FitchRatings

Fitch Upgrades AIB Group to 'BBB' and AIB to 'BBB+'; Outlook Stable

Fitch Ratings - Milan - 30 October 2019:

Fitch Ratings has upgraded AIB Group plc's (AIBG) Long-Term Issuer Default Rating (IDR) to 'BBB' from 'BBB-' and its main operating bank subsidiary Allied Irish Banks plc's (AIB) Long-Term IDR to 'BBB+' from 'BBB-'. The Outlooks are Stable. The agency has also upgraded the entities' Viability Ratings (VRs) to 'bbb' from 'bbb-'. Fitch has also upgraded AIBG's and AIB's Short-Term IDRs to 'F2' from 'F3'. A full list of rating actions is at the end of this rating action commentary.

The upgrades of the VRs and of AIBG's IDRs reflect the asset quality improvements in the past two years through a sustained reduction in legacy problem loans. They also reflect our expectation that the bank will achieve a gross non-performing exposure (NPE) ratio of around 5% by the end of this year, strive to achieve further reductions and operate with lower NPE levels thereafter.

The upgrade of AIB's Long-Term IDR and senior debt ratings to one notch above its VR reflect the build-up of a significant and sustainable qualifying junior debt (QJD) and internal non-preferred senior debt buffer at the bank that provides additional protection for its senior unsecured creditors.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Allied Irish Banks, plc	LT IDR BBB+ Upgrade		BBB-
	ST IDR F2 Upgrade		F3
	Viability bbb Upgrade		bbb-
	Support 5 Affirmed		5
	Support Floor NF Affirmed		NF
	DCR BBB+(dcr) Upgrade		BBB-(dcr)
subordinated	LT B+ Upgrade		B
subordinated	LT C Affirmed		C

senior unsecured	LT BBB+ Upgrade		BBB-
subordinated	LT BBB- Upgrade		BB+
senior unsecured	ST F2 Upgrade		F3
AIB Group (UK) PLC	LT IDR BBB Upgrade		BBB-
	ST IDR F2 Upgrade		F3
	Support 2 Affirmed		2
AIB Group Public Limited Company	LT IDR BBB Upgrade		BBB-
	ST IDR F2 Upgrade		F3
	Viability bbb Upgrade		bbb-
	Support 5 Affirmed		5
	Support Floor NF Affirmed		NF
senior unsecured	LT BBB Upgrade		BBB-
senior unsecured	ST F2 Upgrade		F3

Key Rating Drivers

IDRS, DERIVATIVE COUNTERPARTY RATING (DCR) AND SENIOR DEBT

AIB's Long-Term IDR, senior debt ratings and DCR have been upgraded to one notch above its VR to reflect the level of protection offered to AIB's senior third-party liabilities by existing buffers of QJD and non-preferred senior debt, which we consider sufficient to recapitalise AIB, in case of failure, without triggering a default on its senior third-party liabilities. The upgrade also reflects Fitch's view of the sustainability of these buffers, given the need to comply with minimum requirement for own funds and eligible liabilities (MREL).

The group's MREL is currently set at 28.22% of risk-weighted assets (RWAs) per end-2017 balance sheet, to be reached by 1 January 2021. Under the group's single-point-of-entry resolution strategy, senior debt issued at the holding level is downstreamed to AIB in the form of MREL eligible instruments. Since April 2019, AIBG's externally issued senior debt, which is downstreamed to AIB, is subordinated by statute to AIB's external senior liabilities, as it is in the form of non-preferred senior debt.

We would expect a resolution action to be taken on the bank when it breaches its minimum capital requirements. We assume the intervention point would be at a common equity Tier 1 (CET1) ratio no lower than 7.5% of RWAs. Fitch estimates that post-resolution capital needs mean that a buffer of QJD and internal non-preferred senior debt of about 8% of RWAs would most likely be sufficient to restore AIB's viability without imposing losses on the bank's senior creditors. Fitch estimates the combined buffer of QJD and downstreamed senior non-preferred debt at AIB, including 3Q19 AIBG issuances, to be around 8% of RWAs.

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

The upgrades of 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 under Fitch's Short-Term Ratings Criteria.

VRs

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 the VR 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.

The VRs reflect the bank's strong domestic franchise in core lending and deposit segments in Ireland, improving asset quality, moderate risk appetite and sound and stable funding. The bank operates with strong regulatory capital ratios. However, despite a rapidly reducing stock of problem loans, unreserved problem loans still represent a moderate proportion of capital. Profitability is adequate but potentially variable over the economic cycle, reflecting the bank's geographic concentration to the small, open and cyclical Irish economy.

Asset quality remains a comparatively weaker rating factor. Stage 3 loans, largely Irish residential mortgage loans, accounted for 6.9% of gross loans at end-1H19. This is still high when compared with European norms and international peers but is a significant improvement on the nearly 19% ratio at end-2015 and the 35% ratio reported at end-2013. The bank has been using both portfolio sales and extensive workout and restructuring measures to reduce problem loans, benefiting from the supportive Irish economy and growing investor demand.

AIB's profitability is supported by the wide margins of the concentrated Irish market, its leading market position and pricing power, and pricing discipline in the sector, combined with the gradual return to positive net lending growth and an improving loan mix. An increase in funding costs is possible as the bank builds up its MREL buffers. Our assessment also reflects some cost rigidity in the very near term but with the prospect of moderate cost reductions in the medium-term, combined with more normalised loan impairment charges as large write-backs have tailed away. We expect profitability levels may vary over the economic cycle, reflecting the inherent risks of the Irish economy.

At end-1H19, AIBG's fully loaded common equity Tier 1 (CET1) ratio was 17.3%, which compared well with peers. We expect the group to maintain comfortable buffers over minimum requirements. 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 target for non-performing exposures ratio of around 5% by end-2019. However, unreserved impaired loans, which reduced to a more contained 27% of Fitch Core Capital at end-1H19 (down from 41% at end-1H18), highlight some moderate vulnerability to falling collateral prices.

AIBG's funding profile is supported by strong access to stable retail deposits, and an established and sufficiently diversified wholesale funding franchise, although the latter remains confidence sensitive. Customer deposits fund a significant portion of the bank's assets and have been increasing. Significant loan deleveraging in recent years has reduced funding requirements. Liquidity is sound, supported by a large stock of liquid assets and contingent access to central bank liquidity facilities.

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

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

The IDRs and SR of AIB Group (UK) Plc, AIB's wholly-owned subsidiary, are based on support, reflecting its key role as the main entity operating in the UK, a core market for the group, and a track record of unquestioned support from the parent.

AIB Group (UK) represented 14% of AIBG's gross loans at end-1H19 and 15% of 1H19 operating profit. 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. Fitch has not assigned a VR to AIB Group (UK) as we believe it is closely integrated with AIBG and therefore cannot be analysed meaningfully on a standalone basis.

The Long-Term IDR is equalised with AIB's VR, and not with the Long-Term IDR of AIB, as a large buffer of junior debt to meet its internal MREL has not yet been pre-positioned.

RATING SENSITIVITIES

IDRS, DCR AND SENIOR DEBT

The IDRs, senior debt ratings and DCR of AIB and AIBG are sensitive to changes in the VRs. AIB's ratings are also sensitive to a material reduction in the combined QJD and internal senior non-preferred buffer. The notching is also sensitive to changes in assumptions on the resolution intervention point and post-resolution capital needs, and the development of resolution planning more generally.

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.

VRs

Given AIBG's focus on a fairly small and volatile Irish market upward rating potential is limited. An upgrade will depend on the bank's ability to strengthen its company profile and profitability significantly and operate with a much lower risk appetite.

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 ultimately capitalisation. Negative pressure on the VR would also arise if the bank increases its risk appetite.

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 AIB's VR. The SR would be sensitive to changes in its strategic importance to AIBG as well as AIB's ability to support it. AIB Group (UK)'s Long-Term IDR is also sensitive to the volume of junior and non-preferred debt buffers that will be downstreamed by AIB in the future in order for its UK subsidiary to meet its MREL. Given the high level of AIB Group (UK)'s CET 1 ratio, at 17.2% at end- 2018, it is unlikely that a large buffer of junior instrument will be required to meet its MREL.

ESG Considerations

The highest level of ESG credit relevance for this issuer is a score of 3. ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

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Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018)
Short-Term Ratings Criteria (pub. 02 May 2019)

Additional Disclosures

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