FitchRatings

FITCH UPGRADES BANK OF IRELAND AND ALLIED IRISH BANKS; OUTLOOK POSITIVE

Fitch Ratings-London-16 December 2015: Fitch Ratings has upgraded Bank of Ireland's (BOI) Long- and Short-term Issuer Default Rating (IDR) and Viability Ratings (VRs) to 'BBB-'/'F3/'bbb-' from 'BB+'/'B'/'bb+' and Allied Irish Banks plc's (AIB) Long-term IDR and VR to 'BB+'/'bb+' from 'BB'/'bb'. AIB's Short-term IDR is affirmed at 'B'. The Outlook for the Long-term IDRs is Positive.

The IDRs of BOI and AIB are driven by these banks' stand-alone creditworthiness as expressed by their VRs, which Fitch has today upgraded. The upgrade reflects on-going improvements in these banks' asset quality, business prospects, profitability and capitalisation.

A full list of today's rating actions, which also include rating actions on their rated subsidiaries, is available at the end of this rating action commentary.

KEY RATING DRIVERS
IDRS, VRS AND SENIOR DEBT RATINGS.
Asset quality is a factor which we consider to be of high importance for BOI's and AIB's ratings. The banks' legacy problem assets (including either non-performing or low-yielding loans, as well as forborne, restructured, impaired or defaulted) have been declining rapidly, as the banks continue to seek repayment of or restructure the loans. Profitability is also boosted by new loans gradually replacing some old legacy exposures.

Nonetheless, both BOI and AIB continue to hold large stocks of impaired and other problem loans, and while we believe them to be comfortably reserved, they remain high as a proportion of overall lending. When taken, net of reserves, as a proportion of Fitch Core Capital, they continue to show the banks' vulnerability to declining asset prices. Property-secured lending has continued to benefit from a pick-up in real estate prices and an increasing volume of property sales, including land, supported by Ireland's improving macro-economic environment However, these could change swiftly, depending on investor sentiment and economic conditions.

Weak asset quality continues to constrain these banks' VRs and further rating upgrades will be subject to continued improvements in the quality of the loan books. At present we believe that AIB is still more vulnerable to unexpected falls in asset values and changing investor confidence in Ireland than BOI, as the proportion of impaired loans on its books is still large. BOI's greater franchise in the UK, particularly towards residential mortgage loans, has allowed the bank to benefit from the strong improvement in the performance and profitability of these assets over the past two years.

The capitalisation of both banks has strengthened significantly over the past six months and the Positive Outlook reflects our expectation that this trend is set to continue. This factor is of high importance for AIB, given the high risk of its loan book. Capitalisation has improved on the back of deleveraging, internal capital generation and reduced problem loans.
AIB has reached an agreement with the Irish state in respect of its government-held preference shares, which will simplify its capital structure. The agreement reached is slightly negative in our assessment of AIB's capitalisation as the preference shares benefited from 100% equity credit and the EUR1.7bn repayment in December 2015 will reduce its Fitch Eligible Capital (FCC). However, the conversion of a further EUR1.8bn to common equity and the recent issue of EUR500m high trigger additional tier 1 (AT1) notes, has been a positive factor for its capitalisation.

BOI has received regulatory approval to redeem its outstanding 2009 preference shares (EUR1.3bn), which it plans to do on 4 January 2016.

BOI's and AIB's profitability has continued to improve throughout 2015, partly as a result of large one-off gains including sales of liquid assets, and in the case of AIB, through releases of provisions, but we expect it to stabilise at current levels in 2016. We expect loan impairment charges (LICs) to remain low and that net interest margins (NIM) will continue to benefit from an improved loan mix, a smaller liquidity buffer and low funding costs. On the other hand, costs remain under pressure from continuing investments in systems and risk controls. Costs are being controlled by both banks.

Both banks benefit from strong franchises in Ireland, which should enable them to take full advantage of further improvements in the economy and increasing demand for credit.

SUBSIDIARIES AND AFFILIATED COMPANIES
BOI UK's VR has been upgraded to 'bbb-' from 'bb+', the same as that of BOI, due to the high integration of systems and processes across the group. While its asset quality is healthier than at BOI in Ireland, we do not expect it to improve significantly from current levels over the next 12-18 months, resulting in a Stable Outlook on the IDR.

In our view, BOI UK benefits from a moderate likelihood of support, in case of need, from its parent bank. While we believe that BOI will have an extremely high propensity to support its UK subsidiary, because of the reputational risk it would face in case of a default by BOI UK, its ability to do so is constrained by the large size of BOI UK relative to its own equity. We therefore expect that once BOI's IDR is upgraded to 'BBB', BOI UK's IDR will become support-driven, as opposed to currently being driven by the VR, and will be notched down once from its parent's and remain at 'BBB-'. For this reason, the Outlook on BOI UK has been revised to Stable from Positive.

EBS Limited and AIB Group (UK) Plc are wholly-owned by AIB, and Bank of Ireland Mortgage Bank is wholly-owned by BOI. These subsidiaries are, to varying degrees, reliant on their respective parents for funding and capital support. Their IDRs are therefore based on support and are equalised with their parents'. Fitch has not assigned VRs to these subsidiaries as we believe that these subsidiaries are closely integrated with their respective parents that they cannot be analysed meaningfully on a stand-alone basis.

SUPPORT RATINGS AND SUPPORT RATING FLOORS
BOI's and AIB's SRs and Support Rating Floors (SRF) are affirmed at '5' and 'No Floor' respectively as Fitch believes that senior creditors cannot rely on receiving full extraordinary support from the sovereign in the event that either bank becomes non-viable. In Fitch's view, the EU's Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) provide a framework for resolving banks that is likely to require senior creditors participating in losses, if necessary, instead of or ahead of a bank receiving sovereign support. Full application of BRRD, including the bail-in tool, is required from 1 January 2016 and was introduced in Irish law in July 2015.

The SR of EBS Limited, AIB Group (UK) Plc, and BOI UK are affirmed at '3'. The SR of Bank of Ireland Mortgage Bank is upgraded to '2' from '3' to reflect the strengthened ability of its parent to provide it with support in case of need and the small size of this subsidiary relative to its parent.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The subordinated debt and other hybrid capital issued by BOI and AIB are notched off their issuer's respective VRs and reflect the performance of these instruments.

BOI's and AIB's subordinated Tier 2 debt are notched down once from their respective issuers' VRs, reflecting higher loss severity relative to senior obligations. The upgrade follows that of AIB's and BOI's VRs today.

BOI UK Holding's deferrable subordinated notes guaranteed by BOI are notched off three times from BOI's VR, twice for non-performance given the notes cumulative and deferrable coupon payments at the issuer's discretion and once for loss severity given the absence of write down or equity conversion features. Their upgrade mirrors that of BOI's VR.

AIB's AT1 debt is notched down twice for loss severity and twice for non-performance, reflecting their deep subordination and fully discretionary coupon omission. Their rating is the maximum rating under Fitch's criteria for banks with a VR anchor of 'bb+'

AIB is not paying the discretionary coupons on a number of legacy subordinated notes. The 'C' ratings of these instruments reflect their non-performance and sustained economic losses with weak recovery prospects.

RATING SENSITIVITIES

IDRs, VRs AND SENIOR DEBT RATINGS

The Positive Outlook on BOI's and AIB's IDRs reflects our expectation that the ratings may be upgraded further over the next 12-24 months as improvements in their asset quality and capitalisation continue to feed through to their credit profile. The upgrade would be contingent on continuing reductions in problem assets, either through rehabilitation, the curing of legacy problem loans, or significant non-recourse sales,

Furthermore, we expect that improvements in profitability will feed through in strengthened capitalisation for both banks, reducing their vulnerability to any unexpected adverse changes to the Irish economy.

The IDRs and VRs could face negative pressure if any of our expectations are not met, or if macro-economic conditions reverse and cause further weakening of asset quality to the extent that impairment charges would compromise the banks' profitability and hence capital flexibility.

SUPPORT RATINGS AND SUPPORT RATING FLOORS

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.

SUBSIDIARIES AND AFFILIATED COMPANIES-

The ratings of EBS Limited, AIB Group (UK) Plc and of Bank of Ireland Mortgage Bank are sensitive to the same factors that might drive a change in their parents' ratings. The SR of BOI UK, as for all the other rated subsidiaries, would be sensitive to changes in the strategic importance of the subsidiaries to their respective parents as well as the respective parents' ability to support such subsidiaries (as reflected by higher or lower ratings).

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The ratings of all subordinated instruments are primarily sensitive to a change in the VRs of these institutions, or to changes in their notching in accordance with our criteria.

The rating actions are as follows:

BOI

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+'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes: upgraded to 'BBB-' from 'BB+'
Short-term debt: upgraded to 'F3' from 'B'
Commercial paper: upgraded to 'F3' from 'B'
EUR600m subordinated notes issued by Bank of Ireland Holdings and guaranteed by BOI (XS0125611482): upgraded to 'BB-' from 'B+'
GBP197.3m subordinated notes (XS048771656): upgraded to 'BB+' from 'BB'

Bank of Ireland Mortgage Bank
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'

BOI UK Plc
Long-term IDR: upgraded to 'BBB-' from 'BB+'; Outlook revised to Stable from Positive
Short-term IDR: upgraded to 'F3' from 'B'
Viability Rating: upgraded to 'bbb-' from 'bb+'
Support Rating: affirmed at '3'

AIB
Long-term IDR: upgraded to 'BB+' from 'BB'; Outlook Positive
Short-term IDR: affirmed at 'B' '
Viability Rating: upgraded to 'bb+' from 'bb'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes: upgraded to 'BB+' from 'BB'
Short-term debt, including commercial paper: affirmed at 'B'
EUR750m subordinated Lower Tier 2 notes (XS1325125158): upgraded to 'BB' from 'BB-'
EUR500m subordinated AT1 7% trigger notes (XS1328798779); upgraded to 'B' from 'B-'
Subordinated legacy non-performing debt (XS0232498393; XS0435957682 and XS0124107053): affirmed at 'C'

AIB Group (UK) PLC
Long-term IDR: upgraded to 'BB+' from 'BB'; Outlook Positive
Short-term IDR: affirmed at 'B'
Support Rating: affirmed at '3'

EBS Limited
Long-term IDR: upgraded to 'BB+' from 'BB'; Outlook Positive
Short-term IDR: affirmed at 'B''
Support Rating: affirmed at '3'
Senior long-term debt, (including notes XS0268806709): upgraded to 'BB+' from 'BB'
Short-term debt: affirmed at 'B''

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Applicable Criteria
Global Bank Rating Criteria (pub. 20 Mar 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=863501