2015 Outlook: Irish Banks

Sector on Path to Recovery; Tail Risks Remain

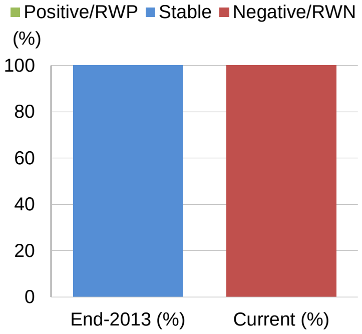
Outlook Report

Rating Outlook

NEGATIVE

(2014: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

STABLE

(2014: STABLE)

- Improving asset quality but significant tail risk
- Pillar banks have returned to profitability
- Profits key to improving weak capitalisation ratios

Related Research

Other Outlooks

www.fitchratings.com/outlooks

Other Research

Global Economic Outlook: World Increasingly Dependent on US Growth Engine (December 2014)

Fitch Affirms BOI and AIB; Negative Outlooks (July 2014)

Ireland (August 2014)

Go to appendix for list of rated entities

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Reducing Implicit Support: The Negative Outlooks on Bank of Ireland (BOI), Allied Irish Banks Plc (AIB) and Ulster Bank Ireland Limited (UBIL) reflect Fitch Ratings' view that the Irish (and UK) authorities' propensity to support banks is set to weaken as progress is made in implementing the legislative and practical aspects of an effective bank resolution framework. Ireland is set to implement the EU's Bank Recovery and Resolution Directive (BRRD) by 1 January 2016.

Our view of possible support for BOI and AIB derives from their systemic importance, while UBIL's derives from its strategic importance to its ultimate parent, Royal Bank of Scotland Group Plc (RBSG) which in turn, is viewed as systemically important by the UK authorities.

VRs on Upward Path: BOI and AIB's Viability Ratings (VRs) have been improving due to their better capital flexibility which is supported by a return to profitability in 2014. Given their strong franchises, reduced risk appetite and a benign operating environment, these banks' VRs have the potential for further upgrades. However, given their large legacy risks, still weak capital ratios and continued exposure to potentially volatile Irish commercial and residential real estate values, the full extent of any potential upgrades is unlikely to be reflected fully in 2015.

Reducing Tail Risk: Asset quality tail risk is significant, with NPL ratios of 17% in BOI and 33% in AIB at end-1H14 and 45% in UBIL at end-2013. However, the emergence of new arrears has slowed, house prices have stabilised and several of the earlier impediments to asset quality normalisation (such as rumours of debt forgiveness and the inability to repossess properties) have been resolved. We therefore expect 2015 to see further reductions in NPLs in all the Fitch-rated banks, with restructurings and renegotiations playing an important role.

Pillar Bank Funding Stable: BOI's and AIB's funding has been stable and loan/ customer deposit (LTD) ratios have benefitted from deleveraging since 2010. We expect these ratios to remain stable or improve slightly in 2015 as loan growth remains sluggish. UBIL's funding profile remains weak with a high 224% LTD ratio at end-2013. Fitch expects this to begin to moderate and RBSG funding reliance to continue to reduce in 2015.

Capitalisation to Improve: Fitch Core Capital (FCC) ratios are weak in BOI and AIB but this is mitigated by the perpetual preference shares, originally part of the government's 2009 recapitalisation, in the capital stack of the banks. Fitch believes that these ratios will continue to improve until their fully loaded Basel III (FLB3) common equity Tier 1 (CET1) ratios converge with other European domestically systemically important banks at around 10%-12%. UBIL's capital has now become adequate for its risk profile.

Outlook Sensitivities

Removal of Support: Based on progress in the implementation of effective bank resolution, we are likely to revise downwards AIB's and BOIs' Support Ratings (SRs) to '5' and Support Rating floors (SRFs) to 'No floor' in 1H15. At this point, the BOI's and AIB's IDRs will be downgraded to level of their respective VRs at the time (they are currently, 'bb-' and 'b+', respectively).

Strategic Importance to RBSG: Fitch downgraded UBIL's IDR in 2014 to reflect the reduced, but still high, strategic importance of UBIL to RBSG. UBIL's IDR is sensitive, therefore, to both RBSG's rating and its continued strategic importance to the UK group.

Key Issues

Asset Quality

Improving NPLs, Significant Tail Risk

NPL ratios remain elevated and the proportion of unreserved NPLs/ FCC remains high in all of the Fitch-rated banks. However, asset quality is beginning to stabilise in Ireland and Fitch expects that new NPL growth will continue to slow in all of the Fitch-rated banks during 2015. However, a large proportion of forborne loans and loans classified as past due but not impaired contributes to the vulnerability of the banks' recoveries.

Figure 1

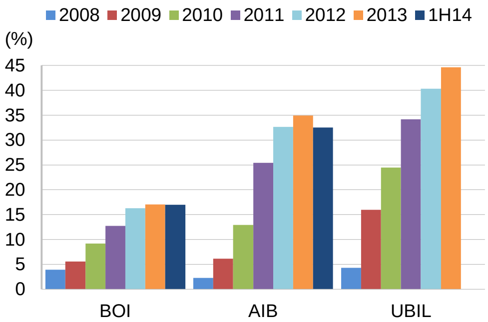
Past due But Not Impaired

(% gross loans)	Total	>90 days
BOI	3.3	1.3
AIB	3.7	1.4
UBL	4.4	0.5

BOI and AIB at end-1H14, UBIL end-2013
Source: Fitch, banks

Figure 2

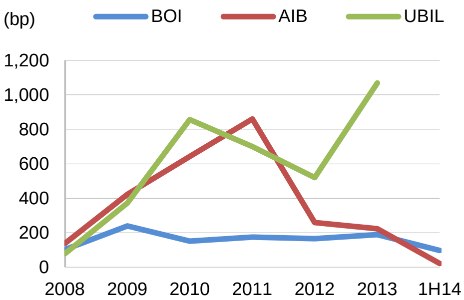
NPL Ratio



Source: Fitch, banks

Figure 3

LIC/Av. Gross Loans



Source: Fitch, banks

RBS Capital Resolution Group

Fitch considers that new NPL formation at UBIL will be low in 2015 as the bank underwent a large scale review of its loan book at end-2013 together with its parent, RBSG. About EUR15bn (about one-third) of gross loans, largely but not fully non-performing, are now being managed by RBS Capital Resolution Group (RCR). This forms part of a wider RBSG strategy for the accelerated realisation of designated assets. RCR has stated an intention to dispose of 55%-70% of its assets before end-2015 and 85% by end-2016. Fitch expects that UBIL's NPLs will reduce meaningfully in 2015 given that in the first nine months of 2014 RBSG reported a net release of impairment charges of GBP803m, mostly in Ulster Bank Limited (UBL, UBIL's parent) and RCR. RBSG attributed the strong write-back to sustained improvements in economic and asset market conditions in the UK and especially Ireland.

UBL's results are reported over two segments in RBSG's accounts, Ulster Bank and RCR (Ireland). Ulster Bank reported a net profit for 9M14 of GBP437m, including write-backs of GBP261m. RCR (Ireland) had negative income of –GBP28m before expenses for the same period but reported GBP394m of impairment releases.

Net Defaults Represent a Large Proportion of Equity

Due to the high preponderance of defaulted loans relating to mortgages and commercial property, there is significant reliance on collateral to support loan valuations. As a result of this, net NPLs/ equity range from 100%-140% at end-1H14. While provision levels for Irish mortgages were lower than those at Irish subsidiaries of foreign banks, we believe that these reserves are adequate. At end-1H14 AIB's loan loss reserve coverage on Irish mortgages was 35% and BOI's was 51%. UBL's mortgage coverage was 53% at end-2013 with UBIL accounting for 88% the group's mortgage exposure.

BOI and AIB provide for mortgage losses based on peak-to-trough assumptions as well as forced-sale-values, which are more conservative than the market indexes but these indexes are theoretical values based on the limited but growing number of new transactions. Neither of the banks' ratios or reserve coverage were materially impacted by the recent asset quality review conducted by the ECB.

Related Criteria

Global Financial Institutions Criteria (January 2014)

Figure 4

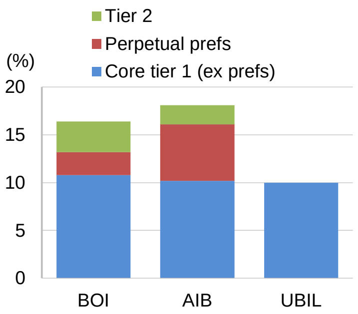
Capital Ratios

	1H14		2013	
	FCC	FEC	FCC	FEC
BOI	7.8	9.1	6.8	7.9
AIB	6.4	12.3	4.7	10.4
UBIL	nr	nr	11.7	11.7

Source: Fitch, banks

Figure 5

Capital Ratios



AIB and BOI at end-1H14, UBIL end-2013
Source: Fitch, banks

Capitalisation

FCC Ratios Expected To Improve

We expect that the currently weak capital ratios reported by the Irish banks will improve in 2015, following on from improvements seen in 1H14. The agency believes that the improved capital flexibility that will come with BOI's and AIB's expected return to profitability in 2014 and supplementary capital in the form of the perpetual preference shares will provide additional loss absorption.

In BOI's case, the perpetual preference shares would add about 240bp to capital if it was considered to be equity and in AIB it would represent an additional 590bp. The perpetual preference shares will continue to be recognised on the transitional basis until 31 December 2017. BOI has stated that it will be using the capital it is generating from profits to facilitate the derecognition of its remaining EUR1.3bn of preference stock in 2016. BOI has proven access to the capital markets over the past 12 months with EUR600m of new equity raised in late-2013 and EUR750m of Tier 2 subordinated debt issued in June 2014.

UBIL's FCC ratio of 11.7% at end-2013 was stronger than BOI's and AIB's, but the bank is loss-making and FCC deteriorated significantly from 17.4% at end-2012. However, Fitch expects UBIL's ratios to be supported by strong asset sales under RBSG's RCR which will materially reduce RWAs. Fitch considers that these disposals are likely to be capital generative in light of the relatively high levels of provisions and high risk-weights on many of these assets.

BOI, AIB and UBIL passed the European Banking Authority (EBA) stress test, with adverse 2016 outcomes of 9.3% for BOI (from a CET1 of 11.8% at end-2013), 6.9% for AIB (from 14.6%) and 6.2% for UBIL. However, CET1 would have reduced to 2.9% for BOI and negative 3.6% for AIB in the 2016 adverse scenario if the assessment was done on a FLB3 basis.

Key Issues

2014 Review

Improving Operating Environment Supports Return To Profitability

Both BOI and AIB returned to profitability in 1H14 which Fitch expects to continue. BOI and AIB had been loss-making since 2009. The improved earnings of the banks were supported by an improving macro-economic environment and outlook in the banks' key markets of Ireland and the UK. Fitch upgraded the Irish sovereign to 'A-' on 15 August 2014

Active cost reduction and materially lower LICs are important drivers of the banks' improving profitability. Both banks also cited improving net interest margins (NIM) as a contributing factor due to reducing cost of funds, better margins on new lending and reducing eligible liabilities guarantee (ELG) fees. BOI calculated its NIM at 208bp during 3Q14 (2013: 184bp, 2H13: 203bp) while AIB reported a NIM of 164bp during 3Q14 excluding the impact of ELG and NAMA senior bonds (2013: 154bp).

Defaulted loans have reduced since end-2013 and arrears in Irish mortgages have fallen in both pillar banks, with reductions in both early and default arrears. BOI reported NPLs of EUR16.4bn at end-3Q14 (end-2013: EUR15.8bn) NPLs were affected by currency movements but we expect further NPL reductions in 2015. AIB's impaired loans had reduced by about 16% to EUR24.3bn at end-3Q14 from EUR28.9bn at end-2013 (1H14: EUR26.0bn).

Repayments continued to exceed new lending in both banks with net loans reducing to EUR83.3bn at end-3Q14 (end-2013: EUR84.5bn) for BOI and to EUR64.7bn for AIB (end-2013: EUR65.7bn). Despite the reducing trend, BOI reported that new business volumes were up by 1H14 compared with the same period in 2013 with new lending totalling EUR4.3bn Similarly, AIB reported that its new lending of EUR2.6bn was 37% higher compared with 1H13.

Annex 1

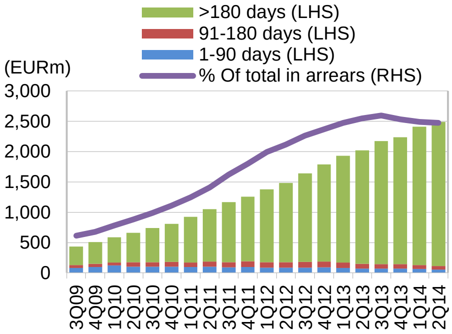
Figure 6
Issuer Ratings

Issuer	Rating/Outlook/RW (Current)	Rating/Outlook/RW (End-2013)	Market Implied Rating (Current)
Bank of Ireland (BOI)	BBB/Neg/bb-	BBB/Stable/b	BB
Allied Irish Banks, plc (AIB)	BBB/Neg/b+	BBB/ Stable/b-	n.a.
Ulster Bank Ireland Limited (UBIL)	BBB+/Neg/ccc	A-/ Stable/ccc	n.a.

Source: Fitch

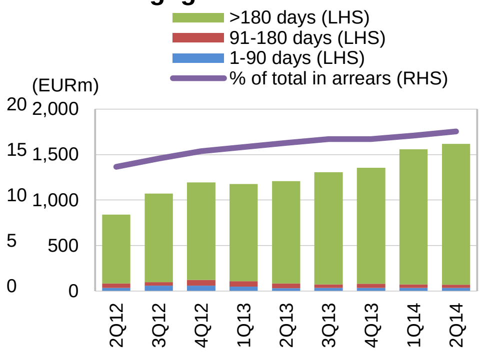
Annex 2 Macroeconomic and Market Backdrop

Figure 7
Residential Mortgage Arrears



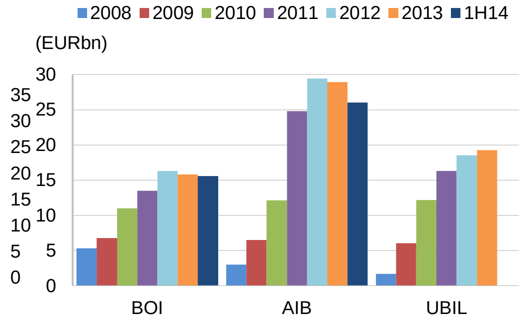
Source: Central Bank of Ireland

Figure 8
BTL Mortgage Arrears



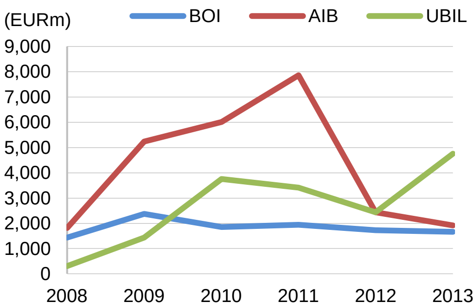
Source: Central Bank of Ireland

Figure 9
NPL Amount



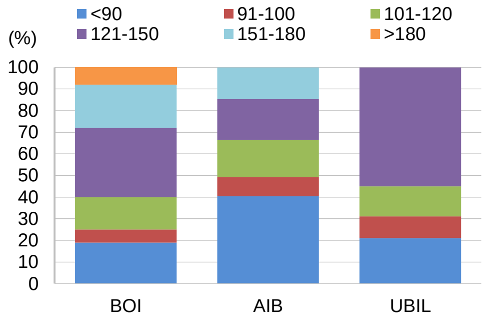
Source: Fitch, banks

Figure 10
Loan Impairment Charges



Source: Fitch, banks

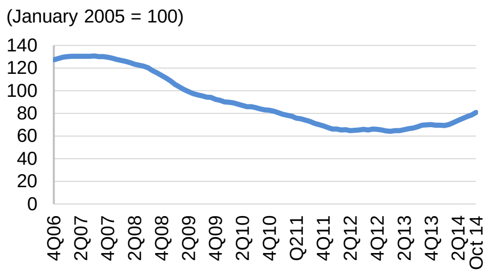
Figure 11
LTVs of Impaired or >90 days at End-2013



Source: Fitch, banks

Figure 12
Irish Residential Property Price Index

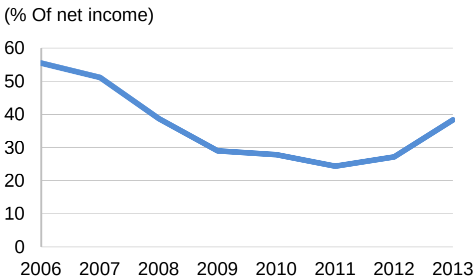
Prices recovering but 40% down from peak



Source: Central statistics office Ireland

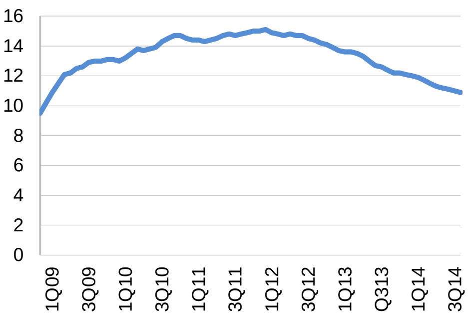
Figure 13
Irish New Mortgage Affordability

National single first time buyer



Source: EBS/DKM

Figure 14
Unemployment Rate (%)



Source: Central statistics office Ireland