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ISSUER IN-DEPTH
8 DECEMBER 2015

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Bank of Ireland and Allied Irish Banks

Peer Comparison - Improving Fundamentals But Different Challenges

Two years after pulling out of recession, Ireland 's (Baa1, positive) thriving economy is also boosting the prospects for its banking system. Last month we changed the outlook for the country's two largest banks, Bank of Ireland (BOI; Baa2/Baa2 positive, ba2)[1] and Allied Irish Bank , p.l.c (AIB; Baa3/Ba1 positive, ba3) to positive from stable. In addition, on 8 December, we changed the outlook for the Irish banking system to positive from stable. In this peer comparison report on the two banks we focus on the key rating drivers and the different challenges they face.

» **Even though the outlook is positive for both banks, BOI has a higher rating since in our opinion it will maintain a stronger credit profile than AIB**. Both institutions are at different stages of the recovery process, with BOI already exploring future dividend distribution thanks to a lower level of asset quality concerns. By contrast, AIB is still owned by the government which is currently planning to sell its shareholding. The different level of the contribution of their international activities to their respective credit profiles will continue to play an important role moving forward given BOI's bigger exposure to the UK (Aa1, stable).

» **While we have only upgraded AIB's standalone baseline credit assessment (BCA) this year, the change in the outlook on the senior unsecured** and deposit ratings of both banks to positive reflects the upward trend in terms of asset quality, capital and profitability for both institutions. The upgrade of AIB's BCA, or its intrinsic financial strength, was largely driven by the conversion of part of the 2009 preference shares held by the government which will result in a net increase in fully loaded CET1 capital of €1.8 billion.

» **Following the capital transaction and the issue of €500 million of high trigger AT1, AIB will have a stronger regulatory capital position than BOI**. However, in our opinion, AIB will need to hold a bigger capital buffer than BOI over the next two to three years, given its larger stock of problem loans, which pose a bigger downside risk. In addition, while BOI's regulatory capital ratio has improved significantly, it remains more volatile than AIB's, reflecting material changes in the value of its pension deficit. After deleveraging and improvements in their capital ratios, both banks now have strong leverage ratios.

RATINGS

Allied Irish Banks, p.l.c.	
LT Bank Deposits	Baa3
LT Senior Unsecured Debt	Ba1
Baseline Credit Assessment	ba3
Outlook	Positive
Bank of Ireland	
LT Bank Deposits	Baa2
LT Senior Unsecured Debt	Baa2
Baseline Credit Assessment	ba2
Outlook	Positive

Source: Moody's Investors Service

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» **AIB has reported higher profits, reflecting larger provision write-backs. However, we consider the quality of BOI's profitability to be higher**, on account of a more stable net interest margin and the diversification benefits it receives from its insurance business, New Ireland (unrated).

» **Both banks maintain sound funding and liquidity profiles and have reduced their reliance on wholesale funding. Funding from monetary authorities has** also declined. While we consider BOI's funding profile to be stronger than AIB's, given its lower use of confidence-sensitive wholesale funding, we believe that AIB has set aside more liquid assets to offset its relatively high funding risk.

» **Both BOI and AIB are subject to an operational resolution regime under the European Union's (EU) Bank Recovery and Resolution Directive, hence we** apply our Advanced Loss Given Failure (LGF) approach to determine these banks' deposit and debt instrument ratings. While the banks' BCAs and deposit ratings differ by one notch, the senior unsecured debt rating of BOI is two notches above AIB's, reflecting its larger pool of senior and subordinated debt, which provides more protection from losses to senior creditors if the bank enters into resolution.

» **We believe there is moderate probability of government support for deposits and senior debt of BOI and AIB as** the two largest and systemically important banks in Ireland.

Compared Baseline Credit Assessments

Exhibit 1
Components of BOI's and AIB's BCA analysis

			SOLVENCY FACTORS						LIQUIDITY FACTORS				QUALITATIVE ADJUSTMENTS		
			Asset Risk		Capital		Profitability		Funding Structure		Liquid Resources				
	Assigned BCA	Weighted Macro Profile	Problem Loans % Gross Loans*	Assigned Score	TCE % RWA**	Assigned Score	Net Income % Tangible Assets	Assigned Score	Market Funds % Tangible Banking Assets	Assigned Score	Liquid Assets % Tangible Banking Assets	Assigned Score	Opacity and Complexity	Business Diversification	Corporate Behaviour
AIB	ba3	Strong -	30.3%	caa3	10.9%	baa3	-0.4%	ba3	22.0%	baa2	25.6%	baa1	0	0	0
BOI	ba2	Strong -	15.5%	b2	11.4%	baa2	0.2%	ba2	15.4%	baa1	20.1%	baa3	0	0	0

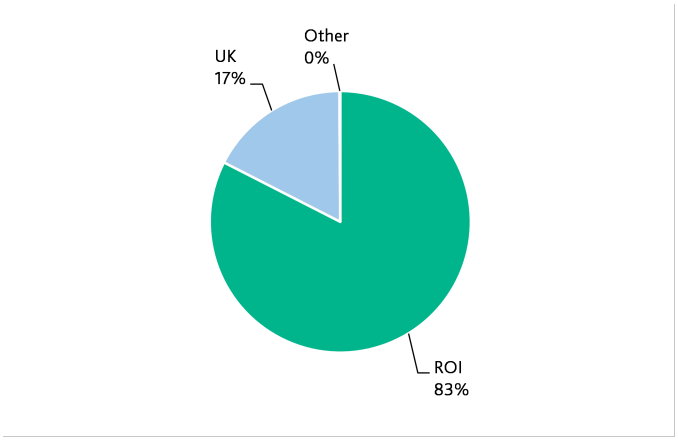
* 2012-H12015 average
** pro-forma post capital transaction and including Q3 profits for AIB and excluding contingent capital notes maturing in 2016 for both

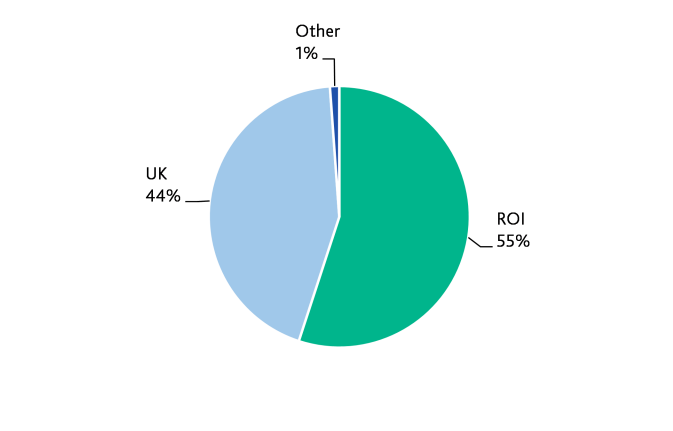
BOI benefits from its larger exposure to the UK market and faces more limited downside risk given the better quality of its legacy portfolio

BOI has a significantly higher proportion of loans outside Ireland with 45% compared to 17% for AIB (see exhibit 2). This geographic diversification helped BOI to maintain a better risk profile during the crisis and, in our view, it contributes to a more limited downside risk in its loan portfolio compared to AIB and other banks more concentrated in Ireland.

Exhibit 2

Geographical breakdown of lending book of AIB (left) and BOI (right) as of June 2015





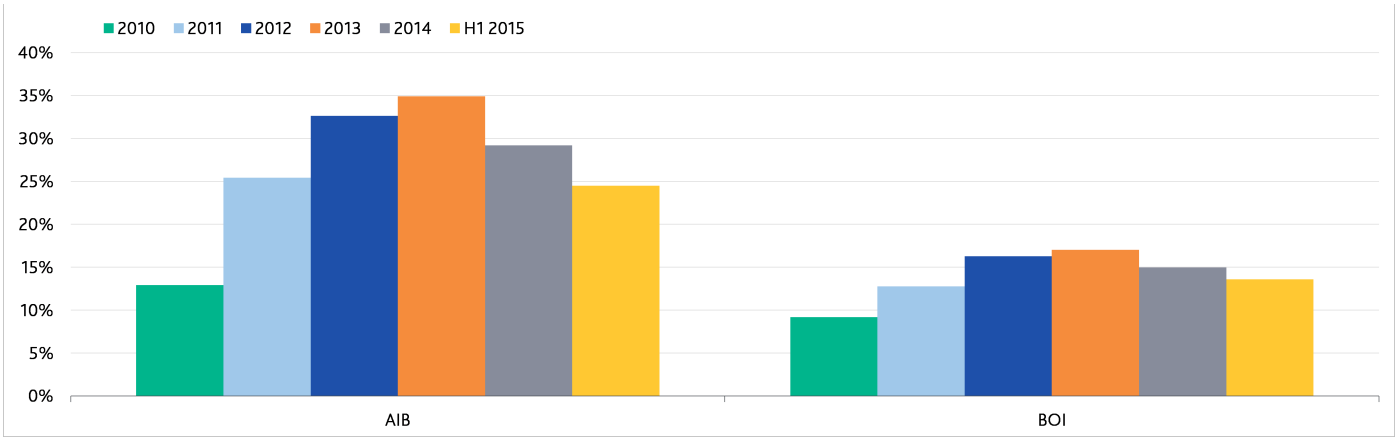
Source: Company reports

Source: Company reports

We expect the quality of the loan portfolios of both banks to continue improving, driven by the favorable operating environment in the UK and Ireland. However, we believe that AIB faces significantly larger challenges with a problem loan ratio of 24.5% compared to BOI's of 13.6% as of June 2015 (see exhibit 3).

Exhibit 3

Problem loan ratio

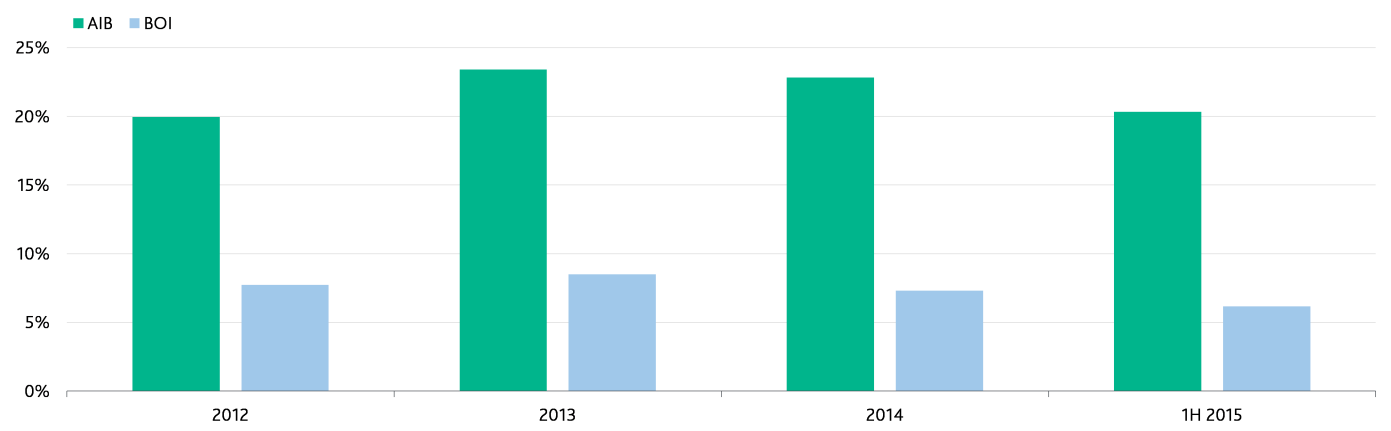


Source: Moody's Investors Service and company reports

The difference in asset quality not only reflects their geographical breakdown, but also their pre-crisis underwriting standards. For example, the proportion of over 90 days past-due mortgage loans at BOI as of June 2015 was 11.1% compared to an impaired loan ratio of 20.9% at AIB (see exhibit 4).

Exhibit 4

Non-performing residential mortgage loans - Ireland



Source: Moody's Investors Service and company reports

Given our positive outlook on the Irish economy and the efforts both banks are making to repair their balance sheets, we expect further improvements in the problem loan ratios of both institutions. Irish banks, including AIB and BOI, have embarked on aggressive restructuring campaigns to reduce the size of their impaired loan portfolios. The results of this strategy have been very positive, considering that 86% of all restructured owner-occupied and 82% of all restructured buy-to-let mortgages in Ireland were meeting the terms of the arrangement as of 30 June 2015 according to the Irish Central Bank. We believe however, that the process will continue to be slow given the reluctance of Irish banks to repossess properties and the long legal process resulting from the current framework.

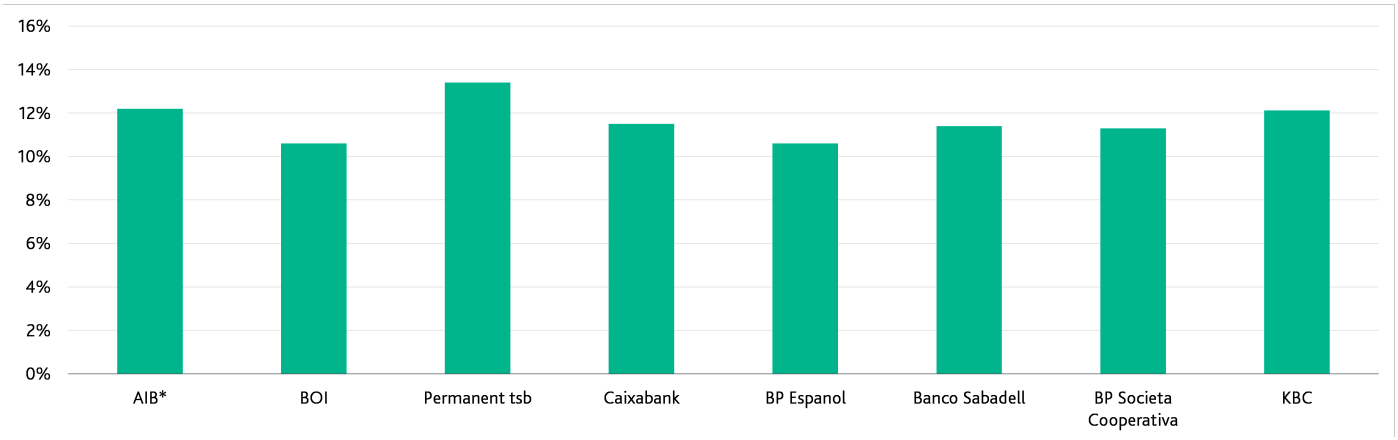
Overall, the quality of the existing book, its different geographic blend and the decline of the problem loan portfolio will continue to support stronger asset quality metrics for BOI.

However, following the conversion of the preference shares into common equity, AIB has a higher regulatory capital ratio

We upgraded AIB's BCA after the bank received approval from the Single Supervisory Mechanism (SSM) to repay €1.7 billion preference shares to the Irish government and to convert the remaining €1.8 billion into common equity. The capital reorganisation increases AIB's pro-forma 'fully loaded' CET1 ratio to 12.2% as of 30 September 2015, materially above the 10.6% reported by BOI in its third quarter management statement[2] . The exhibit below shows the comparison with other European banks.

Exhibit 5

Fully loaded Basel III CET1 ratio[3]

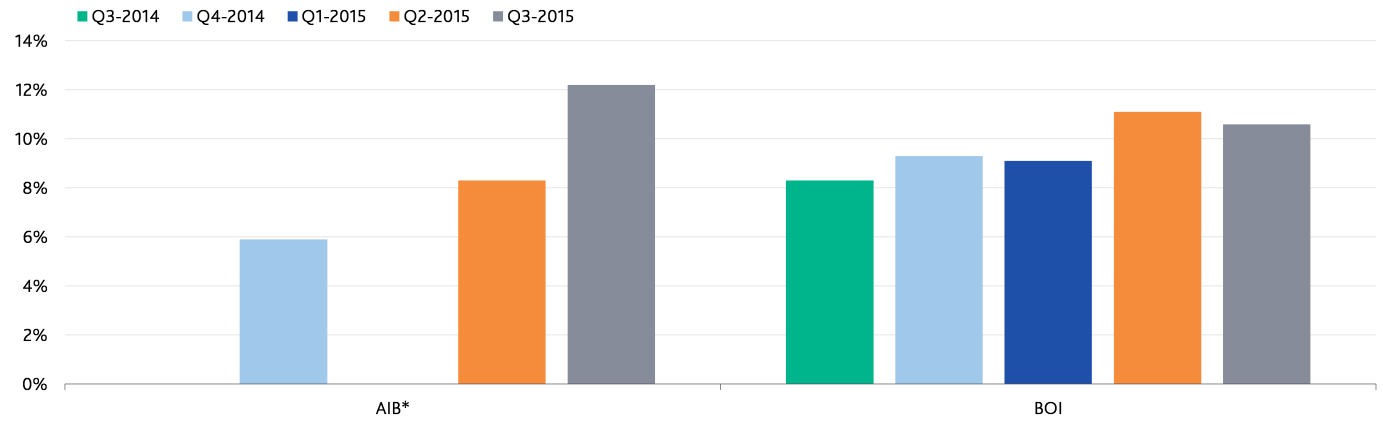


*Pro-forma

Source: Company reports

Although we expect that both banks will maintain strong organic capital generation through retained earnings, we note that their regulatory capital ratios could experience some volatility due to sizable variations in their defined benefit pension scheme deficits, especially in the case of BOI. Despite this volatility, we expect the ratio to maintain an overall upward trend (see exhibit 6) for both banks over the next 12 to 18 months.

Exhibit 6
Evolution of fully loaded CET1 Q3 2014 - Q3 2015



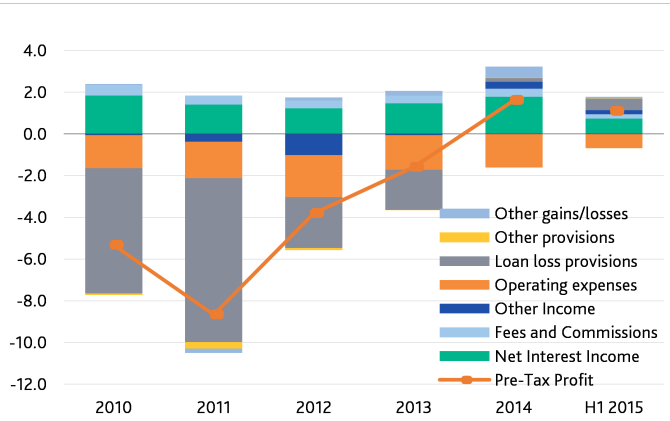
*AIB Q3 2015 is pro-forma metric following capital transaction

Source: Company reports

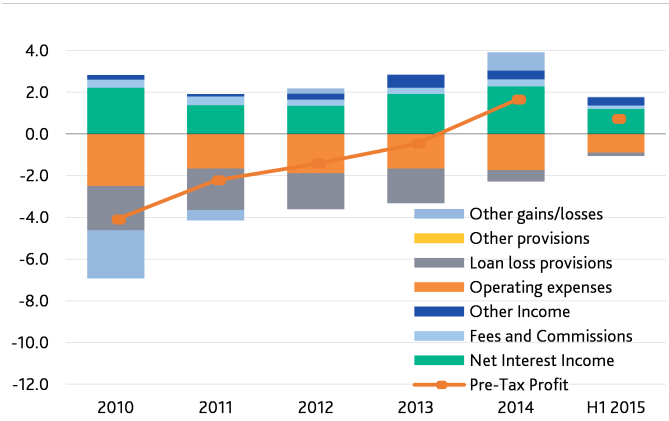
BOI has a better quality of earnings but the gap will narrow

Both banks have reported a material increase in profits, although their recent results have been distorted by a number of one-off asset sales and provision write-backs. Overall, BOI's reported lower net income in 2014 and the first half of 2015, but the profitability ratios have remained less volatile as the recovery has prompted fewer provision write-backs (see exhibit 7).

Exhibit 7
Pre-tax profit components of AIB (left) and BOI (right)



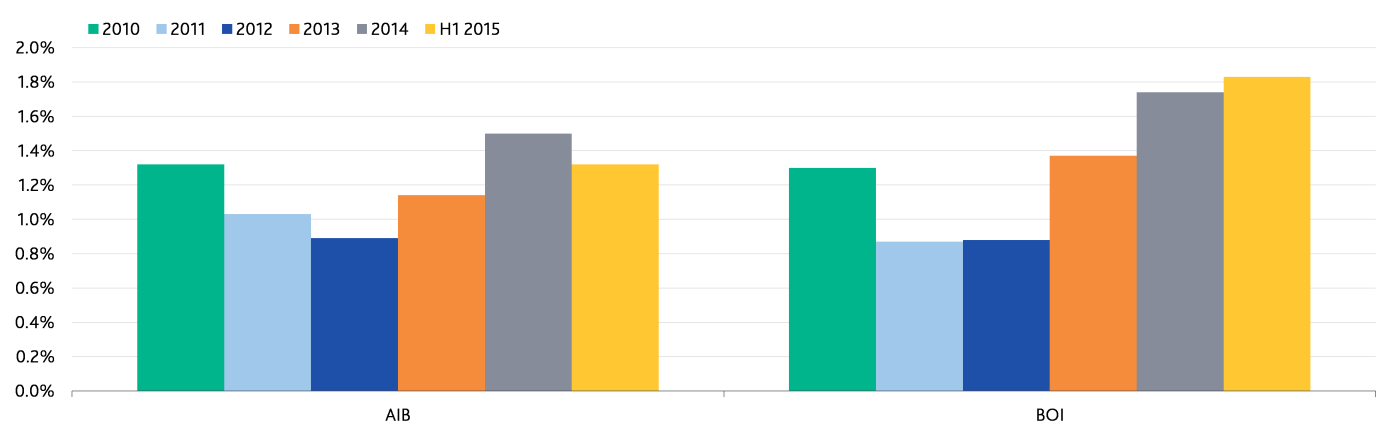
Source: Moody's Investors Service and Company reports



Source: Moody's Investors Service and Company reports

AIB has also a lower net interest margin (NIM), reflecting in part its larger portfolio of low yielding assets issued by the National Asset Management Agency (NAMA) and by the issuance of costly wholesale liabilities (see exhibit 8). As soon as the bonds are repaid and the issuer replaces its legacy liabilities we see AIB closing the gap in terms of NIM.

Exhibit 8
BOI improved its Net Interest Margin faster than AIB



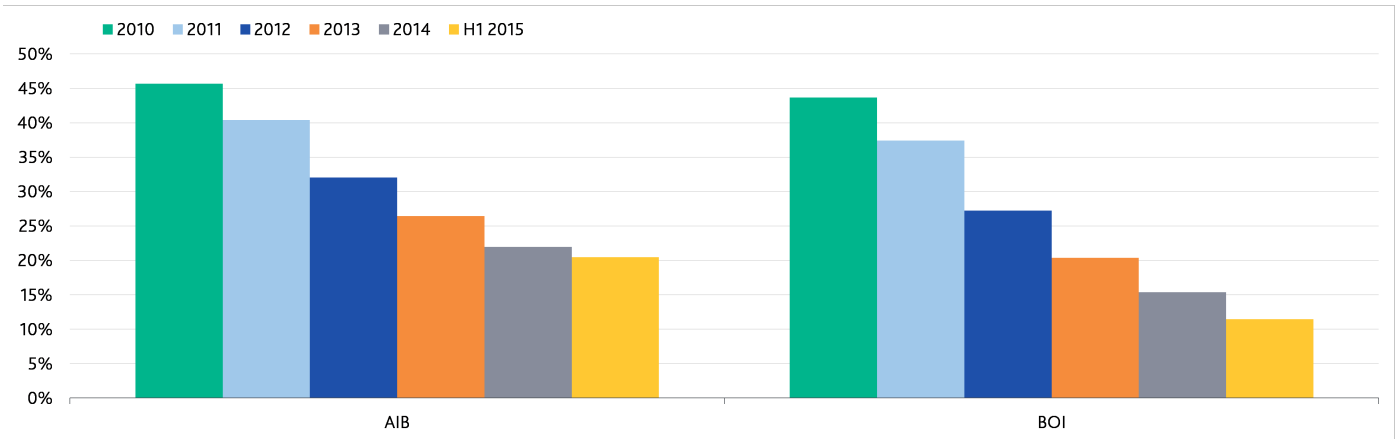
Source: Moody's Investors Service and Company reports

However, we continue to see BOI as having an advantage in terms of fee and commission income given its full ownership of the second largest life insurer in Ireland, New Ireland.

While BOI has a better funding profile, AIB has a higher proportion of liquid assets

Following a number of years of deleveraging their balance sheets, both institutions have made material progress reducing their use of wholesale funding. We calculate that BOI's market funds as a proportion of tangible banking assets declined to 11.5% as of June 2015 from 43.7% as of December 2010, while in the case of AIB the ratio fell to 20.5% from 45.7% during the same period (see exhibit 9). Although the proportion of funding from monetary authorities has also significantly declined for both institutions, BOI remains less reliant on this type of funding with 6.7% of its total wholesale funding compared to 13.5% at AIB as of June 2015.

Exhibit 9
BOI uses less wholesale funding than AIB...

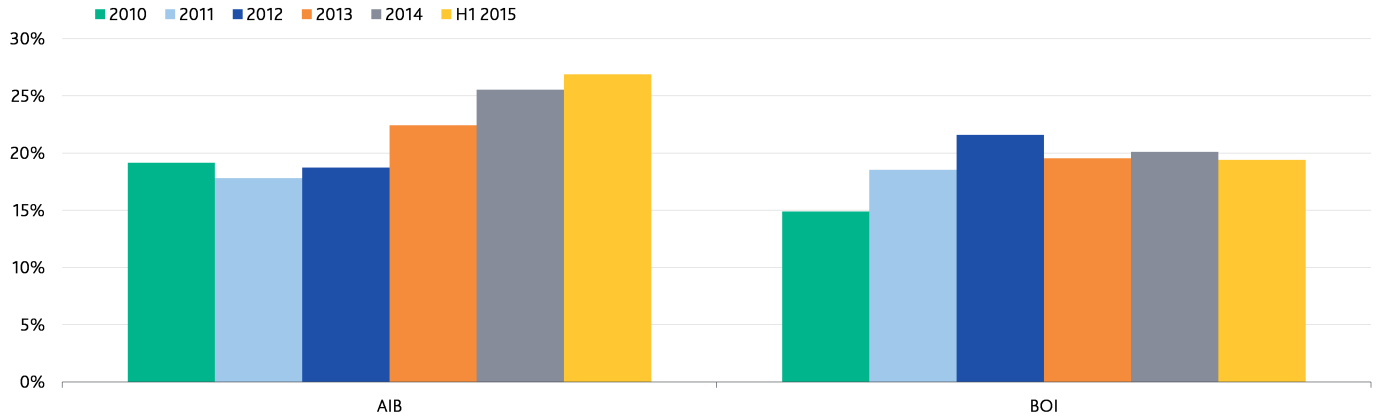


Source: Moody's Investors Service and Company reports

BOI reported a net stable funding ratio of 118% compared to 111% at AIB as of June 2015. Overall, we see BOI's funding profile as slightly more stable than AIB's. However, AIB has more liquid assets after the bank significantly increased the proportion of liquid assets compared to total tangible assets to 26.9% as of June 2015 from 19.1% as of December 2010. Over the same time period, BOI's liquid assets-to-tangible banking assets ratio increased to 19.4% from 14.9% (see exhibit 10).

Exhibit 10

...However, AIB has more on-balance sheet liquidity to mitigate risk



Source: Moody's Investors Service and Company reports

Loss-Given-Failure: BOI's senior debt benefits from a larger volume and greater junior debt cushion

BOI and AIB are subject to an Operational Resolution Regime through Ireland's implementation of the EU Bank Resolution and Recovery Directive, hence we apply our Advanced LGF analysis to both banks. The analysis is conducted along country lines, with the Irish bank considered separately from the UK subsidiary. This reflects our expectation that resolutions will mostly be conducted within national boundaries.

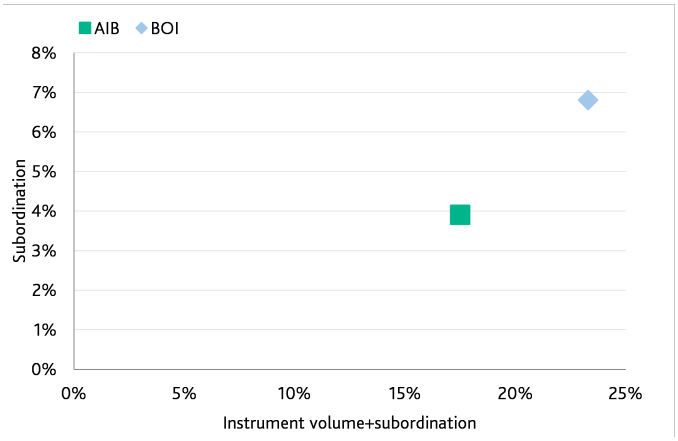
Both banks' deposit ratings benefit from the loss absorption provided by subordinated debt and, potentially, by senior unsecured debt should deposits be treated preferentially in a resolution, as well as the sizable volume of deposits themselves. The LGF analysis indicates BOI's and AIB's deposits are likely to face very low loss-given-failure, leading to two notches of uplift from the BCA. The resulting bank deposits Preliminary Rating Assessment (PRA) are baa3 and ba1 for BOI and AIB, respectively.

BOI's senior unsecured debt PRA of baa3, too, incorporates two notches of uplift from the BCA, reflecting a larger pool of senior debt and a greater subordinated debt cushion in its liability structure. By contrast, AIB's senior unsecured debt only benefits from one notch uplift above its BCA of ba3, resulting in the PRA of ba2 (Exhibit 11).

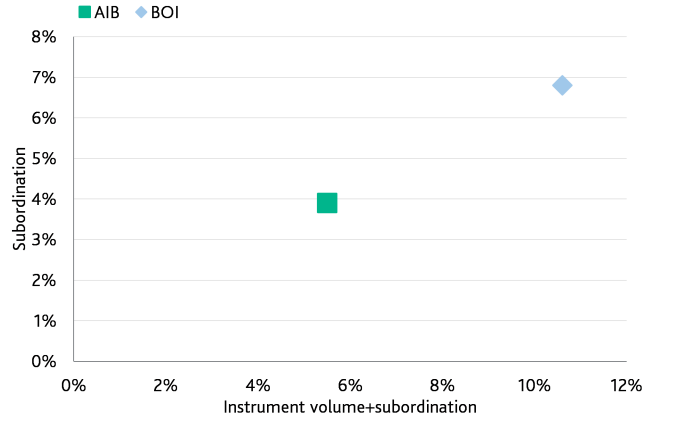
Exhibit 11

Senior unsecured debt LGF analysis under De Jure and De Facto

De Jure



De Facto



Source: Moody's Investors Service

Government Support

BOI and AIB are the two largest banks in Ireland and are considered systemically important banks. We therefore assign a moderate probability of support for the senior debt and deposit ratings of both banks, leading to one notch of uplift from the respective Preliminary Rating Assessments.

Moody's Related Research

Credit Opinion:

» Allied Irish Banks, p.l.c.

» Bank of Ireland

Banking System Outlook:

» Ireland, 8 December 2015

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 The bank ratings shown in this report are the banks' deposit ratings and senior unsecured debt ratings, and their baseline credit assessments.

2 See " Allied Irish Bank's Proposed Capital Reorganisation Gains SSM's Approval, a Credit Positive for Bondholders

3 As of June 2015 for Permanent tsb, Caixabank and BP Societa Cooperativa; as of September 2015 for AIB (pro-forma), BOI, BP Espanol and Banco Sabadell; as of December 2014 for KBC.

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