FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms AIB Group at 'BBB'; Outlook Negative

Thu 15 Oct, 2020 - 12:54 PM ET

Fitch Ratings - Milan - 15 Oct 2020: Fitch Ratings has affirmed AIB Group Public Limited Company's (AIBG) Long-Term Issuer Default Rating (IDR) at 'BBB' and Viability Rating (VR) at 'bbb'. Fitch has also affirmed the group's operating companies Allied Irish Banks (AIB)'s and AIB Group (UK) PLC (AIBUK)'s Long-Term IDRs at 'BBB+'. The Outlooks on the Long-Term IDRs are Negative. A full list of rating actions is below.

The affirmation of the ratings reflects our view that capitalisation and funding firmly underpin the group's ratings despite our expectation of some temporary deterioration in financial metrics due to economic downturn in Ireland. The Negative Outlook reflects downside risks to the ratings should profitability and asset quality deteriorate more permanently and normalise below pre-crisis levels without credible prospects to be restored.

We expect a fall in real Irish GDP of 8.6% this year before recovering 6% in 2021. The pace of recovery will depend on how fast firms' and households' sentiment recovers, which is very uncertain. A further risk to the economic outlook stems from high uncertainty about the future framework for UK-EU trade. We see significant risk of UK-EU trade reverting to WTO terms, which would have an adverse impact on economic developments in Ireland, given its close trade links with the UK.

KEY RATING DRIVERS

VRs, IDRS, DERIVATIVE COUNTERPARTY RATING (DCR) AND SENIOR DEBT

Fitch assesses the group on a consolidated basis. AIBG acts as the holding company of the Allied Irish Banks group and its VR is aligned with that of its wholly-owned operating subsidiary, AIB. The equalisation of the VRs reflects the continued absence of double leverage at the holding company level and no material restrictions to the transfer of capital and liquidity across the group, subject to the operating companies meeting regulatory capital and liquidity requirements.

The VRs reflect the group's strong domestic franchise in core lending and deposits in Ireland - with the latter underpinning the group's sound and stable funding - a moderate risk appetite and strong regulatory capital ratios. Profitability is variable over the economic cycle and influenced by geographic concentration to the small, open and cyclical Irish economy. The VRs also incorporate our expectations that asset quality will temporarily deteriorate but also the bank's commitment and acquired skills to reduce impaired loans to below pre-crisis levels.

The bank reported a 5.8% gross stage 3 loan ratio at end-1H20, which we expect to deteriorate in the near term, due to its sizeable stage 2 exposure (EUR10.5 billion at end-1H20 or 17% of total gross loans). However, given stronger underwriting and government-support measures for several borrower segments, increases of stage 3 exposure should not lead to the impaired loan peaks observed during the global financial crisis. Moreover, a substantial portion of borrowers on payment breaks have returned to normal payment patterns. Over the longer term, the bank has expressed its commitment to reducing the stage 3 loan ratio and we acknowledge its record in reducing impaired loans, its restructuring skills as well as portfolio-disposal capabilities.

AIBG's profitability varies over the economic cycle. The bank reported a large operating loss of over EUR800 million in 1H20, following nearly EUR1.2 billion loan impairment charges, which however should represent 80%-90% of the impairment charges for the full year, and weakness across all revenue lines. Beyond the temporary impact of the coronavirus outbreak, AIBG's profitability continues to be structurally supported by the wide margins of the concentrated Irish market, the bank's leading market position and pricing power, and pricing discipline in the sector. In the near term, however and until there is a return to net lending growth and normalised loan impairment charges, profitability metrics will be well below structural levels. Our negative outlook on the bank's profitability reflects downside risks from profitability normalising at levels that are permanently below pre-2020's, given the impact of the pandemic and Brexit on the Irish economy.

AIBG operates with ample capital buffers above minimum requirements, with rating headroom for a moderate deterioration of reported regulatory ratios in the medium term. Since the financial crisis capitalisation strengthened considerably, supported by a large-scale reduction of legacy impaired loans and improved profitability. Despite the 1H20 loss, AIBG reported strong 20.2% transitional and 16.4% fully loaded common equity Tier 1 (CET1) (15.6% proforma including -80bp impact from the targeted review of internal models on mortgage loans) ratios at end-1H20, comfortably above its maximum distributable amount requirements, with a 1,050bp and a 670bp buffer respectively.

AIBG's funding profile is supported by strong access to stable retail deposits, and an established and sufficiently diversified wholesale funding franchise. Customer deposits have been growing strongly in Ireland in 1H20 and fund a significant portion of the bank's assets. Liquidity is sound, supported by a large stock of liquid assets, including sizeable cash deposited at the central bank, and contingent access to central bank liquidity facilities.

AIBG's Long-Term IDR and senior debt ratings are in line with the bank's VR.

AIB's Long-Term IDR, senior debt ratings and DCR are one notch above the bank's VR to reflect the level of protection offered to AIB's senior third-party liabilities. This is provided via existing resolution funds raised by AIBG and down-streamed to AIB in the form of senior non-preferred debt and designed to protect the operating company's external senior creditors in a group failure. These buffers of junior and senior non-preferred debt are built to comply with minimum requirement for own funds and eligible liabilities (MREL) and the group's strategy to meet the requirement exclusively through the use of junior and senior non-preferred debt. The intermediate MREL is estimated at 27.1% of risk-weighted assets (RWAs), to be reached by 1 January 2022, with which the group was already compliant at end-1H20. AIB's DCR is rated 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.

The Short-Term IDRs and short-term senior debt ratings are based on our assessment of the group's funding and liquidity, which is in line with the level required for a 'F2' rating.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

AIBG's and 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

AIB's and AIBG's subordinated Tier 2 debt ratings are notched down twice from the banks' 'bbb' VRs, reflecting the likelihood of poor recovery prospects for the notes arising from subordination in case of a non-viability event. We do not apply further notches for non-performance risk because the terms of the notes do not provide for loss absorption on a "going concern" basis.

AIB's additional Tier 1 (AT1) debt rating is notched down twice from the VR for loss severity and twice for non-performance risk, reflecting the notes' deep subordination and fully discretionary coupon omission.

The 'C' rating on AIB's legacy subordinated notes reflects their non-performance since the bank is not paying the discretionary coupons and also the notes' sustained economic losses.

SUBSIDIARY COMPANY

The IDRs of AIB Group (UK) PLC (AIBUK), a fully-owned UK subsidiary, are based on institutional support from its parent and equalised with AIB's IDRs to reflect that external senior creditors benefit from resolution funds raised by AIBG and down-streamed to AIBUK through its direct parent bank AIB. These resolution funds are designed to protect the subsidiary's external senior creditors in a group failure. AIBUK is highly integrated into AIB and buffers have been built up to meet resolution requirements.

AIBUK represented 14% of group gross loans at end-1H20. The subsidiary is closely integrated with the group and reliant on the group's systems and processes. Fitch does not assign a VR to AIBUK as we believe it is so closely integrated with AIBG that it cannot be analysed meaningfully on a standalone basis. Our support assessment also reflects fungibility of capital and funding and a record of prompt support from the parent.

RATING SENSITIVITIES

VRs, IDRS, DCR AND SENIOR DEBT

Factors that could, individually or collectively, lead to negative rating action/downgrade:

The IDRs, senior debt ratings and DCR of AIB and AIBG could be downgraded if the VRs are downgraded.

The Short-Term IDRs and short-term senior debt ratings of AIBG are also sensitive to a weakening of our assessment of the group's funding and liquidity.

While capital levels at AIBG provide a sizeable buffer of protection against possible deterioration, the ratings would be downgraded if a worsened operating environment in Ireland, owing to the pandemic, the effects of the post-Brexit relationship between the EU and the UK or a combination of both, results in a notable and permanent increase of capital encumbrance by unreserved impaired loans and in structural deterioration in the bank's ability to generate revenue.

AIBG's ratings would also be downgraded on a material increase in the holding company's double leverage, which we do not expect.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The Outlooks on the Long-Term IDRs could be revised to Stable if the negative impact of the pandemic and of the UK-EU trade relationships on the Irish and UK economy is short and the recovery swift.

Given AIBG's focus on the fairly small and volatile Irish market rating upside is limited. Nonetheless, in the event the group is able to withstand rating pressure arising from the pandemic and the effects of post-Brexit arrangements, an upgrade would depend on its ability to materially strengthen its company profile and profitability and to operate with a much lower risk appetite and impaired loan levels.

SR and SRF

An upgrade of the SRs and upward revision of the SRFs 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 entities' VRs, or to changes in their notching should Fitch change its assessment of loss severity or relative non-performance risk.

SUBSIDIARY COMPANY

AIBUK's ratings are sensitive to the same factors that might drive a change in AIB's IDRs. In addition, the Long-Term IDR could be downgraded if Fitch believes that the subsidiary's external senior creditors no longer benefit from resolution debt buffers designed to protect them. This could result from a change in resolution legislation or a change in the resolution strategy of the group, neither of which we currently expect. The ratings are also sensitive to changes in the bank's strategic importance to AIBG.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

The ratings of AIBUK are directly linked to AIB's.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the

entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Allied Irish Banks, plc	LT IDR	BBB+ Rating Outlook Negative	Affirmed	BBB+ Rating Outlook Negative
	ST IDR	F2	Affirmed	F2
	Viability	bbb	Affirmed	bbb
	Support	5	Affirmed	5
	Support Floor	NF	Affirmed	NF
	DCR	BBB+(dcr)	Affirmed	BBB+(dcr)
• subordinated	LT	C	Affirmed	C

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

AIB Group (UK) PLC	EU Issued
AIB Group Public Limited Company	EU Issued
Allied Irish Banks, plc	EU Issued

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Banks Europe Ireland United Kingdom
