FITCH AFFIRMS BANK OF IRELAND GROUP PLC; OUTLOOK STABLE

Fitch Ratings-London-13 November 2018: Fitch Ratings has affirmed Bank of Ireland Group plc's (BOIG) and Bank of Ireland's (BOI) Long-Term Issuer Default Ratings (IDRs) at 'BBB' and Viability Ratings (VRs) at 'bbb'. The Outlook on BOIG's Long-Term IDR is Stable. The Outlook on BOI's Long-Term IDR has been revised to Positive from Stable.

The agency has also affirmed Bank of Ireland (UK) plc's Long-Term IDR at 'BBB' and VR at 'bbb'. The Outlook is Stable.

A full list of rating actions is at the end of this rating action commentary.

The revision of the Outlook on BOI's Long-Term IDR reflects our expectation that BOI's reference liabilities, i.e. senior third-party creditors, will receive additional protection when the terms of the senior debt received by BOI from its parent holding company, BOIG, are amended so that the debt becomes junior to BOI's external senior obligations. We believe that senior debt issued by BOI to BOIG during 2018 to down-stream the proceeds of BOIG senior debt issuance, will be converted to non-preferred senior (NPS) debt, thereby protecting the bank's senior external creditors in case of failure and qualifying for internal minimum requirement for own funds and eligible liabilities (MREL), shortly after legislation is introduced in Irish law (expected to take place by the end of 2018). Once sufficient internally down-streamed qualifying junior debt (QJD) and NPS debt is in place, we expect to upgrade BOI's IDRs by one notch to 'BBB+'.

KEY RATING DRIVERS

IDRS, DERIVATIVE COUNTERPARTY RATING (DCR) AND SENIOR DEBT

BOI is the main operating bank of BOIG. The Positive Outlook on BOI's Long-Term IDRs and senior debt ratings reflects the large volumes of debt issued so far by both BOIG and BOI, which includes additional Tier 1 (AT1) instruments, Tier 2 debt and senior debt received by BOI from its parent holding company. BOIG will be subject to MREL requirements of 26.39% of risk-weighted assets (RWAs) by 1 January 2021, as communicated by the Single Resolution Board and the Bank of England.

In case of failure, we have assumed that the intervention for BOIG would be around its current minimum common equity Tier 1 (CET1) requirement of 6.75%. We have also assumed that BOIG would need to meet its minimum total capital requirements immediately after a resolution action, which on a fully loaded basis, including combined buffers, currently amounts to 14.25%. 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 the BOI level.

At end-3Q18, BOI's QJD and holding company senior debt buffer was EUR4 billion, estimated by Fitch to be around 8.6% of RWAs. In Fitch's opinion, this should be sufficient to recapitalise the group in a resolution scenario to meet its expected post resolution total capital requirement without hitting BOI senior debt.

BOI'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 'F2' Short-Term IDRs of BOIG and BOI are at the higher of the two possible Short-Term ratings mapped to a Long-Term IDR of 'BBB'. This reflects strong on-balance sheet liquidity and extensive contingency liquidity facilities through various central bank facilities.

BOIG's ratings reflect its role as the group holding company and are aligned with those of its main operating subsidiary, BOI. As a result, BOIG's ratings are driven by the same considerations that affect BOI's ratings. The equalisation of BOIG's ratings with BOI's 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 Stable Outlook on BOIG's Long-term IDR reflects our expectation of Stable prospects for the group.

VR
BOI's, and therefore BOIG's, VRs are driven by improving asset quality, a strong domestic retail and corporate banking franchise, a diversified business model, sound profitability, improved capitalisation and a stable funding profile. The ratings also consider the group's significant, albeit reducing, exposure to low-yielding and non-performing Irish loans.

Asset quality continues to improve, driven by the successful work out of impaired and restructured loans, as well as low inflows of new problem loans. Asset quality indicators are better than domestic peers due to a larger proportion of well-performing UK mortgages and a better quality Irish mortgage book. BOIG's impaired loans ratio based on Stage 3 loans under IFRS 9 fell to 6.7% at end-1H18 from 7.7% on 1 January 2018, while allowances for Stage 3 loans were an adequate 39%. The bank remains well on track to meet its non-performing exposures (as defined by the EBA) target of 5% by end-2019 (end-1H18: 7.5% of gross loans), with the bank not ruling out selling selective non-performing portfolios to institutional investors, depending on market conditions.

Fitch considers BOIG's strong Irish franchise and diversified business model to be rating strengths. Our franchise assessment is underpinned by strong market positions across several businesses, providing BOI with deposit and loan pricing power. BOIG's Irish business is well diversified across product and client segments, offering a full range of retail, corporate, SME and wealth and insurance products across its multi-channel strategy. The group's UK subsidiary continues to provide a consistent source of revenue and loan book diversification.

Underlying profitability has strengthened in recent years, reaching more stable levels, supported by an improving loan mix, falling funding costs and low loan impairment charges. This has helped offset weak net loan growth and the bank's large exposure to non-performing and/or low-yielding legacy tracker mortgages. In the shorter term, Fitch expects further revenue and profitability improvements will remain challenged by increasing competition, lower loan loss allowance releases, higher regulatory-related costs and ongoing investments related to investment in technology and digitalisation. We see better longer-term profitability prospects supported by a pick-up in net loan growth, further improvements in the loan mix and better cost efficiency.

BOIG's ambitious strategy, announced in June 2018, includes significant Irish mortgage growth, increased mortgage lending in less-served segments in the UK, and its corporate lending in both countries. It also includes a step-up in its programme to improve operational efficiency following several years of under-investment in operations while it focused on rebuilding capital after the financial crisis. It is targeting a cost/income ratio of 50% by 2021, with loan growth an important driver of income in addition to a reduction in the absolute cost level. While the strategy adds risk, we do not expect loan growth to be heavily skewed to higher-risk sectors or materially outpace internal capital generation. If successfully executed, it should result in improved operating efficiency and profitability.

Capitalisation has improved in recent years, driven by deleveraging, sound organic capital generation and lower pension volatility. BOIG's Fitch Core Capital ratio has improved steadily and stood at 14.4% at end-1H18 (end-2017: 14.2%). In line with profitability, we expect capital improvements will slow due to higher investment costs as well as approximately 70bps reduction in the group's fully-loaded CET1 ratio related to the ECB's targeted review of internal models. Unreserved impaired loans have been falling, reducing BOIG's vulnerability to falling collateral prices although it remains elevated at 51% at the end-1H18.

Funding is a key strength for BOIG, with the group benefiting from a strong retail banking franchise and access to a stable and granular deposit base. Non-interest bearing current account balances make up a large proportion of total customer deposits, supporting a stable funding base. Access to the wholesale markets is strong and diversified with BOIG and BOI regular issuers in the secured and unsecured markets.

On-balance sheet liquidity is sound and largely in the form of cash and cash equivalents and high-quality liquid assets, supported by contingent access to liquidity through various central bank facilities. The group's liquidity coverage ratio was a sound 139% at end-1H18 (end-2017: 136%), comfortably above minimum requirements.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)
BOIG's and BOI's SRs of '5' and SRFs 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.

SUBSIDIARY AND AFFILIATED COMPANY
BOI UK's IDRs reflect the bank's standalone credit profile, as expressed by its VR. Prospects for BOI UK's standalone credit profile are stable, as reflected in its Stable Outlook.

Asset quality is sound, supported by a well-performing mortgage book and reduced exposure to higher risk legacy commercial loans. Residential mortgages make up over three-quarters of BOI UK's loan book and are performing well, supported by low interest rates and low unemployment. Our assessment of asset quality factors also considers an above-average exposure to sectors that we view as more vulnerable in an economic downturn, such as buy-to-let, while the bank is also targeting increased lending towards specialist segments of the UK residential market, which will add further risk. We expect underwriting standards within these segments to remain sound, with the bank continuing to focus on prime borrowers.

The ratings consider the bank's modest franchise and relatively undiversified business model, which is concentrated on the UK mortgage and savings market. The business model is also reliant on third party partnerships, the largest of which is the partnership with the Post Office, which accounts for the majority of the bank's revenue and funding. It also factors in the high level of integration with the parent's systems, processes and management.

Profitability is sound, supported by low funding costs and low loan impairment charges, although we expect both to gradually rise over the medium term. The bank's net interest margin compares well with peers, reflecting a higher than average exposure to higher margin segments of the retail market, including motor finance.

Funding is predominately sourced through retail deposits via the Post Office, with no reliance on funding from the parent. On-balance sheet liquidity is sound and is supported by contingent liquidity from the Bank of England, if required.

Capitalisation has improved in recent years, driven by reductions of the bank's legacy commercial property loans and sound profitability. The bank has been repatriating excess capital to its parent, although we expect regulatory capital ratios to be maintained with adequate buffers over minimum requirements.

In our view, BOI UK benefits from a high probability of support, if required, from its parent bank as reflected in the '2' Support Rating. Although we view BOIG's propensity to support its UK subsidiary as extremely high, driven by the large reputational risk it would face in case of a default by BOI UK, the ability to do so is somewhat constrained by the large size of BOI UK relative to the parent's own equity.

BOI UK's DCR is at the same level as the Long-Term IDR because under UK legislation, derivative counterparties have no preferential status over other senior obligations in a resolution scenario.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The ratings on BOI's subordinated Tier 2 debt are 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.

RATING SENSITIVITIES
IDRS, DCRS, VRs AND SENIOR DEBT
Fitch expects to upgrade BOI's IDR by one notch above its VR when debt received from BOIG becomes subordinated to BOI's other senior creditors, and provided that the amount together with its external QJD remains sufficient and sustainable and could be made available to protect third-party preferred senior obligations from default in case of failure, either under a resolution process or as part of a private-sector solution (ie distressed debt exchange) to avoid a resolution action.

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

BOIG's and BOI's ratings could be upgraded if the bank makes progress in reducing the still high proportion of problem loans to levels more commensurate with higher rated peers while reducing capital encumbrance and a successful execution of its strategy to improve cost efficiency and profitability.

BOIG's and BOI's ratings could come under pressure if the economic effect of the UK's decision to leave the EU is particularly severe for either Ireland or the UK 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. Negative rating action could also arise from materially higher-than-expected investment costs that significantly erode profitability.

BOIG's ratings would be downgraded if there was a material increase in the holding company's double leverage, which we do not expect.

SUPPORT RATING AND SUPPORT RATING FLOOR
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 BOI's VR, or to changes in their notching in accordance with our criteria and assumptions on non-performance risk.

SUBSIDIARY AND AFFILIATED COMPANIES
Ratings upside for BOI UK's ratings is limited in the medium term, given the bank's appetite for more vulnerable segments of the mortgage market and a reliance on the Post Office partnership, which although long term in nature, exposes the bank to termination risk.

BOI UK's VR and IDRs are primarily sensitive to a material increase in exposure to higher risk segments of the mortgage market and/or commercial real estate through its Northern Irish business.

The ratings are also sensitive to structural deterioration in profitability, through tighter margins and higher loan impairment charges and weaker asset quality. This could be caused by a material weakening of the operating environment in the UK if the economic effect of the UK's decision to leave the EU on the bank's business model is particularly severe. We believe that in an adverse Brexit scenario, the ratings will have low headroom because of its relatively modest franchise and fairly undiversified business model, although we believe that its vulnerability to a no-deal Brexit scenario is moderate, reflecting its stable and overall low-risk business model. It is also exposed to any stress on its Irish parent, given the high level of integration of systems and processes.

BOI UK's IDRs would only be upgraded if there is an upgrade of either its VR, for example due to a more diversified business model and less reliance on key strategic partnerships for both deposits and loan products, or if there is at least a two-notch upgrade of BOIG's VR. The reason for the latter is that the SR of '2' reflects Fitch's view that BOIG has a strong propensity to support BOI UK but its ability to provide support is constrained by BOI UK's large size relative to BOIG's own equity. Therefore the probability of support, if solely based on institutional support, is reflected in a 'BBB-' Long-Term IDR. We consequently expect that if BOIG's Long-Term IDR is upgraded to 'BBB+', BOI UK's IDR would remain at 'BBB', in line with its VR.

The rating actions are as follows:

Bank of Ireland Group plc
Long-Term IDR affirmed at 'BBB'; Outlook Stable
Short-Term IDR: affirmed at 'F2'
Viability Rating: affirmed at 'bbb'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'

Bank of Ireland
Long-Term IDR affirmed at 'BBB'; Outlook revised to Positive from Stable
Short-Term IDR: affirmed at 'F2'
Viability Rating: affirmed at 'bbb'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Derivative Counterparty Rating: affirmed at 'BBB(dcr)'
Short-term debt, including certificates of deposit: affirmed at 'F2'
GBP197.3 million subordinated notes (XS0487711656): affirmed at 'BBB-'

Bank of Ireland (UK) Plc
Long-Term IDR affirmed at 'BBB'; Outlook Stable
Short-Term IDR affirmed at 'F3'
Viability Rating affirmed at 'bbb'

Support Rating affirmed at '2'
Derivative Counterparty Rating: affirmed at 'BBB(dcr)'

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Additional information is available on www.fitchratings.com

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