

## **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

Contact:

Primary Analyst

Claudia Nelson

Senior Director

+44 20 3530 1191

Fitch Ratings Limited

30 North Colonnade

London E14 5GN

Secondary Analyst

Joanna Drobnik, CFA

Director

+44 20 3530 1318

Committee Chairperson

Christian Scarafia

javascript:togglePRTab(6); confirmation();Senior Director

+44 20 3530 1012

Media Relations: Elaine Bailey, London, Tel: +44 203 530 1153, Email: [elaine.bailey@fitchratings.com](mailto:elaine.bailey@fitchratings.com).

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)

## Applicable Criteria

Global Bank Rating Criteria (pub. 25 Nov 2016)

<https://www.fitchratings.com/site/re/891051>

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT [WWW.FITCHRATINGS.COM](http://WWW.FITCHRATINGS.COM). PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2017 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001