MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Co-operative Bank's deposit and senior unsecured debt ratings at Caa2

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Outlook on the ratings remains positive

London, 18 August 2016 -- Moody's Investors Service has today affirmed Co-operative Bank plc's long-term deposit and senior unsecured debt ratings at Caa2. The outlook on both ratings remains positive reflecting Moody's expectation that the bank's credit fundamentals will continue to improve, albeit at a slower pace than previously expected.

Moody's also affirmed Co-operative Bank's Counterparty Risk Assessment (CR Assessment) at B2(cr)/ Not Prime(cr). The bank's short-term deposit and debt ratings were affirmed at Not Prime.

The rating action reflects the affirmation of the bank's standalone baseline credit assessment (BCA) at caa2 as well as the results of Moody's Advanced Loss Given Failure (LGF) analysis.

RATINGS RATIONALE

---RATIONALE FOR THE BCA

The affirmation of Co-operative Bank's BCA at caa2 recognizes: (1) the significant progress the bank has made in reducing its low-quality non-core portfolio and, consequently, its downside risks; (2) adequate, although decreasing, capital metrics; (3) the improvements in asset quality; and (4) the maintenance of solid funding and liquidity positions. At the same time, the bank's BCA of caa2 continues to reflect (1) the considerable execution risk to the transformation plan amid a more challenging operating environment for UK banks post the UK vote to leave the EU; (2) the expectation of continued net losses through to 2017, eroding the bank's capital and leverage position; and (3) the bank's continuing reliance on regulatory forbearance with regards to its inability to consistently comply with its Individual Capital Guidance (ICG) and non-compliance with regulators' requirements in relation to credit risk modelling and certain IT standards.

Co-operative Bank has demonstrated significant progress in delivering on its restructuring plan, deleveraging a significant proportion of its low-quality non-core assets and reducing its downside risk. During the course of 2015, the bank executed two securitization transactions with loans from its non-core residential mortgage book, Optimum, for a total of GBP3.1 billion. In addition, the bank achieved a GBP2.2 billion reduction in its non-core commercial portfolio. As a result, impaired loans fell by 60% to GBP961 million as of December 2015, and the impaired loan ratio improved to 4.8% from 9.2% a year earlier. Improvements were also achieved in addressing operating efficiency issues with total operating expenses falling by GBP76.5 million, or 13%, in 2015. Previous recapitalisation processes and the disposal of some non-core assets in a capital accretive way have led to an improvement in the regulatory capital ratios to an adequate level. However, further expected losses and the greater difficulty the bank now faces to sell assets without eroding its capital metrics, will drive the capital and leverage ratios down in 2016 and 2017. The bank's fully-loaded common equity tier 1 (CET1) fell to 14.1% at the end of the first quarter of 2016 from 15.5% at end-2015, driven by the losses incurred in the period.

Co-operative Bank has agreed an updated turnaround plan with the Prudential Regulation Authority, which includes suspending the plan to sell the remaining Optimum assets in response to the more unfavorable market conditions in the UK. This will slow down the pace of the deleveraging process.

The bank also recently extended the timeline for its capital strategic plan, and is still reliant on regulatory forbearance relating to the inability to consistently comply with its ICG, non-compliance with internal credit risk modelling requirements and the need to upgrade its IT infrastructure to comply with applicable standards.

Finally, despite the progress made in cost cutting and improvements in net interest margin, profitability remains negative, disrupted by high business investment costs, losses on asset disposals, conduct charges and fair value adjustment unwind related to the merger with Britannia Building Society. Most of these legacy items are expected to clear in the next couple of years, but the bank is unlikely to return to profit until 2018. Without the support from earnings generation, Moody's continues to view the bank's capital position as extremely vulnerable. Given the delay in further deleveraging, capital ratios will continue to fall leaving the bank with limited resources to face unexpected losses, including conduct-remediation costs and additional impairments caused by more adverse economic conditions.

The BCA of caa2 continues to incorporate a one-notch negative adjustment for business diversification and a two-notch negative adjustment for corporate behavior. Going forward Co-operative Bank will primarily focus on its retail franchise. As the bank runs down its corporate and commercial assets, its business model will effectively become less diversified. While Moody's believes that the current management team has developed a realistic de-risking and restructuring plan, the bank continues to face a number of challenges resulting from past control failures and its future performance could still be affected by these legacy issues. For these and other reasons, Moody's believes Co-operative Bank still faces material challenges on its way towards achieving a sustainable business model.

--- RATIONALE FOR THE DEPOSIT AND SENIOR DEBT RATINGS

The affirmation of the Co-operative Bank's long-term deposit and senior unsecured debt ratings at Caa2 and the affirmation of short-term deposit and debt ratings at Not Prime also incorporate the results of Moody's Advanced LGF analysis and the assumption of low government support probability.

Co-operative Bank is subject to an Operational Resolution Regime through the United Kingdom's implementation of the EU Bank Resolution and Recovery Directive (BRRD), and Moody's Advanced LGF analysis therefore applies. The following standard assumptions are made: residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and a 25% probability to deposits being preferred to senior unsecured debt. Particular to Co-operative Bank, the proportion of deposits considered junior is 10%, as opposed to the standard assumption of 26%, due to largely retail-oriented depositor base of the bank.

The bank's deposits are likely to face a moderate loss-given-failure driven by (1) declining deposit volume and (2) a relatively low level of subordinated debt in the liability structure that would otherwise provide a loss absorbing cushion for deposits. This results in the Preliminary Rating Assessment (PRA) for the deposits in line with the BCA at caa2.

Senior unsecured debt is also likely to face a moderate loss-given-failure, and its PRA of caa2 is at the same level as the BCA.

Moody's assumes a low probability of government support for Co-operative Bank's deposits and senior debt, resulting in no uplift from the PRA.

--- RATIONALE FOR THE POSITIVE OUTLOOK

The outlook on all ratings is positive, reflecting Moody's expectation that despite the considerable challenges Co-operative Bank continues to face, which are exacerbated by the weakening operating environment, the bank will continue implementing its business restructuring plan and improving its credit fundamentals, albeit at a slower pace than previously expected.

--- RATIONALE FOR THE CR ASSESSMENT

As part of today's action, Moody's also affirmed the bank's CR Assessment at B2(cr)/NP(cr), three notches above the BCA of caa2. The CR Assessment is driven by the banks' standalone assessment and by a considerable amount of bail-in-able deposit and debt in the liability structure likely to shield counterparty obligations from losses.

WHAT COULD CHANGE THE RATINGS UP/DOWN

The Co-operative Bank's BCA could be upgraded if the bank demonstrates further progress in (1) restructuring its business, (2) reducing the size of its non-core portfolio and (3) implementing cost-saving initiatives; while (4) maintaining satisfactory capital ratios. A positive change in the BCA would likely lead to an upgrade in all ratings.

An downgrade in the bank's BCA could be triggered as a result of (1) the bank's capital position eroding to unacceptable levels; (2) further delays in progress on cost saving and restructuring plans; and (3) significantly higher than expected impairment or conduct charges. A negative movement in the bank's BCA would likely lead to the downgrade of all ratings.

LIST OF AFFECTED RATINGS

The following ratings and assessments were affirmed with the outlook remaining positive:

....Senior Unsecured Regular Bond/Debenture, Caa2

....Senior Unsecured Medium-Term Note Program, (P)Caa2

....Senior Unsecured Long Term Deposit Rating, Caa2

.... Baseline Credit Assessment, caa2

.... Adjusted Baseline Credit Assessment, caa2

.... Counterparty Risk Assessment, B2(cr)

.... Counterparty Risk Assessment, NP(cr)

....Senior Unsecured Commercial Paper, NP

.... Short Term Deposit Rating, Affirmed NP

....Other Short Term, (P)NP

The principal methodology used in these ratings was Banks published in January 2016. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

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