FitchRatings

Fitch Affirms BOI and AIB; Negative Outlooks

Ratings Endorsement Policy

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Fitch Ratings-London-29 July 2014: Fitch Ratings has affirmed Bank of Ireland's (BOI) and Allied Irish Banks, plc's (AIB) Long-term Issuer Default Ratings (IDRs) at 'BBB' with Negative Outlooks and Short-term IDRs at 'F2'.

At the same time, Fitch has upgraded BOI's Viability Rating (VR) to 'bb-' from 'b+' and AIB's VR to 'b+' from 'b-'. BOI's 100%-subsidiary, Bank of Ireland (UK) Limited (BOI UK) has been assigned a VR at 'bb-'. A full list of rating actions is at the end of this rating action commentary.

The upgrades of BOI and AIB's VRs are supported by on-going improvements to Fitch's expectations of the banks' return to profitability in 2014, providing them with enhanced capital flexibility in a benign operating environment. The VRs also consider BOI's and AIB's weak, albeit improving, asset quality and loan book concentrations to real estate. AIB's VR benefits from a sizeable tranche of government-held perpetual preference shares and we expect a significant proportion of these preference shares to convert into equity. Fitch considers that additional external capital may be difficult to access after this has been used.

KEY RATING DRIVERS - IDRs AND SENIOR DEBT, SRs, SUPPORT RATING FLOORS

The affirmation of BOI's and AIB's IDRs, senior debt ratings, Support Ratings (SR) and Support Rating Floors (SRF) reflects Fitch's view that there would be a high probability of support from the Irish authorities if required. Fitch considers support to be even stronger in the short term, resulting in the banks' Short-term IDRs being affirmed at 'F2', which is the higher of two potential Short-term ratings mapping to their 'BBB' Long-term IDRs. However, the Negative Outlooks on the IDRs reflect our view that the support propensity may weaken over time as progress is made in implementing the legislative and practical aspects of enabling an effective bank resolution framework, which would also result in a downgrade of the SRs and SRFs. Any downgrade of the Irish sovereign rating, which is highly unlikely in the near term, would also likely be reflected in negative rating action on BOI and AIB.

RATING SENSITIVITIES - IDRs, SRs, SUPPORT RATING FLOOR AND SENIOR DEBT

BOI and AIB's IDRs, SRs, SRFs and senior debt ratings are sensitive to any change in Fitch's assumptions about the on-going availability of extraordinary sovereign support for the banks. Of these, the greatest sensitivity is to a weakening of support propensity in respect of further progress being made in addressing both the legislative and the practical impediments to effective bank resolution. Where SRFs are assigned, Fitch's base case is that sufficient progress is likely to have been made for banks' Support Ratings to be downgraded to '5' and SRFs to be revised downwards to 'No Floor' by late-2014 or in 1H15. The timing will be influenced by Fitch's continuing analysis of progress made on bank resolution and could also be influenced by idiosyncratic events, for example should there be risks to the availability of sovereign support for a bank that is likely to meet the conditions for resolution during 2014, whether as part of an asset quality review or another event.

The banks' SRFs would be revised down and their SRs, IDRs and senior debt ratings downgraded if Fitch concludes that potential sovereign support had weakened relative to its previous assessment. Given BOI's and AIB's VRs, any downgrades of the banks' Long-term IDRs and senior debt ratings relating to a revaluation of support could be by multiple notches.

KEY RATING DRIVERS- VRs

The VRs of BOI and AIB take into account the banks' steady progress to profitability, which should provide them with enhanced capital flexibility and allow for more dynamic capital planning. Fitch expects that both BOI and AIB will report modest profits in 2014, which Fitch expects should increase further in 2015, driven by significantly lower impairment charges, supported by improving net interest income on the back of bank-led lower funding costs across the sector since 2H12.

Capital flexibility remains key to the Irish banks' recoveries and we believe that BOI's credit profile is stronger as a result of its demonstrated access to both the debt and equity capital markets during 2013. AIB's VR benefits from a sizeable tranche of government-held perpetual preference shares and we expect a significant proportion of these preference shares to convert into equity. Fitch considers that additional external capital may be difficult to access after this has been used.

Both banks have a large stock of NPLs, with BOI reporting an NPL ratio of 17% at end-2013 and AIB 35%. Both banks have high levels of net impaired loans/equity with BOI at 115% while the ratio for AIB including preference shares is

118%. However, a large proportion of this stock relates to property-secured lending, which has stable to improving values in most cases and is supported by Ireland's improving macro-economic environment.

Fitch Core Capital (FCC) ratios are low at 6.8% for BOI and 4.7% for AIB at end-2013 but supported on a transitional regulatory basis by perpetual preference shares. At BOI, these perpetual preference shares added about 230bps to end-2013 core Tier 1 capital and 560bps in AIB. Fitch considers that a large proportion of AIB's perpetual preference shares will be converted in late 2014 or early 2015, after the European Banking Authority (EBA) stress test and will significantly bolster capital. The agency expects that BOI's profit generation over the next two to three years will support capital-accretive common equity Tier 1 (CET1) and FCC ratios in line with or ahead of fully-loaded Basel 3 requirements.

The VRs of BOI and AIB are non-investment grade. Fitch considers that the continued recovery of the Irish banks is dependent on a persistent supportive macro-environment as they have a higher vulnerability to adverse changes in business or economic conditions over time.

BOI UK has a VR of 'bb-', which is the same level as BOI due to high levels of integration of people, systems and processes across the group and BOI UK's large (24% of gross loans) relative to the group. However, BOI UK has its own funding franchise through the UK Post Office, better capitalisation and better asset quality by virtue of a more benign operating environment than parent BOI, which could support ratings upgrades ahead of the parent.

RATING SENSITIVITIES - VRs
BOI, BOI UK and AIB's VRs take into account Fitch's expectations of modest internal capital generation through profitability from 2014 and stable and improving asset quality and capital ratios. The VRs could face negative pressure if any of these expectations are not met, for example through a material reassessment of asset quality and capitalisation following the AQR and EBA stress test or if macro-conditions were to reverse and cause further weakening of asset quality to the extent that impairment charges would compromise the banks' profitability and hence capital flexibility.

AIB's VR would also be sensitive to the proportion of perpetual preference shares converted into equity being materially less than we expect. Demonstrated access to equity markets could support an upgrade of AIB's VR.

Upward potential for these VRs is limited in the near term due to the extremely large stock of NPLs and high levels of unprovided impaired loans/equity. Any positive rating action would need to follow a material reduction of this tail risk, either through rehabilitation and curing or through the non-recourse sale of portfolios of NPLs.

BOI UK could be upgraded in the longer term as the UK environment is expected to improve faster than Ireland, although BOI UK's VR would still be linked to the VR of the parent and could be constrained by it.

KEY RATING DRIVERS AND SENSITIVITIES - GOVERNMENT GUARANTEED DEBT, COMMERCIAL PAPER
These ratings relate to the guaranteed debt securities that are yet to mature and remain guaranteed following the withdrawal of the Eligible Liabilities Guarantee scheme in March 2013. The ratings of these instruments are sensitive to the ratings of the Irish sovereign.

KEY RATING DRIVERS AND SENSITIVITIES - SUBORDINATED DEBT
The subordinated debt issued by BOI and AIB is rated with reference to their respective VRs and the performance of these instruments. AIB is not paying the discretionary coupons on its subordinated notes. The 'C' ratings of these instruments reflect their non-performance and sustained economic losses with weak recovery prospects. BOI's subordinated debt has been upgraded to 'B+' and BOI (UK)'s deferrable subordinated notes guaranteed by BOI have been upgraded to 'B-' following the upgrade of BOI's VR. The ratings of all subordinated instruments are primarily sensitive to any change in the VRs of these institutions.

SUSBIDIARY AND AFFILIATED COMPANY KEY RATING DRIVERS AND SENSITIVITIES
EBS Limited and AIB Group (UK) Plc are owned by AIB and Bank of Ireland Mortgage Bank is owned by BOI. All of these subsidiaries are wholly owned by respective parents, and to varying degrees are reliant on their parent banks for funding and capital support. Their IDRs are aligned with their parents', and are sensitive to the same factors that might drive a change in their parents' ratings.

The rating actions are as follows:

AIB
Long-term IDR: affirmed at 'BBB'; Outlook Negative
Short-term IDR: affirmed at 'F2'
Viability Rating: upgraded to 'b+' from 'b-'
Support Rating: affirmed at '2'
Support Rating Floor: affirmed at 'BBB'

Senior unsecured notes: affirmed at 'BBB'
Short-term debt: affirmed at 'F2'
Commercial Paper: affirmed at 'F2'
Subordinated notes: affirmed at 'C'
Sovereign-guaranteed Long-term notes: affirmed at 'BBB+'

AIB (UK)
Long-term IDR: affirmed at 'BBB'; Outlook Negative
Short-term IDR: affirmed at 'F2'
Support Rating: affirmed at '2'

EBS
Long-term IDR: affirmed at 'BBB'; Outlook Negative
Short-term IDR: affirmed at 'F2'
Support Rating: affirmed at '2'
Senior unsecured notes: affirmed at 'BBB'
Short-term debt: affirmed at 'F2'
Sovereign-guaranteed Long-term notes: affirmed at 'BBB+'

BOI
Long-term IDR: affirmed at 'BBB'; Outlook Negative
Short-term IDR: affirmed at 'F2'
Viability Rating: upgraded to 'bb-' from 'b+'
Support Rating: affirmed at '2'
Support Rating Floor: affirmed at 'BBB'
Senior unsecured notes: affirmed at 'BBB'
Short-term debt: affirmed at 'F2'
Subordinated debt: upgraded to 'B+' from 'B'
Sovereign-guaranteed notes: affirmed at 'BBB+'
BOI UK Holdings deferrable subordinated notes guaranteed by BOI: upgraded to 'B-' from 'CCC'

BOI Mortgage Bank
Long-term IDR: affirmed at 'BBB'; Outlook Negative
Short-term IDR: affirmed at 'F2'
Support Rating: affirmed at '2'

BOI UK Plc
Long-term IDR: affirmed at 'BBB'; Outlook Negative
Short-term IDR: affirmed at 'F2'
Viability Rating: assigned at 'bb-'
Support Rating: affirmed at '2'

Contact:
Primary Analyst
Denzil De Bie
Director
+44 20 3530 1592
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Alan Milne
Associate Director
+44 20 3530 1491

Committee Chairperson
Maria Jose Lockerbie
Managing Director
+44 20 3530 1083

Media Relations: Elaine Bailey, London, Tel: +44 203 530 1153, Email: elaine.bailey@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable criteria, 'Global Financial Institutions Rating Criteria' dated 31 January 2014 are available at www.fitchratings.com.

Related Research
"Fitch Revises Outlooks on 18 EU Commercial Banks to Negative on Weakening Support", dated 26 March 2014

"2014 Outlook: Irish Banks", dated 12 December 2013

Applicable Criteria and Related Research:
Global Financial Institutions Rating Criteria
2014: Outlook: Irish Banks

Additional Disclosure
Solicitation Status