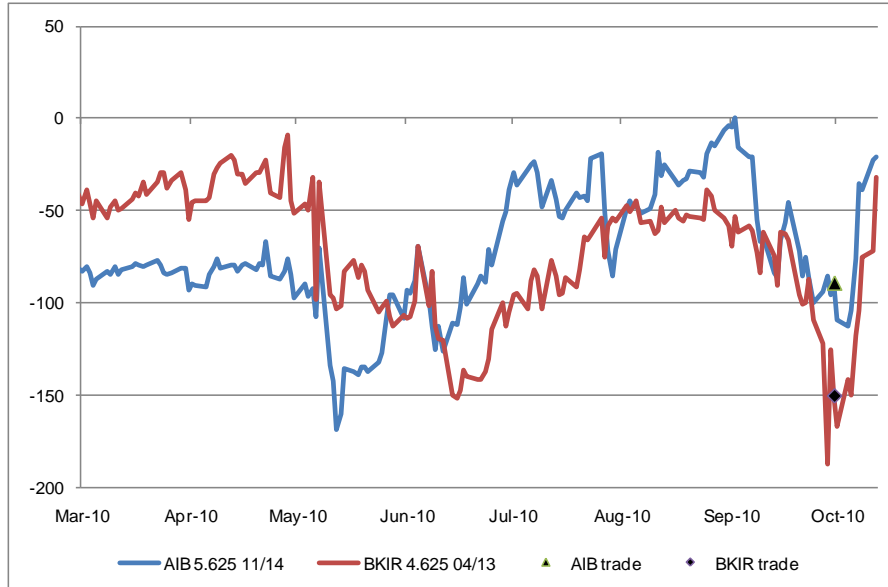
Source: Bloomberg

Irish bank equity still makes no fundamental sense to us, unless one is nimble enough to correctly time the risk-on/risk-off game. Significant government ownership and a weak macroeconomic backdrop will make it hard to generate a profit, let alone provide dividends. Investors that participated in Bank of Ireland's H1 equity offer have already borne a paper loss of almost 20%.

Credit is unattractive as well. As we mentioned in [Ireland: Hedge your Bets](#), the Minister of Finance's statement was highly supportive of senior debt and explicitly mentioned burden-sharing with subordinated debt holders. We reiterate our view: we recommend hedged bets and remain Underweight on subordinated risk. Senior debt is not without risks either; as losses mount and market confidence in the sovereign continues to deteriorate, the sovereign may eventually face a choice between its own solvency and that of its banks. We still do not rule out the potential for burden-sharing with the senior unsecured creditors of nationalized entities.

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Figure 8: Negative Basis Trades Have Moved in Our Favor (CDS-Bond ASW, bps)



Source: Bloomberg

Since recommending a negative basis trade on September 30 (**Figure 8**), i.e. purchasing senior bank bonds and the relevant senior bank CDS, the cash bonds have performed well. We recommend unwinding both trades now for a mid-basis tightening of 68 bps and 118 bps on the AIB and BKIR trade, respectively.