FITCH UPGRADES ALLIED IRISH BANKS, PLC TO 'BBB-'; OUTLOOK REMAINS POSITIVE

Fitch Ratings-London-23 November 2017: Fitch Ratings has upgraded Allied Irish Bank's (AIB) Long- and Short-Term Issuer Default Rating (IDRs) and Viability Rating (VR) to 'BBB-'/'F3'/'bbb-' from 'BB+'/'B'/'bb+'. The Outlook for the Long-Term IDR remains Positive.

In addition, Fitch has assigned a 'BBB-(dcr)' Derivative Counterparty Rating (DCR) to AIB as part of its roll-out of significant derivative counterparties in western Europe and the US. DCRs are issuer ratings and express Fitch's view of banks' relative vulnerability to default under derivative contracts with third-party, non-government counterparties.

The IDRs of AIB reflects its standalone strength as reflected in its VR, which Fitch has today upgraded. The upgrade reflects continued improvements in asset quality, a longer record of stable profitability and strengthened capitalisation. The Positive Outlook reflects rating upside if the bank continues to make progress in reducing problem loans.

KEY RATING DRIVERS
IDRS, DCRS, VR AND SENIOR DEBT
AIB's VR and IDRs are driven by the bank's strong domestic franchise, strengthened capitalisation, sound funding profile, diversified revenue streams by product and customer, and improving, albeit still weak, asset quality.

Asset quality remains a key factor constraining the VR in the low 'bbb' range. Asset quality indicators have been improving at a strong pace due to a supportive Irish economy, non-recourse loan sales and the general progress in reducing legacy impaired assets.

The bank's impaired loans ratio fell to 12.2% of gross loans at end-1H17 (from 14% at end-2016) and we expect this positive trend to continue over the medium-term, albeit at a more moderate pace, as the bank works through smaller exposures (namely residential mortgages). Our assessment of asset quality also factors in a high proportion of non-performing loans, which include all loans that are 90 days past due but not impaired and forborne loans that add up to a high proportion of the bank's balance sheet.

AIB's strong domestic franchise (particularly in mortgages) and diversified business model across retail and corporate banking is a rating strength for the bank. The franchise benefits from a highly concentrated Irish banking sector while the bank's strong positioning in its key operating segments provides AIB with clear loan and deposit pricing power.

Profitability has improved strongly in recent years, driven by a pick-up in new lending volumes, large releases of loan loss reserves and a strengthening of the bank's net interest margin. Nonetheless, revenue and profitability remain constrained by sluggish net loan growth and the bank's large exposure to low-yielding tracker mortgages. Although we expect profitability to remain challenged by the low interest rate environment, increasing competition and investment costs related to technology and digitalisation, we expect it to remain sound, supported by an improving loan mix and low loan impairment charges.

Capitalisation has strengthened considerably since 2015, supported by improving internal capital generation, the reduction of legacy loans and the conversion of perpetual government-held preference shares to equity in 2016. AIB reported a 19.9% transitional common equity Tier 1 ratio (16.6% on a fully-loaded basis) at end-1H17, comfortably above its Pillar 2 requirements. However, we expect the bank will maintain comfortable buffers over minimum requirements while it works through its still large stock of non-performing loans. Although the proportion of unreserved impaired loans to Fitch Core Capital (FCC) continues to fall (end-1H17: 38.2%; end-2016: 48.2%) its level still highlights AIB's vulnerability to potentially falling collateral prices.

Funding is sound and supported by strong access to retail deposits, little use of central bank funding and a well-established and diversified wholesale funding franchise. The strong pace of deleveraging and sluggish net loan growth has reduced funding requirements, allowing the bank to roll-off more expensive and less stable funding. We believe the bank is strongly -positioned to meet minimum requirement for own funds and eligible liabilities (MREL), through a mixture of regulatory capital and MREL-compliant senior issuance, given recent improvements in solvency and its good wholesale market access. Liquidity is sound, supported by a large stock of liquid assets and contingent access to liquidity sources through various central bank facilities.

We have assigned a DCR to AIB due to its significant derivatives activity domestically. The DCR is at the same level as the Long-Term IDR because under Irish legislation, derivative counterparties have no preferential status over other senior obligations in a resolution scenario.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)
AIB's SR of '5' and SRF of 'No Floor' reflect Fitch's view that senior creditors cannot rely on extraordinary support from the Irish authorities in the event that the bank becomes non-viable. In our opinion, the EU's Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) provide a framework that is likely to require senior creditors to participate in losses for resolving the bank.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The ratings on the subordinated debt and other hybrid capital issued by AIB are notched off AIB's VR and reflect Fitch's assessment of their incremental non-performance risk relative to the VR (up to three notches) and assumptions around loss severity (up to two notches).

AIB's subordinated Tier 2 debt rating is notched down once from the bank's VR, reflecting larger loss severity relative to senior obligations given their subordinated status. No notching is applied for incremental non-performance risk as the write-down of the notes will only occur after the point of non-viability is reached and there is no prior coupon flexibility.

AIB's AT1 debt rating is notched down twice for loss severity and three times for non-performance risk, reflecting the notes' deep subordination and fully discretionary coupon omission.

The 'C' rating on AIB's legacy subordinated notes reflects these instruments' non-performance since the bank is not paying the discretionary coupons and also the notes' sustained economic losses, resulting in weak recoveries.

SUBSIDIARY AND AFFILIATED COMPANY
EBS Limited and AIB Group (UK) Plc are wholly-owned by AIB. Both subsidiaries are, to varying degrees, reliant on AIB for funding and capital support. Their IDRs, SRs and senior debt ratings are therefore based on support, and their IDRs and senior debt ratings are equalised with AIB's. Fitch has not assigned VRs to these subsidiaries as we believe they are closely integrated with AIB and therefore cannot be analysed meaningfully on a stand-alone basis.

RATING SENSITIVITIES
IDRS, DCRS, VRS AND SENIOR DEBT

The Positive Outlook on AIB's IDRs reflect our expectation that the ratings could be upgraded, should the bank continue to make progress in reducing its stock of problem loans over the next 24 months while maintaining sound capitalisation, funding and liquidity and continuing to generate adequate profitability.

The ratings could come under pressure if the economic effect of the UK's decision to leave the EU is particularly severe for either Ireland as it could negatively impact asset quality and capitalisation. Negative pressure on the VR, and hence the IDRs, would also arise if the bank increases its risk appetite, for example, by materially increasing its exposure to commercial real estate.

SR AND SRFS
An upgrade to the SR and upward revision to the SRF would be contingent on a positive change in the sovereign's propensity to support its banks. While not impossible, this is highly unlikely in Fitch's view.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The ratings of all subordinated instruments are primarily sensitive to a change in the VR of AIB, or to changes in their notching in accordance with our criteria and assumptions on non-performance risk.

SUBSIDIARY AND AFFILIATED COMPANIES
The ratings of EBS Limited and AIB Group (UK) Plc are sensitive to the same factors that might drive a change in AIB's. The SR of both subsidiaries would be sensitive to changes in their strategic importance to AIB as well as AIB's ability to support them.

The rating actions are as follows:

Allied Irish Banks
Long-Term IDR upgraded to 'BBB-' from 'BB+'; Outlook Positive
Short-Term IDR: upgraded to 'F3' from 'B'
Viability Rating: upgraded to 'bbb-' from 'bb+'
Derivative Counterparty Rating: assigned at 'BBB-(dcr)'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes upgraded to 'BBB-' from 'BB+'
Short-term debt, including commercial paper upgraded to 'F3' from 'B'
EMTN EUR10 billion programme Long-Term and Short-Term ratings upgraded to 'BBB-' from 'BB+' and 'F3' from 'B', respectively
EUR750 million subordinated lower tier 2 notes (XS1325125158) upgraded to 'BB+' from 'BB'
EUR500 million subordinated AT1 7% trigger notes (XS1328798779) affirmed at 'B'
Subordinated legacy non-performing debt (XS0232498393, XS0214107053 and XS0435957682) affirmed at 'C'

AIB Group (UK) PLC
Long-Term IDR upgraded to 'BBB-' from 'BB+'; Outlook Positive
Short-Term IDR upgraded to 'F3' from 'B'
Support Rating upgraded to '2' from '3'

EBS d.a.c.
Long-Term IDR upgraded to 'BBB-' from 'BB+'; Outlook Positive
Short-Term IDR: upgraded to 'F3' from 'B'
Support Rating: upgraded to '2' from '3'
Senior long-term debt upgraded to 'BBB-' from 'BB+'
Short-term debt upgraded to 'F3' from 'B'

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Applicable Criteria
Global Bank Rating Criteria (pub. 25 Nov 2016)
https://www.fitchratings.com/site/re/891051