MOODY'S INVESTORS SERVICE

Credit Opinion: Co-Operative Bank Plc

Global Credit Research - 05 Nov 2014

Manchester, United Kingdom

Ratings

Category	**Moody's Rating**
Outlook	Negative(m)
Bank Deposits	Caa2/NP
Bank Financial Strength	E
Baseline Credit Assessment	ca
Adjusted Baseline Credit Assessment	ca
Senior Unsecured	Caa2
Commercial Paper -Dom Curr	NP
Other Short Term -Dom Curr	(P)NP

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Key Indicators

Co-Operative Bank Plc (Consolidated Financials)[1]

	[2]**6-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (GBP million)	**41,076.6**	**43,396.1**	**49,772.8**	**48,955.6**	**45,581.3**	[4]**-2.6**
Total Assets (EUR million)	**51,297.8**	**52,161.3**	**61,366.5**	**58,608.1**	**53,195.9**	[4]**-0.9**
Total Assets (USD million)	**70,234.4**	**71,875.2**	**80,905.1**	**76,081.8**	**71,364.6**	[4]**-0.4**
Tangible Common Equity (GBP million)	**1,988.5**	**1,629.1**	**1,579.4**	**2,230.9**	**2,090.7**	[4]**-1.2**
Tangible Common Equity (EUR million)	**2,483.3**	**1,958.2**	**1,947.3**	**2,670.8**	**2,440.0**	[4]**0.4**
Tangible Common Equity (USD million)	**3,400.0**	**2,698.3**	**2,567.3**	**3,467.1**	**3,273.3**	[4]**1.0**
Net Interest Margin (%)	**1.0**	**1.0**	**1.2**	**1.4**	**1.4**	[5]**1.2**
PPI / Average RWA (%)	**-1.2**	**-0.7**	**1.6**	**1.0**	**0.9**	[6]**-1.2**
Net Income / Average RWA (%)	**-0.8**	**-8.0**	**-1.8**	**0.3**	**0.2**	[6]**-0.8**
(Market Funds - Liquid Assets) / Total Assets (%)	**-11.0**	**-6.0**	**-5.9**	**-9.1**	**-2.8**	[5]**-6.9**
Core Deposits / Average Gross Loans (%)	**105.1**	**100.0**	**107.7**	**105.2**	**98.7**	[5]**103.3**
Tier 1 Ratio (%)	**11.6**	**9.3**	**8.1**	**10.1**	**9.9**	[6]**11.6**
Tangible Common Equity / RWA (%)	**14.3**	**11.6**	**8.8**	**11.0**	**10.7**	[6]**14.3**
Cost / Income Ratio (%)	**131.2**	**116.9**	**60.4**	**73.5**	**78.5**	[5]**92.1**
Problem Loans / Gross Loans (%)	**11.0**	**10.8**	**11.0**	**8.1**	**7.8**	[5]**9.7**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**110.4**	**125.5**	**144.6**	**104.6**	**115.3**	[5]**120.1**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Co-operative Bank plc's deposit and senior debt ratings are Caa2/Not Prime with a negative outlook. The bank's baseline credit assessment (BCA) is ca, equivalent to a standalone bank financial strength rating of E. The two notch gap between standalone and debt rating primarily reflects the benefit to senior unsecured creditors from the improved, albeit still vulnerable, capital and leverage positions and the cushion from the outstanding £196 million of subordinated debt and the reduced likelihood of systemic support coming from the UK government given that the ongoing deleveraging process is leading the bank to a smaller and less systemically important financial institution. We also note that the bank continues to benefit from regulatory forbearance to meet regulatory capital requirements (the Prudential Regulation Authority's Individual Capital Guidance - ICG). Our decision to limit the uplift to two notches reflects our concerns over the damage the bank's franchise has suffered, its impaired profitability and the consequent uncertainties for bondholders, supplemented with a reduced likelihood that the UK government would commit taxpayer's money to inject capital into the bank if this was required in the future.

Co-operative Bank's standalone ratings at the E/ca level reflect (1) remaining challenges for the bank to become a sustainable and viable institution - via a business plan that involves significant execution risk in achieving its intended cost savings and business restructuring, (2) still vulnerable capital position and (3) significant differences in carrying value versus fair value for the non-core (Optimum) portfolio and potential additional conduct remediation costs, both of which may weigh on future profitability.

The deposit and senior debt ratings are rated Caa2. The negative outlook reflects our view that (1) the Co-operative Bank's business plan to improve its longer-term capitalisation and return to sustainable profitability is subject to significant execution risks and (2) the likelihood that the UK authorities will provide systemic support to the bank will diminish over time. The enforcement investigations of the Co-operative Bank by the UK's Prudential Regulation Authority (PRA), including consideration of the role of former senior managers, and by the Financial Conduct Authority (FCA) as well as the previously announced plans by the Treasury to order an independent investigation into events at the Co-operative Bank and the circumstances surrounding them presents further challenges for the bank.

Rating Drivers

- In our opinion, the bank's business plan is exposed to a high level of execution risk although, it will likely benefit from the favorable operating environment in the UK

- Asset quality is poor in the non-core portfolio, due to a sizable exposure to commercial real estate (CRE) and predominantly interest only intermediary residential mortgages (a portfolio otherwise known as Optimum)

- Profitability is negative and will likely remain low

- The bank's reliance on wholesale funding is low and current liquidity levels are sufficient

Rating Outlook

The negative outlook on Co-Operative Bank's Caa2 long term debt and deposit ratings incorporates the significant execution risks related to the business plan and the reduced likelihood of systemic support coming from the UK government.

What Could Change the Rating - Up

Upward pressure on the long-term debt and deposit ratings of the Co-operative Bank could develop over the longer term as we see evidence regarding the sustainability of the franchise; together with significant progress being made in the bank's restructuring, deleveraging and cost-saving initiatives.

What Could Change the Rating - Down

Negative pressure on the senior unsecured debt and deposit ratings would stem from either (1) the bank's inability to maintain its regulatory capital ratios at adequate levels, (2) delays in the progress on the cost saving and restructuring plans; or (3) a significant deterioration of its liquidity and, (4) higher than expected impairments or conduct related costs.

DETAILED RATING CONSIDERATIONS

WEAK, ALBEIT IMPROVED, CAPITAL LEVELS AND OUTLINED BUSINESS PLAN INCORPORATES HIGH LEVEL OF EXECUTION RISK

Although the successful completion of the liability-management exercise (LME) in December 2013 and the additional £400 million capital increase raised in May 2014 comprised a significant milestone for Co-operative Bank's restructuring and improved capital position, the bank still faces significant challenges to become a viable and sustainable institution given the high execution risk in achieving the results expected through cost savings and business restructuring.

The reduction of its non-core portfolio will likely take a long time given uncertainty regarding the pricing for assets in its portfolio although, we believe that the favorable operating environment in the UK will likely provide opportunities to the bank to dispose some assets in a capital accretive way. Nevertheless, we note the high levels of impairments and differences between the bank's assets' carrying value and their fair value, especially related to Optimum, a book of predominantly interest-only intermediary and acquired mortgage book assets (reduced to £6.6 billion as of June 2014 from £7.1 billion a year earlier). Moreover, despite the improving operating conditions, there is also uncertainty regarding the turning point at which the bank will start generate capital organically through earnings retention. We note that the bank still requires some sizable investments in IT over the next three years (between £400 - 500 million).

Following the successful completion of the LME and the £400 million capital raise, Co-operative Bank reported a CRD IV fully loaded CET1 ratio of 11.5% as of June 2014, up from the 3% as of June 2013. The capital position's improvement reflects the increase in CET1 of £1.1 billion and the reduction in RWAs by 3.6 billion year on year following the ongoing deleveraging. The bank's reported CRD IV fully loaded leverage ratio increased to 3.7% as of June 2014 from 1.1% a year earlier.

Despite this additional capital increase, we note that the bank will remain vulnerable to further shocks, and is reliant on regulatory forbearance, for a sustained period of time particularly relating to its non compliance with its Individual Capital Guidance (ICG). The bank has discussed, and agreed, a business plan with the PRA that would help to cure the ICG breach within 4 to 5 years. However, the PRA does retain discretion to revisit the Bank's non-compliance with its ICG. As a result, we believe that the bank has limited room to absorb unexpected losses, including conduct-remediation costs and additional impairments caused by adverse economic and market conditions. With the recent opening of enforcement investigations by the PRA and FCA, the risk of fines being imposed against the firm remains significant. In addition, we believe that the bank may face some challenges to pass the PRA stress test given the severity of the losses that a sharp decline in house and commercial real estate (CRE) prices would imply plus the inability of the bank to offset these potential losses given its weak earnings generation capacity. We continue to believe that the bank's ability to generate meaningful additional capital and address any shortfall in the short term will rely heavily on its shareholders.

WEAK ASSET QUALITY, ALBEIT STABILISING DUE TO THE FAVORABLE OPERATING ENVIRONMENT AND THE ONGOING DELEVERAGING PROCESS

According to our calculations, the bank's problem loan ratio increased slightly to 11% as of June 2014 from 10.8% in 2013 with the non-core portfolio as the main source of problem loans. The non-core portfolio comprises the assets managed for run down or exit and includes the corporate, CRE and Optimum portfolios. The CRE and the corporate books are relatively concentrated and have high non-performing loan ratios with 63% and 45% respectively although, the coverage ratios of both portfolios is also high at 34% and 41% respectively. Optimum, acquired as a result of the merger with Britannia was 14% impaired as of June 2014 2014 (including those balances 30 days past due as per Co-operative Bank's definition) and continues to show significant differences between assets' carrying vale and their fair value amounting to around £1.1 billion.

Despite the slight deterioration in its problem loan ratio, the bank registered a significant decrease in impairment charge due to the deleveraging process and updated collateral values. The bank registered a credit of £86 million in the first half of 2014 compared to a charge of £496 million at half year 2013. However, the bank's reported coverage ratio declined to 28.4% as of June 2014 from 33.5% at the end of 2013.

PROFITABILITY REMAINS SUBDUED

We consider that the bank's profitability will likely remain negative for a number of years due to low interest margins, reduction of its non-core portfolio, potential further impairment charges, IT costs and potential conduct risks as well as an exceptionally high cost base.

Co-operative Bank reported a loss before taxes in the first half of 2014 of £76 million compared to a loss of £845 million at half year 2013. We note a material decrease in net interest income by 10% during the first half of 2014 compared to the same period in 2013 following the a reduction in the level of assets coupled with stabile operating expenses. As a result, according to our calculations, the bank's cost income ratio increased to 131% as of June 2014 from 117% at end-2013. However, net losses declined significantly driven by lower impairment costs charges (£87 million credit compared to charges of £496 million) and a reduction in conduct remediation charges.

DEPENDENCE ON WHOLESALE FUNDING IS CURRENTLY LOW

The bank's liquidity profile remains satisfactory since customer deposits continue to be its primary source of funding (84% of total funding as of June 2014). The bank's reported loan-to-deposit ratio stood at 91% as of June 2014, (gross customer loans as a percentage of customer deposits). The bank has limited medium-term funding to replace in the next five years (about £2.9 billion). As of June 2014, the bank increased its liquid asset buffer to £7.6 billion from £6.98 billion at end-2013 on the back of a greater amount of balances with central banks.

Global Local Currency Deposit Rating (Joint Default Analysis)

The Caa2/NP bank deposit ratings of Co-operative Bank reflect the ca BCA, the benefit to senior creditors of the additional capital raised and outstanding subordinated debt, and our assessment of a reduced likelihood of systemic support as the ongoing deleveraging process is leading to a smaller and less systemically important financial institution. The outlook on the Caa2 deposit and senior debt rating is negative.

Foreign Currency Deposit Rating

The foreign-currency deposit ratings of Co-operative Bank are unconstrained, given that the UK has a country ceiling of Aaa.

Foreign Currency Debt Rating

The foreign-currency debt ratings of Co-operative Bank are unconstrained, given that the UK has a country ceiling of Aaa.

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Risk Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Co-Operative Bank Plc

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						C	
Factor: Franchise Value						C-	
Market share and sustainability			x				
Geographical diversification			x				
Earnings stability				x			
Earnings Diversification [2]							
Factor: Risk Positioning						D+	
Corporate Governance [2]							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management			x				
- Risk Management			x				
- Controls		x					
Financial Reporting Transparency			x				
- Global Comparability	x						
- Frequency and Timeliness				x			
- Quality of Financial Information				x			
Credit Risk Concentration	--	--	--	--	--		

- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management		x					
Market Risk Appetite	x						
Factor: Operating Environment						**B**	
Economic Stability			x				
Integrity and Corruption		x					
Legal System	x						
Financial Factors (50%)						**D+**	
Factor: Profitability						**E+**	
PPI % Average RWA (Basel II)				0.66%			
Net Income % Average RWA (Basel II)					-3.17%		
Factor: Liquidity						**B**	
(Market Funds - Liquid Assets) % Total Assets		-7.00%					
Liquidity Management		x					
Factor: Capital Adequacy						**B+**	
Tier 1 Ratio (%) (Basel II)		9.17%					
Tangible Common Equity % RWA (Basel II)	10.49%						
Factor: Efficiency						**E**	
Cost / Income Ratio					83.61%		
Factor: Asset Quality						**E+**	
Problem Loans % Gross Loans				9.98%			
Problem Loans % (Equity + LLR)					124.90%		
Lowest Combined Financial Factor Score (15%)						**E+**	
Economic Insolvency Override						**D**	
Aggregate BFSR Score						**D**	
Aggregate BCA Score						**ba2**	
Assigned BFSR						**E**	
Assigned BCA						**ca**	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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