FITCH AFFIRMS AIB GROUP AT 'BBB-'; OUTLOOK POSITIVE

Fitch Ratings-London-13 November 2018: Fitch Ratings has affirmed AIB Group plc's (AIBG) and Allied Irish Banks, plc's (AIB) Long-Term Issuer Default Ratings (IDR) and Viability Ratings (VR) at 'BBB-'. The Outlooks on the Long-Term IDRs are Positive. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
IDRS, VRS AND SENIOR DEBT
AIBG's ratings reflect its role as the holding company of the Allied Irish Banks group and are aligned with those of its wholly-owned operating subsidiary, AIB. The equalisation of the ratings 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.

AIBG's IDRs and senior debt ratings are driven by its VR, which reflects our view of the bank's strong domestic franchise in its core segments (retail and corporate banking), improving asset quality, moderate risk appetite, strengthened capitalisation, adequate profitability and sound funding profile. The ratings also take into account the bank's still sizeable stock of problem loans, high proportion of unreserved loans to capital and the bank's limited geographic diversification.

The Positive Outlook on AIBG's IDR reflects our expectation that problems loans will continue to reduce. Asset quality remains the key constraining factor, keeping AIBG's VR in the lower 'bbb' range. Stage 3 loans accounted for 11% of gross loans at end-1H18. This is high compared with peers but is a significant improvement on the 35% non-performing loan (NPL) ratio reported at end-2013. The bank has been using both portfolio sales and extensive workout measures to reduce problem loans, benefiting from the supportive Irish economy and growing investor demand. We expect the speed of asset quality improvement to moderate as AIBG increasingly works through smaller exposures and exposures in late arrears, which are harder to resolve.

AIBG's profitability improved in recent years with reserve releases, deposit re-pricing, volume growth and an improving loan mix, offsetting pressure on mortgage lending margins and excess liquidity costs. We expect the bank to continue to benefit from an uptick in lending, in particular in higher yielding loans, but profitability will remain challenged by the low interest rate environment, increasing competition, elevated investments in technology and digitalisation, and rising funding costs as the bank builds bail-inable debt buffers.

Capitalisation and leverage are strong, with significant buffers over regulatory requirements. At end-3Q18, AIBG's fully loaded common equity Tier 1 (CET1) ratio was 17.9%, which compared well with peers. We expect the bank to maintain comfortable buffers over minimum requirements while it works through its still large stock of problem loans. Unreserved impaired loans are still high (41% of Fitch Core Capital at end-1H18), highlighting AIBG's vulnerability to falling collateral prices. The bank recommenced ordinary dividend payments in 2017, and targets a future 50%-60% payout ratio. Special dividends could be considered once it reaches its 5% target for non-performing exposures ratio.

AIBG's funding profile is sound and supported by strong access to retail deposits, and a well-established and diversified wholesale funding franchise. Significant deleveraging in recent years 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 AIBG's MRELcompliant 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.

Independently, AIB's Positive Outlook also reflects Fitch's expectation that over the next 12-18 months, AIBG will build up and downstream to AIB a sufficient and sustainable buffer of qualifying junior debt (QJD) and non-preferred senior (NPS) debt to recapitalise AIB, if case of failure, without triggering a default on AIB's senior third-party liabilities.

The announced MREL requirements were set at 28.04% of risk-weighted assets (RWA) per end-2016 balance sheet, to be reached by 1 January 2021. Following the adopted single-point-of-entry resolution strategy, all MREL instruments are issued at the holding level and downstreamed to AIB - currently on a like-to-like basis. However, once the Irish legislation permits (which we expect by end-2018), we expect the terms of the downstreamed senior debt to change to NPS so that it becomes subordinated to AIB's senior obligations issued externally.

In case of failure, we have assumed that the intervention for AIBG would be around its current minimum CET1 requirement of 7.65%. We have also assumed that AIBG would need to meet its total minimum capital requirements immediately after a resolution action, which on a fully loaded basis, including combined capital buffers, currently amounts to 15.2%. Fitch's view of the regulatory intervention point and post-resolution capital needs taken together suggest a QJD and holding company senior debt buffer of around 8% of RWAs could be required to restore viability without hitting senior creditors at AIB level.

At end-3Q18, AIB's QJD and holding company senior debt buffer was EUR3 billion, or 5.6% of RWA. Fitch expects that AIBG will build up the required amount in the next 12-18 months.

We assign a DCR to AIB (and not AIBG) due to its significant domestic derivatives activity. 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)

AIBG'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 their 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
AIB Group (UK) Plc is wholly-owned by AIB and represented 14% of AIBG's net loans and 11% of re-occurring operating income at end-1H18. The subsidiary is closely integrated with the group and is heavily reliant on the group's systems and processes. It contributes positively to the group's performance and until recently relied heavily on parent funding. Its IDRs, SRs and senior debt ratings are therefore based on support, and are equalised with AIBG's. Fitch has not assigned a VR to AIB UK as we believe it is closely integrated with AIBG and therefore cannot be analysed meaningfully on a standalone basis.

RATING SENSITIVITIES
IDRS, DCRS, VRS AND SENIOR DEBT
The Positive Outlook on AIBG's IDR reflects 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 12-24 months while maintaining other financials metrics at current levels.

The Positive Outlook on AIB's IDR also reflects our expectation that the Long-Term IDR will likely be upgraded to one notch above AIB's VR once the buffer of bail-inable debt exceeds 8% of RWAs.

The DCR is primarily sensitive to a change in AIB's Long-Term IDR. We expect to upgrade the DCR if AIB's' Long-Term IDR is upgraded.

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 of the SR and upward revision of 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 AIB's VR, or to changes in their notching in accordance with our criteria and assumptions on non-performance risk.

SUBSIDIARY AND AFFILIATED COMPANIES
AIB Group (UK) Plc's ratings are sensitive to the same factors that might drive a change in AIBG's. The SR would be sensitive to changes in its strategic importance to AIBG as well as AIBG's ability to support it.

The rating actions are as follows:

AIB Group Public Limited Company
Long-Term IDR affirmed at 'BBB-'; Outlook Positive
Short-Term IDR: affirmed at 'F3'
Viability Rating: affirmed at 'bbb-'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes affirmed at 'BBB-'
EMTN EUR10 billion programme long-term and short-term ratings affirmed at 'BBB-' and 'F3', respectively

EMTN USD10 billion programme long-term and short-term ratings affirmed at 'BBB-' and 'F3', respectively

Allied Irish Banks, plc
Long-Term IDR affirmed at 'BBB-'; Outlook Positive
Short-Term IDR: affirmed at 'F3'
Viability Rating: affirmed at 'bbb-'
Derivative Counterparty Rating: affirmed at 'BBB-(dcr)'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes affirmed at 'BBB-'
Short-term debt, including commercial paper affirmed at 'F3'
EMTN EUR10 billion programme long-term and short-term ratings affirmed at 'BBB-' and 'F3', respectively
EUR750 million subordinated lower tier 2 notes (XS1325125158) affirmed at '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 affirmed at 'BBB-'; Outlook Positive
Short-Term IDR affirmed at 'F3'
Support Rating affirmed at '2'

Contact:
Primary Analyst
Marc Ellsmore
Director
+44 20 3530 1438
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Maria Shishkina
Associate Director
+44 20 3530 1379

Committee Chairperson
Bjorn Norman
Senior Director
+44 20 3530 1330

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@thefitchgroup.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Bank Rating Criteria (pub. 12 Oct 2018)
https://www.fitchratings.com/site/re/10044408