FITCH AFFIRMS BANK OF IRELAND AND ALLIED IRISH BANKS; OUTLOOKS POSITIVE

Fitch Ratings-London-05 December 2016: Fitch Ratings has affirmed Bank of Ireland's (BOI) Long-Term Issuer Default Rating (IDR) and Viability Rating (VR) at 'BBB-' and 'bbb-' and Allied Irish Banks plc's (AIB) Long-Term IDR and VR at 'BB+' and 'bb+'. The Outlooks for the Long-Term IDRs are Positive.

A full list of today's rating actions, which also include rating actions on their rated subsidiaries, is available at the end of this rating action commentary.

KEY RATING DRIVERS
IDRS, VRs AND SENIOR DEBT
The IDRs of BOI and AIB reflect their standalone strength as expressed in their VRs. Our assessment of the VRs takes into consideration the banks' strong domestic franchises, strengthened capitalisation, normalised funding profiles, sound liquidity, diversified revenue streams, and improving, albeit still weak, asset quality.

The Positive Outlooks continue to reflect the potential for upgrading BOI's and AIB's VRs and IDRs, should the banks continue to further improve their asset quality and strengthen their capitalisation, while continuing to generate satisfactory profits and maintaining their sound funding and liquidity.

The UK's decision to leave the EU could be negative for the Irish economy and slow improvements in the banks' asset quality and capitalisation. However, the extent of any weakening of the Irish operating environment, triggered by a slowdown of GDP growth in the UK, sterling depreciation, and potential future trade barriers, will only become clear over time as the EU-UK negotiations develop.

We consider asset quality to be of high importance in assessing the banks' VRs and IDRs. Despite strong improvements in recent years, asset quality remains weak and a key constraint on both banks' VRs with rating upgrades subject to continued improvements in the quality of their loan books.

Our assessment of asset quality also factors in a high proportion of forborne loans at both banks, still large exposures to low-yielding loans (including tracker mortgages) and defaulted but not impaired loans, all of which add up to a high proportion of the banks' balance sheets.

The impaired loans ratio at both banks has been declining at a fast pace through restructuring and non-recourse sales as they take advantage of improving economic conditions and strong investor appetite. We expect asset quality improvements to continue as a result of a supportive Irish economy, continued demand for properties in Ireland and the proactive stance being taken by management to continue to reduce these legacy assets.

Asset sales have been a key component of deleveraging and are sensitive to investor sentiment. Although BOI and AIB remain among the EU's most active in reducing stocks of problems loans, working through the remaining impaired loans, which are arguably less easy to sell, will take time.

BOI's asset quality is better than AIB's due to a lower stock of impaired loans and a large exposure to better-performing residential mortgages in the UK.

Both banks have direct exposure to the UK operating environment mainly through their subsidiaries. A downturn in UK real estate prices, which could be a result of the UK's vote to leave the EU, is a risk for BOI as its UK lending, largely retail mortgages and commercial real estate loans, account for 40% of its overall loan portfolio. AIB is less exposed to a downturn in the UK's operating environment because the UK represents a lower 10% of its lending.

The capitalisation of both banks has significantly improved over the past three years, driven by deleveraging of legacy assets, a simplification of their respective capital structures and solid internal capital generation. At end-1H16, BOI and AIB reported transitional common equity tier 1 (CET1) ratios of 12.8% and 16.5%, respectively, comfortably above their respective Supervisory Review and Evaluation (SREP) requirements.

The proportion of unreserved impaired loans to Fitch Core Capital has been falling rapidly and was around the 60% mark at both banks at end-1H16. However, it continues to show the banks' vulnerability to falling asset prices and to deterioration in their stocks of unreserved problem assets. AIB's ratio was boosted significantly by the partial conversion of the bank's government-held preference shares in December 2015, which resulted in a net increase in common equity of EUR1.8bn.

Our assessment of capital also takes into account weaker fully-loaded regulatory capital ratios of 10.7% and 13.3% at BOI and AIB, respectively at end-1H16. This is primarily driven by the deduction of deferred tax assets (DTA), which represented 15% and 27% of phased-in CET1 at BOI and AIB, respectively at end-1H16.

Both banks' capital positions have been strengthened over the past 12 months through the repayment or conversion to equity of all outstanding government-held preference shares and Tier 2 contingent capital convertible notes issued to the Irish government in July 2011. BOI and AIB have demonstrated their ability to access the capital markets over the past two years by issuing CRD IV-compliant additional Tier 1 and Tier 2 debt. AIB's regulatory capital ratios are stronger than BOI given the bank's weaker asset quality.

The performance of both banks continues to be affected by persistent low interest rates, which result in a big drag from the large stocks of low-yielding tracker mortgages. We expect profitability to be challenged by margin pressure from low interest rates, increasing competition, muted net loan growth and increased investment in technology and digitalisation. Some of these pressures should be offset by improving loan mixes, low funding costs, supported by the redemption of expensive legacy funding in 3Q16, loan impairment charges remaining low and increasing efficiency.

Funding profiles at both banks have returned to normalised levels with the majority of funding sourced from stable customer deposits, little usage of central bank funding and established access to wholesale markets. As a result, the loan-to-customer deposit ratio across both banks is much improved. We do not expect funding strategies to alter materially once the banks' receive minimum requirements for own funds and eligible liabilities (MREL) requirements, given their improving solvency and proven access to long-term wholesale funding markets.

SUBSIDIARY AND AFFILIATED COMPANIES

BOI UK's IDRs reflect the bank's standalone credit profile, as expressed in the subsidiary's VR. Our assessment factors in the slightly weaker asset quality metrics of BOI UK versus its UK peers, its stable funding profile and its sound profitability. It incorporates the bank's modest franchise and fairly undiversified business model, which concentrates on the UK mortgage and savings market. It also factors in the high level of integration with the parent's systems, processes and management.

Prospects for BOI UK's standalone credit profile are stable, as reflected in the subsidiary's Rating Outlook.

In our view, BOI UK benefits from a moderate likelihood of support, if required, from its parent bank as reflected in the '3' Support Rating. Although we view BOI'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 constrained by the large size of BOI UK relative to the parent's own equity.

EBS Limited and AIB Group (UK) Plc are wholly-owned by AIB, and Bank of Ireland Mortgage Bank is wholly-owned by BOI. These subsidiaries are, to varying degrees, reliant on their respective parents for funding and capital support. Their IDRs are therefore based on support and are equalised with their respective parents'. Fitch has not assigned VRs to these subsidiaries as we believe that these subsidiaries are closely integrated with their respective parents and they cannot be analysed meaningfully on a stand-alone basis.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF) (BOI and AIB)
BOI's and AIB'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 either 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 either bank.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The subordinated debt and other hybrid capital issued by BOI and AIB are notched off their issuers' respective VRs 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).

BOI's and AIB's subordinated Tier 2 debt are notched down once from their respective issuers' VRs, reflecting higher loss severity relative to senior obligations given their subordinated status.

BOI UK Holding's deferrable subordinated notes guaranteed by BOI are notched off three times from BOI's VR, twice for non-performance given the notes cumulative and deferrable coupon payments at the issuer's discretion and once for loss severity given the absence of writedown or equity conversion features.

AIB's AT1 debt is notched down twice for loss severity and twice for non-performance, reflecting their deep subordination and fully discretionary coupon omission. Their rating is the maximum rating under Fitch's criteria for banks with a VR anchor of 'bb+'.

The 'C' rating on AIB's legacy subordinated notes reflect these instruments' non-performance since the bank is not paying the discretionary coupons and also the notes' sustained economic losses, resulting in weak recoveries.

RATING SENSITIVITIES
IDRS, VRs AND SENIOR DEBT RATINGS
The Positive Outlooks on BOI's and AIB's IDRs reflect our expectation than the ratings may be upgraded, should the banks continue to further improve their asset quality and strengthen capitalisation. Although under some pressure, we expect profitability to continue feeding through to strengthened capitalisation for both banks, reducing their vulnerability to unexpected adverse changes to the Irish economy.

The ratings could come under pressure if any of our expectations are not met. This could happen for instance 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 slow improvements in asset quality and capitalisation. Negative pressure on the VRs, and hence the IDRs, would also arise if the banks increase their risk appetite, for example, by materially increasing their exposure to commercial real estate.

SUPPORT RATING AND SUPPORT RATING FLOOR (BOI and AIB)
An upgrade to the SR and upward revision to 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.

SUBSIDIARY AND AFFILIATED COMPANIES
The ratings of EBS Limited, AIB Group (UK) Plc and of Bank of Ireland Mortgage Bank are sensitive to the same factors that might drive a change in their parents' ratings.

BOI UK's VRs and IDRs are primarily sensitive to a 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 is particularly severe.

BOI UK's IDRs would only be upgraded if there is an upgrade in either the subsidiary's 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 BOI's rating. The reason for the latter is that we view BOI UK as benefiting from only a moderate likelihood of support if required, as reflected in its SR of '3'. We therefore expect that if BOI's IDR is upgraded to 'BBB', BOI UK's IDR would remain at 'BBB-', in line with the VR.

The SR of BOI UK, as for all other rated subsidiaries, would be sensitive to changes in the strategic importance of the subsidiaries to their respective parents as well as the respective parents' ability to support such subsidiaries (as reflected by higher or lower ratings).

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The ratings of all subordinated instruments are primarily sensitive to a change in the VRs of these banks, or to changes in their notching in accordance with our criteria and assumptions on non-performance risk.

The rating actions are as follows:

Bank of Ireland
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-'
Short-term debt affirmed at 'F3'
Commercial paper affirmed at 'F3'
EUR600m subordinated notes issued by Bank of Ireland Holdings and guaranteed by BOI (XS0125611482) affirmed at 'BB-'
GBP197.3m subordinated notes (XS048771656) affirmed at 'BB+'

Bank of Ireland Mortgage Bank
Long-Term IDR affirmed at 'BBB-'; Outlook Positive
Short-Term IDR affirmed at 'F3'
Support Rating affirmed at '2'

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 '3'

AIB
Long-Term IDR affirmed at 'BB+'; Outlook Positive
Short-Term IDR affirmed at 'B'
Viability Rating affirmed at 'bb+'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'No Floor'
Senior unsecured notes affirmed at 'BB+'
Short-term debt, including commercial paper affirmed at 'B'
EUR750m subordinated Lower Tier 2 notes (XS1325125158) affirmed at 'BB'
EUR500m subordinated AT1 7% trigger notes (XS1328798779) affirmed at 'B'
Subordinated legacy non-performing debt (XS0232498393; XS0435957682 and XS0124107053) affirmed at 'C'

AIB Group (UK) PLC
Long-Term IDR affirmed at 'BB+'; Outlook Positive
Short-Term IDR affirmed at 'B'
Support Rating affirmed at '3'

EBS d.a.c.
Long-Term IDR affirmed at 'BB+'; Outlook Positive
Short-Term IDR affirmed at 'B'
Support Rating affirmed at '3'
Senior long-term debt affirmed at 'BB+'
Short-term debt affirmed at 'B'

Contact:
Primary Analyst
Joanna Drobnik, CFA
Director
+44 20 3530 1318
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analysts
Marc Ellsmore (Bank of Ireland)
Associate Director
+44 20 3530 1438

Aabid Hanif (Allied Irish Banks)
Associate Director
+44 20 3530 1786

Committee Chairperson
Francesca Vasciminno
Senior Director
+39 02 879087 225

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 Bank Rating Criteria (pub. 25 Nov 2016)
https://www.fitchratings.com/site/re/891051