FITCH DOWNGRADES CO-OP BANK'S IDR TO 'B-' AND VR TO 'CC'

Fitch Ratings-London-21 February 2017: Fitch Ratings has downgraded UK-based The Co-operative Bank p.l.c.'s (Co-op Bank) Long-Term Issuer Default Rating (IDR) to 'B-' from 'B' and placed it on Rating Watch Evolving (RWE). The Viability Rating (VR) was downgraded to 'cc' from 'b'. A full list of rating actions is at the end of this rating action commentary.

The downgrade of the VR reflects Fitch's view that a failure of the bank appears probable as it likely needs to obtain new equity capital to restore viability. Fitch believes there is a very high risk that this will include a restructuring of its subordinated debt that we are likely to consider a distressed debt exchange, which would result in a failure according to our definitions. On 13 February, Co-op Bank announced that it was seeking a buyer and was also considering ways to strengthen its capitalisation including raising capital from current shareholders or from new strategic investors and a potential liability management exercise of its public debt.

The downgrade of the Long-Term IDR reflects Fitch's opinion that risks to senior bondholders have also increased, due to the need to raise capital and the potential that this could include a liability management exchange. The downgrade has been limited to one notch to 'B-' because we believe that the outstanding GBP456m of subordinated debt that could be converted into equity and potential other sources of external capital provide a limited margin of safety for senior debt holders.

However, the RWE on the bank's IDRs and senior debt ratings reflects the heightened risk of a further downgrade if the capital raised from the potential conversion of subordinated debt or other capital issuance is not sufficient, and senior debt is also exposed to losses, for example as part of a wider debt restructuring. Conversely, if a strong shareholder injects capital into the bank and provides it with sufficient resources to continue its operations, without any senior creditor suffering a loss, the IDR could be upgraded depending on the strength of the new shareholder.

Whether losses on the senior debt are incurred will depend on the ultimate amount of capital required by the bank, which will depend on a number of factors that are not yet clear. These include additional IT investments above those originally set out in its business plan, the extent of risk-weighted asset deleveraging that can be achieved and any associated losses that will be borne by the bank on deleveraging. The bank is also having ongoing negotiations with the Co-operative group on their joint pension scheme, the outcome of which may affect the bank's capital needs.

KEY RATING DRIVERS
IDRS, VR AND SENIOR DEBT
Co-op Bank's Long-Term IDR and senior debt are two notches above the VR to reflect Fitch's view that the probability that senior creditors will have to bear losses is lower than the probability of failure for the bank. This is primarily because we believe that a failure of the bank would not necessarily result in losses for senior creditors if a solution is found that involves only junior bondholders.

The VR primarily reflects clear deficiencies in the bank's capital that has been eroded because of losses. The bank still benefits from a relatively sound franchise and its asset quality has gradually improved, in line with a reducing risk appetite and improved risk controls. While we believe that its access to funding and liquidity has weakened, it remains, in our view relatively stable.

Our view of management and strategy reflects the difficulties it has encountered in executing its recovery plan. However, these considerations all have a lower influence on the bank's VR than its weak capitalisation.

Co-op Bank has stated that its CET1 ratio was at least 10% at end-2016, but that this ratio will fall and remain below 10% over the medium term, unless it is able to raise fresh capital or reduce its risk-weighted assets in a capital accretive way during the period. It remains in regulatory forbearance in terms of guidance (the bank expects not to meet its Individual Capital Guidance until at least 2020) but its projections indicate that it will maintain a CET1 ratio above 6% and a total capital ratio above 8% throughout the period of the plan.

Its ability to generate profits is under significant pressure from low interest rates and greater than originally envisaged investment costs and conduct charges. Further investments in the bank's IT systems are necessary to improve its efficiency and risk controls.

A return to profitability is highly correlated with the bank's ability to generate new, better quality and higher yielding mortgage loans and for operating costs to continue to reduce.

Asset quality has been improving, with impaired loans falling to just 4.4% of gross loans at end-1H16, although the bank has retained a high proportion of non-conforming mortgages in its Optimum loan portfolio and in its available for sale portfolios. Furthermore, reserve coverage of impaired loans is low and renders the bank's capital somewhat vulnerable to falling real estate prices.

Funding is largely obtained from customer deposits, which are mostly from retail clients but also from SMEs. Primary liquidity was a reasonable 12.7% of total assets at end-1H16, which is in line with the sector. It is of good quality but this is likely to have reduced at year-end. The bank continues to have access to contingent liquidity sources, primarily in the form of assets eligible for discounting at the Bank of England.

The Co-op Bank's senior debt is rated in line with its IDR, reflecting Fitch's expectations of average recovery prospects for senior debt holders in the event of default or resolution (Recovery Rating of 'RR4').

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)
Co-op Bank's SR and SRF reflect Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities in the event the group becomes non-viable given the resolution legislation in place as well as its low systemic importance.

We have placed the SR on Rating Watch Positive (RWP) to indicate the heightened possibility that a new shareholder might be found to support the bank, in which case the SR would be upgraded in line with our assessment of both the ability and propensity of the new shareholder to support the Co-op Bank provided senior bondholders do not suffer loss. If the SR becomes dependent on institutional support, we will withdraw the SRF.

RATING SENSITIVITIES
IDRS, VR AND SENIOR DEBT
Co-op Bank's VR is primarily sensitive to the size of any capital increase and how this capital is obtained. The formal launch of a subordinated debt distressed debt exchange would result in the bank's VR being downgraded to 'c'. A conversion of junior debt into equity that constitutes a distressed debt exchange would result in the bank's failure according to our definitions, as would a material injection of external capital. At that point we would downgrade the VR to 'f' before upgrading it to the level commensurate with the bank's subsequent risk profile and capitalisation.

Co-op Bank's IDRs and senior debt ratings would be downgraded if a senior debt distressed debt exchange becomes more likely, if the bank is unable to attract sufficient new equity capital (or generate it via a subordinated debt restructuring) to strengthen its capitalisation. The formal launch of a senior debt distressed debt exchange would result in the bank's IDRs being downgraded to 'C'. Co-op Bank's IDRs would be downgraded to 'RD' or 'D' if capital raised from a conversion of subordinated debt and/or any external capital raising is not sufficient to restore capitalisation and if, as a result, senior bondholders also suffer losses.

If Co-op Bank is acquired by a strong institutional investor, which is able to provide it with sufficiently strong extraordinary support and prevent a default on senior debt, we would upgrade its IDRs and senior debt ratings. The ultimate level of its ratings will depend on the extent of support provided and on the likelihood of any additional support being provided as and when required by its new shareholder.

Fitch expects to resolve the RWE once a clear plan on how capital will be raised is agreed. This may take longer than the typical six-month period for the review of a rating watch.

SUPPORT RATING AND SUPPORT RATING FLOOR
An upgrade of the SR and the withdrawal of the SRF would be contingent on an acquisition by a strong institutional investor, which is indicated by the RWP.

A positive change in the UK sovereign's propensity to support senior bondholders that would be necessary for an upward revision of the SRF is, in Fitch's view, highly unlikely.

The rating actions are as follows:
Long-Term IDR: downgraded to 'B-' from 'B'; placed on RWE
Short-Term IDR: 'B'; placed on RWE
Viability Rating: downgraded to 'cc' from 'b'
Support Rating: '5', placed on RWP
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes' Long-Term rating: downgraded to 'B-'/'RR4' from 'B'/'RR4', placed on RWE
Senior unsecured notes' Short-Term rating: 'B', placed on RWE

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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