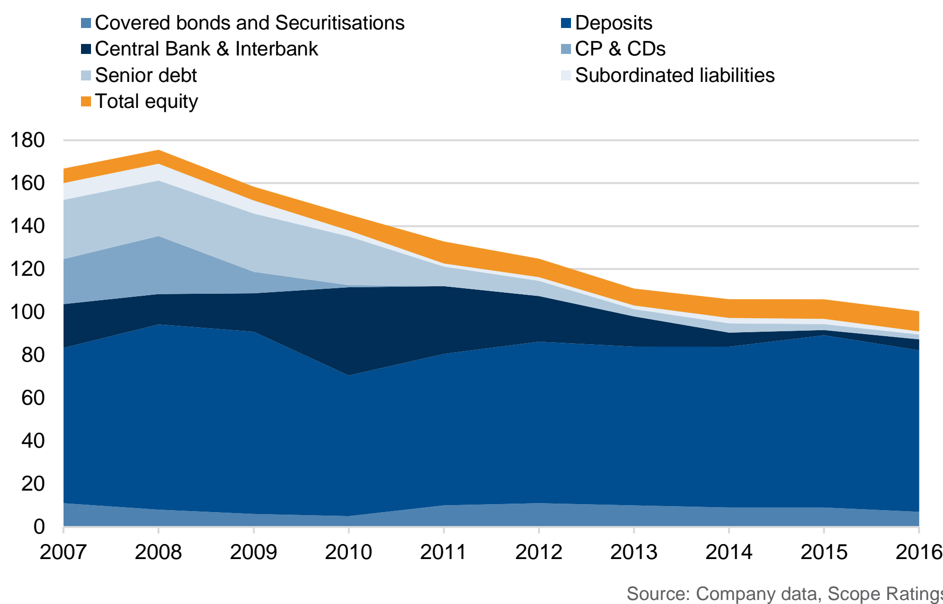
Spotlight on Irish Bank Funding: Preparing for MREL

In this report Scope comments on the evolution of the funding profiles of Ireland's two Pillar Banks, Bank of Ireland (BOI) and Allied Irish Banks (AIB) since the beginning of the financial crisis. We review how large-scale asset reductions have successfully led to a reduction in the banks' wholesale funding needs and much lower dependence on guarantees and central bank facilities

We also look at the two banks' plans to issue debt out of holding companies to meet the minimum requirements for own funds and eligible liabilities (MREL).

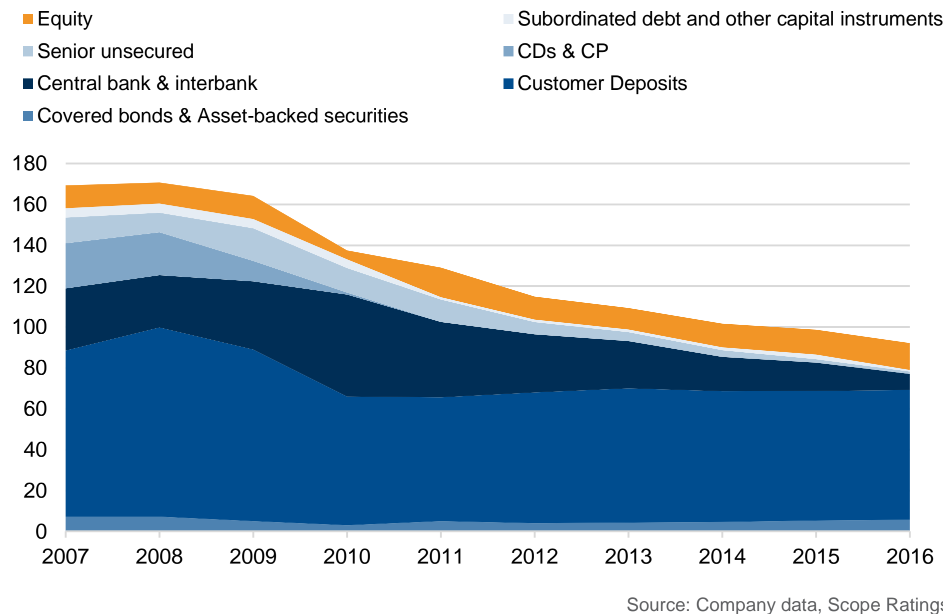
At this time, Scope does not have public ratings on these two Irish banks.

Figure 1: BOI Funding and Capital Structure Evolution 2007-2016 (EUR bn)



Source: Company data, Scope Ratings

Figure 2: AIB Funding and Capital Structure Evolution 2007-2016 (EUR bn)



Source: Company data, Scope Ratings

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A more stable post-crisis funding profile

Forced and dramatic reduction in assets (both performing and nonperforming) has contributed to a marked improvement in BOI and AIB's funding profiles in recent years, admittedly somewhat driven by necessity (see Appendix for a potted summary of the effects of the financial crisis on the banks). Both have returned to predominantly deposit-funded lending models, with loans to deposits ratios near 100%. BOI's total assets fell by 35% and AIB's by 46% between YE07 and YE16. Deposits remained the largest funding source throughout, and the banks have resized themselves to fit their deposit bases better. Deposits at BOI are almost the same size as it was pre- crisis (see Figure 1), up just 4% between YE07 and YE16. AIB, experiencing deeper asset quality issues, saw deposits fall 22% over the period (see Figure 2).

Both banks mainly source deposits from their Irish and UK retail networks (see Figures 3 and 4). Of the two, BOI has a larger UK franchise, thus more exposure to the decline in sterling. Between YE15 and YE16 this led to a EUR4.2 bn fall in its deposit base.

Figure 3: Bank of Ireland Split of Customer Deposits as of YE15 and YE16 (EUR bn)

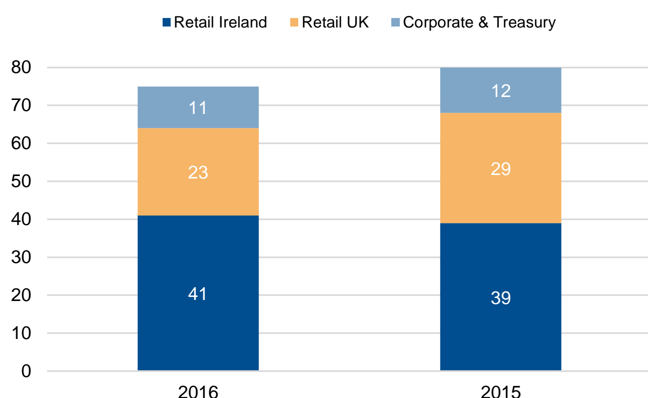
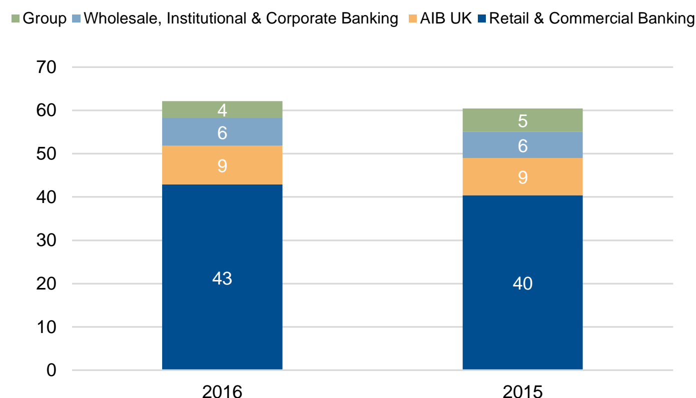


Figure 4: Allied Irish Banks Split of Customer Deposits as of YE15 and YE16 (EUR bn)



Source: SNL, Scope Ratings

Source: SNL, Scope Ratings

Unsecured versus secured wholesale funding – a material change

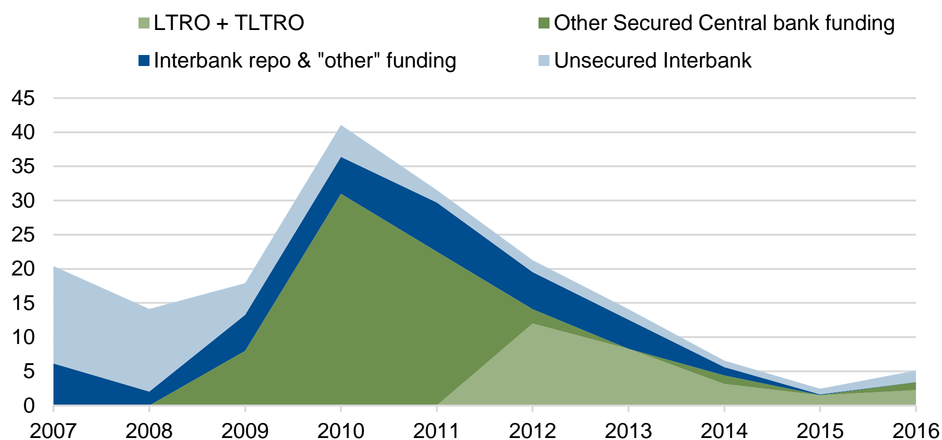
Although market access has been restored, by YE16 unsecured wholesale borrowings comprised just 2% of the two banks' funding. All BOI's liabilities under the Eligible Liabilities Guarantee (ELG) scheme (see Appendix for further details) matured or were replaced during 2016. AIB has minimal ELG liabilities outstanding.

The financial crisis has profoundly changed the banks' approach to wholesale funding, which is now far more conservative. The level of wholesale unsecured funding from banks, central banks and the debt markets is now much lower than it was even as far back as 2000. At the end of that year 26% of BOI's funding and 24% of AIB's funding, including subordinated debt, was from unsecured wholesale sources. As of 1H17 the level stood at 4% for both banks. Short-term funding in the form of CDs and commercial paper diminished rapidly after 2009 (see Figures 1 and 2). AIB set up a euro-commercial paper programme in 2016, but amounts outstanding are small.

AIB and BOI are now materially less dependent on various forms of secured wholesale funding than was the case at the height of the crisis, when they were forced to seek secured central bank repo funding from the ECB and Irish Central Bank (see Figures 5 and 6). They are, however, still using more secured central bank funding than was the case pre-crisis. Both have accessed the ECB's TLTRO II facility, and in addition BOI has drawn against the Bank of England's Term Funding Scheme (set up to provide economic stimulus in the wake of the Brexit vote) and Indexed Long-Term Repo (ILTR) facilities.

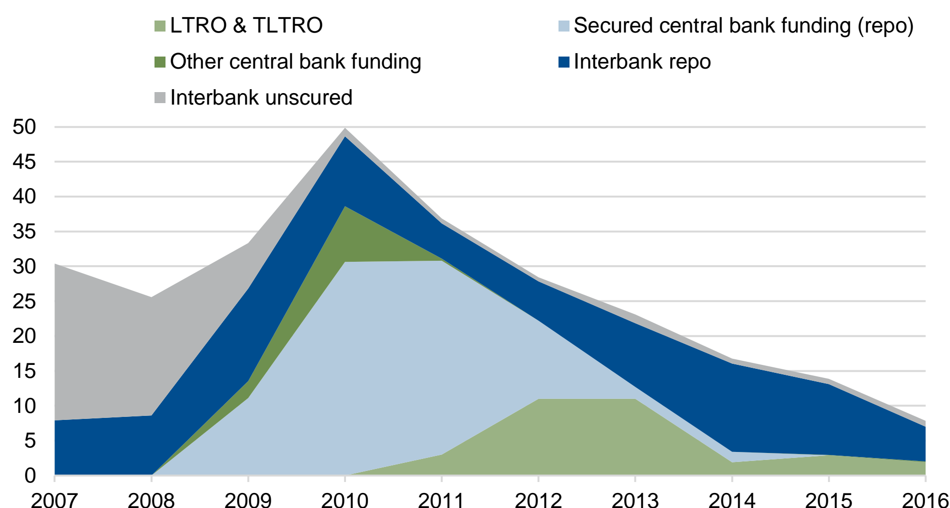
Both banks make use of covered bonds and asset-backed securities, comprising about 7-8% of funding.

Figure 5: BOI: Breakdown of interbank and central bank funding, 2007-2016



Source: Company Reports, SNL, Scope Ratings

Figure 6: AIB: Breakdown of interbank and central bank funding, 2007-2016



Source: Company Reports, SNL, Scope Ratings

Looking ahead – holding companies (holdcos) and MREL debt

Given the predominantly deposit-funded nature of BOI and AIB's simplified business models, the pattern of unsecured issuance going forward is, somewhat ironically, likely to be driven more by regulatory requirements than the need to refinance existing debt.

In February 2017 the Single Resolution Board (SRB) notified both banks that their preferred resolution strategy consists of single point of entry bail-in at holding company level, and asked them to set up new holdcos to facilitate this. This mirrors the approach that will be applied to UK banks, and was agreed in conjunction with the UK's Prudential Regulatory Authority, as competent authority for the banks' UK subsidiaries.

The banks expect to issue all MREL-eligible debt instruments out of the holdcos. New senior unsecured debt will therefore be structurally subordinated to deposits and operating company senior debt.

BOI has already set up a new listed holding company, Bank of Ireland Group PLC (BOIG), as of 7th July 2017. On 9th September 2017 it raised Tier 2 capital out of BOIG in two tranches of GBP300 mn and USD500 mn. AIB expects its holdco, AIB Group PLC, to be operational by the end of 2017, subject to the necessary legal approvals. Given AIB's limited need for senior unsecured funding at operating company level, Scope expects no debt issuance from AIB before then.

Future amounts of MREL-eligible debt to be issued remain unclear, as aspects of the MREL framework have yet to be clarified. The EC published proposals covering, inter alia, the MREL framework in November 2016. Subsequently the EBA recommended (n its Final Report on MREL published in December 2016) that an institution's risk-weighted assets should form the denominator for the MREL percentage calculation, rather than total liabilities and own funds. It is not certain whether this will be implemented. The treatment of uninsured deposits also remains to be decided.

BOI notes that the SRB has published the methodology for an 'informative target' for MREL, and from this identifies a possible target level for eligible liabilities of 27.25%[1], expressed as a percentage of RWAs. Based on 1H17 RWAs of EUR 48.8 bn, BOI would have an MREL requirement of EUR 13.3 bn. Total regulatory capital at 1H17 was EUR 8.9 bn, which (after adding in the new issues made in July) suggests a shortfall of about EUR 3.6 bn to be issued by the holding company. AIB's needs may be in a similar range, as it has noted that it expects to issue EUR3-5 bn of securities eligible for MREL purposes over the medium to long term2.. Both banks are expected to receive detailed guidance on MREL by the end of 2017. This should also include guidance on internal MREL and downstreaming requirements, and the phase-in period.

We also note that operating using a holding company structure has implications for total capital ratios, as under the Capital Requirements Regulation (articles 85-88). Some existing AT1 and Tier 2 capital instruments issued by the banks will not qualify as regulatory capital, although reported CET1 ratios will remain unaffected, and the instruments will still be eligible to count towards MREL. In this respect AIB estimates that the impact on its transitional Tier 1 and total capital ratios respectively is about 40 bps and 80 bps respectively, based on YE16 figures. Both AIB and BOI have indicated that they may take mitigating actions, which could involve calling the instruments (with regulatory approval) at the earliest possible call dates, or, if market conditions permit, seeking some form of buyback and/or exchange offer. Such actions could increase the amount of debt to be issued by the holding companies.

1 Bank of Ireland Credit Presentation, Feb 2017
2 AIB's IPO Prospectus, 12 June 2017.

Appendix

The financial crisis and the banks – a potted history

In the 1990s and up until 2000 (see Figures 7 and 8) deposits were the Irish banks' dominant source of funding.

By the time the crisis hit the country in 2008, banks' rapidly expanding levels of unsecured external wholesale funding had fuelled a wave of speculative long-term lending against property. By the end of 2007 41% of BOI's funding and 37% of AIB's comprised unsecured senior debt, commercial paper, CDs and interbank borrowings. A high proportion of the funds were short term and came from foreign banks (see Figures 1 and 2).

Ireland entered recession, unemployment rose to almost 15%, and output, especially related to the construction sector, collapsed. Real estate prices plunged and the banks saw their unsecured funding melt away.

Figure 7: BOI Loans, Deposits and Funding (EUR bn)

	2000	2007	2010	2016	1H17
Total assets	68.0	188.8	167.5	123.1	122.0
Net loans	44.8	125.0	114.6	78.4	76.9
Total deposits	41.0	72.3	65.4	75.2	74.7
Bank/central bank unsecured	10.3	35.3	5.9	1.7	1.2
Secured funding	0.0	17.1	41.4	10.4	11.3
Senior Unsecured debt	2.8	48.5	23.7	2.3	1.1
Subordinated debt	1.9	7.8	2.8	1.4	1.4
Loans to deposits ratio	109%	173%	175%	104%	103%

Source: Company Reports, SNL, Scope Ratings

Figure 8: AIB Loans, Deposits and Funding (EUR bn)

	2000	2007	2010	2016	1H17
Total assets	77.5	177.9	145.7	95.6	90.5
Net loans	45.9	127.6	86.4	60.6	58.8
Total deposits	48.4	81.3	52.4	63.5	63.7
Bank/central bank unsecured	11.0	22.5	0.8	0.7	0.4
Secured funding	1.5	15.1	43.6	12.6	8.1
Senior Unsecured debt	4.3	47.2	22.2	2.1	1.5
Subordinated debt	0.3	4.6	4.3	0.8	0.8
Loans to deposits ratio	95%	157%	165%	95%	94%

Source: Company Reports, SNL, Scope Ratings

Extraordinary measures had to be taken to shore up the banks. From 2009 onwards this involved nationalisations, capital injections and two of the country's lending institutions (Anglo Irish and Irish Nationwide Building Society) eventually being wound up. Initially the measures focused on liquidity. In September 2008 the Irish government unilaterally put in place a blanket guarantee scheme standing behind all deposits (retail, commercial, institutional and wholesale), covered bonds, senior debt and dated subordinated debt (lower tier 2 instruments). It also backed all new facilities issued from midnight 29 September 2008 and expiring by 28 September 2010. The guarantee ended up covering EUR 375 bn on top of EUR 77 bn already covered by the Deposit Guarantee Scheme. Despite the guarantee the banks continued to face short-term liquidity pressures and deposit withdrawals, and they required substantial access to short-term liquidity support

from Ireland's Central Bank (emergency liquidity assistance), on top of the collateralised support provided by the ECB (see Figures 5 and 6).

As the crisis remained unresolved, the Eligible Liabilities Guarantee (ELG) Scheme was introduced in December 2009, before the original; scheme ran out. For a fee, banks could have government guarantees for senior unsecured CDs and CP, senior unsecured bonds and some other senior unsecured debt, for up to five years. Demand and term deposits were also covered where deposit protection schemes did not provide cover. This time dated subordinated debt was excluded. The ELG scheme came to an end for all new liabilities on 28th March 2013.

The original guarantee amount amounted to about 200% of GDP and led to concerns over the sovereign's position, especially as a 'funding cliff' approached in September 2010 as it was due to expire. Banks had understandably issued guaranteed funding out to this horizon, and thus a large amount would need to be refinanced that month under the ELG scheme. Having lost capital markets access, in November 2010 Ireland took a EUR85 bn bailout from the IMF, European Commission and the ECB (the Troika), including support for the banking sector. One condition of this programme, which lasted until the end of 2013, was that the banking sector be restructured and fundamentally downsized, with capital adequacy being restored. Within this, AIB and BOI both went through a Prudential Liquidity Assessment Review in 2011, which identified assets to be disposed of to return the banks to stable funding levels. In addition, the banks (BOI, AIB and also Permanent TSB) were required to undertake Liability Management exercises, which meant buying back their subordinated debt from investors at a discount to par value. In this way they collectively reduced their subordinated debt by about EUR 15.5 bn.

Return to the wholesale debt markets

By the end of 2012 the situation had finally stabilised enough that AIB and BOI could look to go to the market with unguaranteed bonds, beginning with covered bonds. BOI then raised EUR 250 mn in subordinated debt in December 2012 in a 10 year deal targeted at its equity investors. In May 2013 BOI was able to raise senior unsecured unguaranteed funding for the first time since the crisis, followed by AIB in November 2013, for terms of three to three and a half years. Senior unsecured issues made in 2015 were for five years. Both banks also issued capital instruments in 2015.

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