FitchRatings

Fitch Revises The Co-operative Bank Plc's Outlook to Stable; Affirms at 'B'

Fitch Ratings-London-19 November 2015: Fitch Ratings has revised The Co-operative Bank Plc's (Co-op Bank) Outlook to Stable from Negative. Its Long- and Short-term Issuer Default Ratings (IDRs) have been affirmed at 'B' and its Viability Rating (VR) at 'b'. A full list of rating actions is available at the end of this rating action commentary.

The Outlook revision reflects the progress the bank has made in deleveraging its non-core book and the consequent reduction in its tail risk. It also reflects our expectation that a greater degree of stability will be seen in the bank's management and in the implementation of the bank's stated strategy.

KEY RATING DRIVERS
IDRS, VR AND SENIOR DEBT
The IDRs and senior debt ratings are driven by Co-op Bank's standalone credit profile as reflected in the VR. They reflect our expectation that the bank will continue to report operating losses for at least the next two years and the continued pressure such losses will have on the bank's capital. The pressure is exacerbated by structural and operational challenges it faces in the execution of its turnaround strategy. While measures have been undertaken to improve its risk controls, they remain weak and Fitch believes that they will not become commensurate with the bank's risk profile until investments in IT systems are completed.

Co-op Bank is forecasting losses for at least 2015 and 2016, based on the level of investment required in its IT infrastructure and the continued unwind of fair value adjustments associated with its merger with Britannia Building Society in 2009. Fitch believes that losses are likely to continue beyond 2016 and may be exacerbated by potential further conduct risk charges and lower income streams, as the balance sheet shrinks. A focus on cost reduction will be an important element in returning the bank to profitability given the pressure on revenue from a low-yielding legacy book and a focus on building up secured retail loans, where yields are traditionally low.

Asset quality is weak but improved in 2015, both as a result of the progress made in the deleveraging of the non-core book and benign economic conditions. Fitch expects the bank to continue to deleverage, albeit at a slower pace, which should further improve the performance of the overall book. Currently Co-op Bank's loan book includes a high proportion of poorly performing and non-core residential (prime and adverse) and buy-to-let mortgage loans, as well as corporate loans backed by commercial real estate. These loans suffer from a combination of high arrears, low yields, and weak reserve coverage.

We view capitalisation as weak given that it still faces significant structural and operational risks. Challenges include the further deleveraging, the development of its retail and SME franchise, the continuing investment in significantly underdeveloped IT systems, the required continued improvements in risk controls, and significantly improving cost efficiency. In addition, the quality and structure of the loan book makes the bank's capitalisation vulnerable to a weakening of the UK's real estate prices and to changes in interest rates, both of which are significant risks in the highly indebted UK household sector, despite the current favourable environment.

The 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 and/or resolution given its current balance sheet structure with a fairly thin layer of subordinated debt and significant reduction in risk-weighted assets. This is reflected in a Recovery Rating of 'RR4' which is affirmed today.

SUPPORT RATING AND SUPPORT RATING FLOOR
The bank's Support Rating of '5' and Support Rating Floor of 'No Floor' have been affirmed and reflect Fitch's opinion that support cannot be relied upon, given the bank's low systemic importance.

RATING SENSITIVITIES
IDRS, VR AND SENIOR DEBT
The Stable Outlook indicates that we do not expect to take negative or positive rating action over the next 12 to 18 months. However, a rating downgrade could be triggered by larger-than- expected one-off losses and a continued erosion of capital, without an improvement in the profitability of the core franchise, or materially higher-than-budgeted investment needs. Ratings could also be downgraded if the bank is unable to re-launch its core business effectively.

Positive rating action is unlikely until the bank improves underlying profitability and capital generation, and risk control measures strengthen further.

Senior debt is also sensitive to our assessment of recoveries that the bank's senior debt holders could expect in the case of default.

SUPPORT RATING AND SUPPORT RATING FLOOR
Fitch does not expect any change to Support Rating and Support Rating Floor.]

The rating actions are as follows:
Long-term IDR affirmed at 'B'; Outlook revised to Stable from Negative
Short-term IDR affirmed at 'B'
Viability Rating affirmed at 'b'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'No Floor'
Senior unsecured notes' Long-term rating affirmed at 'B'/'RR4'
Senior unsecured notes' Short-term rating affirmed at 'B'

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Applicable Criteria
Global Bank Rating Criteria (pub. 20 Mar 2015)

(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=863501)

Additional Disclosures

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