

15 Oct 2020 | Affirmation

Fitch Affirms Bank of Ireland Group at 'BBB'; Outlook Negative

Fitch Ratings-Milan-15 October 2020:

Fitch Ratings has affirmed Bank of Ireland Group plc's (BOIG) Long-Term Issuer Default Rating (IDR) at 'BBB' with a Negative Outlook and Viability Rating (VR) at 'bbb'. At the same time, the agency has affirmed the ratings of BOIG's operating subsidiaries, Bank of Ireland (BOI) and Bank of Ireland (UK) plc (BOI UK). The Outlooks on their Long-Term IDRs are Negative.

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

The affirmation reflects our view that funding and capitalisation underpin the group's ratings despite the expectation of some temporary deterioration in financial metrics due to economic downturn in Ireland. The Negative Outlook reflects significant downside risks to Fitch's baseline economic forecast, which could result in much higher pressure on BOIG's earnings and strategy execution as well as asset quality.

We expect a fall in real Irish GDP of 8.6% this year and economic activity to recover at a sustained pace in 2021, with real GDP rising by 6.0%. The pace of recovery will depend on how fast firms' and household sentiment recovers, which is very uncertain. A further risk to the economic outlook stems from the high degree of uncertainty about the future framework for UK-EU trade. There is a significant risk that UK-EU trade reverts to WTO terms, which would have an adverse impact on economic developments in Ireland, given its close trade links with the UK.

Key Rating Drivers

VRS, IDRS, DERIVATIVE COUNTERPARTY RATINGS (DCR) AND SENIOR DEBT

Fitch assesses BOIG on a consolidated basis. BOIG's VR reflects its role as the group holding company and is aligned with that of its main operating subsidiary, BOI. The equalisation of the VRs 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.

BOI's and BOIG's VRs are driven by the group's strong domestic retail and corporate banking franchise in the small Irish economy and diversified business model, sound regulatory capitalisation levels with comfortable buffers above minimum capital requirements and a stable funding and liquidity profile. The VRs also consider our expectation of below average asset quality in the next two years and adequate profitability, which will be challenged in the short to medium term by increased loan impairment charges, lower business volumes and lower-for-longer interest rates.

BOIG's impaired loans ratio based on Stage 3 loans increased to 5.6% at end-1H20 from 3.8% at end-2019, and Stage 2 loans doubled to 14.0% of gross loans. However, significant volume of loans on payment breaks

reverted to normal payment patterns. The increase in Stage 3 loans was mostly driven by the implementation of new definition of default, while inflows of new Stage 3 loans remained limited. We expect Stage 3 loans to increase significantly over the next two years, but to levels below the peaks observed in the aftermath of the last global financial crisis due to the tightened underwriting standards. BOIG has a long history and a comprehensive framework for dealing with challenged assets, which could facilitate smoother handling of new problem loans.

BOIG reported a net loss of EUR725 million in 1H20, predominantly driven by EUR937 million loan impairment charges, which subject to no further deterioration in the economic environment management expects to increase to EUR1.1 billion-EUR1.3 billion for 2020. The bank will report a material loss for the year. Underlying profitability is supported by its diversified business model and dominant market position. However, we believe there is a risk that it would structurally normalise at levels below those observed pre-pandemic. A new UK-EU trade framework based on WTO terms in place from 2021 could depress it further through the adverse impact on the Irish economy.

Capitalisation has improved in recent years, driven by deleveraging, sound organic capital generation and lower pension volatility. Regulatory capital and leverage ratios remain sound despite the 1H20 loss, with the transitional common equity Tier 1 (CET1) ratio of 14.9% at end-1H20 (13.6% on a fully-loaded basis). Capital encumbrance by unreserved impaired loans is fairly high compared with peers (32% of CET1 capital at end-1H20). We believe these capitalisation levels can absorb moderate increases in risk charges and risk-weighted assets (RWA) and still be adequate.

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. The group has proven and diversified access to the secured and unsecured wholesale markets.

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 149% at end-1H20, comfortably above minimum requirements.

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

BOI's Long-Term IDR and DCR are one notch above the VR to reflect the level of protection offered to BOI's senior third-party liabilities by existing resolution funds ultimately raised by BOIG, downstreamed to BOI and designed to protect the operating company's external senior creditors in a group failure. The buffers of junior and downstreamed holding company senior debt are built to comply with minimum requirement for own funds and eligible liabilities (MREL). BOI's Derivative Counterparty Rating (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.

BOIG's 'F2' Short-Term IDR and short-term senior debt ratings are at the higher of the two possible Short-Term ratings mapped to a Long-Term IDR of 'BBB' and are based on our assessment of the group's funding and liquidity, which is in line with the level required for the 'F2' rating. The 'F2' Short-Term IDR is also the baseline for BOI's 'BBB+' Long-Term IDR under the criteria.

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.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The rating on BOIG's subordinated Tier 2 debt is notched down twice from the entity's VR, reflecting the likelihood of poor recovery prospects for the notes arising from subordination in case of a non-viability event. We do not apply further notches for non-performance risk because the terms of the notes do not provide for loss absorption on a "going concern" basis.

SUBSIDIARY - BOI UK

BOI UK's IDRs reflect the protection offered to its senior third-party liabilities by existing group buffers of junior and holding company senior debt and is one notch above its VR.

BOI UK's VR is driven by a modest franchise in the UK, acceptable asset quality and profitability, somewhat constrained by a narrow business model and with significant downside risks from the pandemic, and sound reported capital ratios.

The ratings consider the bank's modest franchise and relatively undiversified business model, which is concentrated on the UK mass market mortgage lending. Following a strategic review, the UK operations are expected to reduce in volume terms and become more specialised with a focus on bespoke mortgage lending, motor finance, consumer lending, and travel money. Its business model will remain reliant on third party partnerships, which currently results in the bank's weaker operational efficiency compared with peers. The largest is the partnership with the Post Office, which accounts for the majority of the bank's funding.

Asset quality is acceptable, supported by currently well-performing mortgage lending and reduced exposure to higher risk legacy commercial loans. Residential mortgage loans make up over three-quarters of BOI UK's loans and includes an above-average exposure to sectors that we view as more vulnerable in an economic downturn, such as buy-to-let. We expect the book's asset quality to deteriorate once the government support measures are unwound and pandemic implications on individuals become clear. While the bank is also targeting increased lending towards specialist segments of the UK residential market, we expect underwriting standards within these segments to remain sound, with the bank continuing to focus on prime borrowers.

The bank is seeking to improve profitability by focusing on higher-margin lending and downsizing parts of business with lower returns. In the short term, profitability will be under pressure from rising loan impairment charges and lower business volumes and there is a risk it will structurally normalise at levels below pre-pandemic.

Funding is predominately sourced through retail deposits via the Post Office, with limited wholesale funding (predominantly from the parent). On-balance sheet liquidity is sound and is supported by contingent liquidity from the Bank of England, if required.

Capitalisation is sound, supported by reductions in the bank's legacy commercial property loans and acceptable 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.

BOI UK benefits from a high probability of support, if required, from its parent bank as reflected in the '2' SR. 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.

RATING SENSITIVITIES

VRS, IDRS, DCR AND SENIOR DEBT

Factors that could, individually or collectively, lead to negative rating action/downgrade:

The ratings would likely be downgraded if the recovery of the Irish economy in 2021 becomes less likely or turns out to be materially weaker than we currently expect, either because of the pandemic or the effects of the post-Brexit relationship between the EU and the UK or both. A delay to this recovery would likely result in sustained pressure on the bank's earnings and deeper damage to asset quality, which would be difficult to restore within a short period of time. Capitalisation level below the bank's pre-coronavirus target of 13% fully-loaded CET1 ratio without credible prospects to restore it in a reasonable timeframe could also lead to a downgrade.

BOIG's ratings would also be downgraded if there was a material increase in the holding company's double leverage, which we do not expect. BOIG's Short-Term IDR and short-term senior debt ratings are also sensitive to a weakening of our assessment of the group's funding and liquidity.

BOI's Long-Term IDR and DCR could be downgraded if Fitch believes that external senior creditors no longer benefit from resolution debt buffers. This could result from a change in resolution legislation or change in the resolution strategy of the group, neither of which we currently expect.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The Outlooks on the Long-Term IDRs could be revised to Stable if the negative impact of the pandemic and of UK-EU trade relationships on the Irish and UK economy is short and the recovery relatively fast.

In the event the group is able to withstand ratings pressure arising from the pandemic, its ratings could be upgraded if the group successfully executes its strategy to improve cost efficiency and profitability and demonstrates its ability to operate with lower levels of problem loans and much reduced capital encumbrance.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The rating of BOIG's Tier 2 debt is primarily sensitive to a change in the VR, or to changes in their notching should Fitch change its assessment of loss severity or relative non-performance risk.

SUBSIDIARY - BOI UK

BOI UK's IDRs could be downgraded if Fitch believes that external senior creditors no longer benefit from group resolution debt buffers. The IDRs are also sensitive to change in the bank's VR.

BOI UK's VR would likely be downgraded if the pandemic causes significantly larger damage to the UK economy than we currently expect as the hit to the bank's asset quality and earnings would be deeper and more sustained than currently embedded in our assessments. The VR also remains sensitive to how the UK leaves the EU and how this affects the UK's economic outlook and how big the negative impact on earnings, asset quality, liquidity and funding will be. Structurally BOI UK's VR is also sensitive to its strategy to target underserved and niche market segments, if this results in increased risk appetite and credit risk.

Based on institutional support, BOI UK's Long-Term IDR could only be upgraded if there is at least a two-notch upgrade of BOI's Long-Term IDR. If BOI's Long-Term IDR is upgraded to 'A-', BOI UK's IDR would remain 'BBB+'.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [<https://www.fitchratings.com/site/re/10111579>]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

Public Ratings with Credit Linkage to other ratings

The ratings of Bank of Ireland (UK) Plc are directly linked to Bank of Ireland; a change in Fitch's assessment of the ratings of Bank of Ireland may result in a change in the ratings of Bank of Ireland (UK) Plc.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Bank of Ireland Group Public Limited Company; Long Term Issuer Default Rating; Affirmed; BBB; Rating Outlook Negative

; Short Term Issuer Default Rating; Affirmed; F2

; Viability Rating; Affirmed; bbb

; Support Rating; Affirmed; 5

; Support Rating Floor; Affirmed; NF

----subordinated; Long Term Rating; Affirmed; BB+

Bank of Ireland; Long Term Issuer Default Rating; Affirmed; BBB+; Rating Outlook Negative

; Short Term Issuer Default Rating; Affirmed; F2

; Viability Rating; Affirmed; bbb

; Support Rating; Affirmed; 5

; Support Rating Floor; Affirmed; NF

; Derivative Counterparty Rating; Affirmed; BBB+(dcr)

----senior unsecured; Short Term Rating; Affirmed; F2

Bank of Ireland (UK) Plc; Long Term Issuer Default Rating; Affirmed; BBB+; Rating Outlook Negative

; Short Term Issuer Default Rating; Affirmed; F2

; Viability Rating; Affirmed; bbb

; Support Rating; Affirmed; 2

; Derivative Counterparty Rating; Affirmed; BBB+(dcr)

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Additional information is available on www.fitchratings.com

Applicable Criteria

[Bank Rating Criteria \(pub. 28 Feb 2020\) \(including rating assumption sensitivity\)](#)

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