MOODY'S
INVESTORS SERVICE

Credit Opinion: Co-Operative Bank Plc

Global Credit Research - 13 Aug 2015

Manchester, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Positive
Bank Deposits	Caa2/NP
Baseline Credit Assessment	caa2
Adjusted Baseline Credit Assessment	caa2
Senior Unsecured	Caa2
Commercial Paper -Dom Curr	NP
Other Short Term -Dom Curr	(P)NP

Contacts

Analyst	Phone
Carlos Suarez Duarte/London	44.20.7772.5454
Michael Eberhardt, CFA/London	
Nicholas Hill/Paris	33.1.53.30.10.20
Maija Sankauskaite/London	44.20.7772.5454

Key Indicators

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

	[2]**12-14**	[2]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (GBP million)	**37,582.9**	**43,383.8**	**49,772.8**	**48,955.6**	**45,581.3**	[4]**-4.7**
Total Assets (EUR million)	**48,428.9**	**52,146.5**	**61,366.5**	**58,608.1**	**53,195.9**	[4]**-2.3**
Total Assets (USD million)	**58,601.5**	**71,854.8**	**80,905.1**	**76,081.8**	**71,364.6**	[4]**-4.8**
Tangible Common Equity (GBP million)	**1,792.7**	**1,625.2**	**1,444.6**	**2,108.4**	**1,968.2**	[4]**-2.3**
Tangible Common Equity (EUR million)	**2,310.1**	**1,953.5**	**1,781.1**	**2,524.2**	**2,297.0**	[4]**0.1**
Tangible Common Equity (USD million)	**2,795.3**	**2,691.8**	**2,348.2**	**3,276.7**	**3,081.5**	[4]**-2.4**
Problem Loans / Gross Loans (%)	**9.3**	**10.8**	**11.0**	**8.1**	**7.8**	[5]**9.4**
Tangible Common Equity / Risk Weighted Assets (%)	**14.2**	**10.8**	**8.1**	**10.4**	**10.1**	[6]**12.5**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**103.5**	**131.1**	**178.7**	**115.5**	**125.4**	[5]**130.8**
Net Interest Margin (%)	**0.8**	**0.7**	**1.2**	**1.4**	**1.3**	[5]**1.1**
PPI / Average RWA (%)	**-2.2**	**-1.7**	**1.6**	**1.0**	**0.8**	[6]**-2.0**
Net Income / Tangible Assets (%)	**-0.4**	**-3.0**	**-0.7**	**0.1**	**0.1**	[5]**-0.8**
Cost / Income Ratio (%)	**166.8**	**150.6**	**61.2**	**74.5**	**79.5**	[5]**106.5**
Market Funds / Tangible Banking Assets (%)	**12.6**	**17.7**	**19.2**	**17.8**	**17.7**	[5]**17.0**
Liquid Banking Assets / Tangible Banking Assets (%)	**25.5**	**22.6**	**25.0**	**26.4**	**19.8**	[5]**23.9**
Gross Loans / Total Deposits (%)	**85.1**	**90.1**	**88.3**	**89.7**	**98.7**	[5]**90.4**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or 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 - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

We rate Co-Operative Bank's long-term bank deposits and senior unsecured debt at Caa2. These ratings are underpinned by (1) the bank's caa2 baseline credit assessment (BCA); (2) the results of our Advanced Loss Given Failure (LGF) analysis which leads to a Preliminary Rating Assessment (PRA) for both deposits and senior unsecured debt at the same level as the BCA and; (3) a low expectation of government support, resulting in no uplift from the PRA for both deposit and senior unsecured debt ratings.

The ratings of the Co-Operative Bank's short-term deposit and short-term debt are Not Prime. We also assign a Counterparty Risk Assessment (CR Assessment) of B2(cr)/NP(cr) to the bank.

Co-Operative Bank's BCA at caa2 reflects (1) its strengthened capital position; (2) the progress at reducing its non-core portfolio; (3) improving asset quality; and (4) solid funding and liquidity position. The BCA also incorporates (1) the challenges the bank faces to become a sustainable institution - via a business plan that involves significant execution risk; (2) our expectation of net losses continuing through to 2016, eroding the bank's capital position; and (3) the potential for additional conduct remediation, regulatory settlements and litigation costs that could also have a negative effect on the bank's capital position.

RATING DRIVERS

- Weak asset quality driven by a large non-core portfolio, although asset disposals helping to reduce downside risk

- Strengthened capital position, but remains unable to generate capital through earnings

- Negative Profitability due to high cost base

- Low reliance on wholesale funding and sufficient liquidity levels

- The declining volume of deposits and low level of junior debt in the liabilities structure indicate a moderate loss-given-failure rate leading to a PRA for deposits and senior debt in line with the BCA

RATING OUTLOOK

The outlook on all ratings is positive, reflecting our expectation that the favourable operating environment in the United Kingdom will continue to aid Co-Operative Bank in implementing its business restructuring plan and non-core asset disposal and to improve its credit fundamentals.

What Could Change the Rating - Up

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

What Could Change the Rating - Down

The BCA could be downgraded as a result of (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; (3) a significant deterioration in liquidity; and (4) higher than expected impairment or conduct charges. A negative movement in the bank's BCA would likely lead to the downgrade of all ratings.

DETAILED RATING CONSIDERATIONS

CO-OPERATIVE BANK'S BCA IS SUPPORTED BY ITS VERY STRONG- MACRO PROFILE

As a retail domestic bank, Co-Operative Bank's operating environment is heavily influenced by the United Kingdom and its Macro Profile is thus aligned with that of the UK at Very Strong-. UK banks benefit from operating in a wealthy and developed country with a very high degree of economic, institutional and government financial strength as well as very low susceptibility to event risk. The main risks to the system stem from the high level of indebtedness of UK households, which are thus sensitive to changes in interest rates. UK banks are largely funded by deposits and banks' funding structure has remained relatively stable in the past few years, with slight increases in capital and internal funds as well as declines in short-term funding. The UK banking sector is relatively concentrated but the price-setting dominance of large banks is somewhat challenged by competition from the shadow banking market.

WEAK, ALTHOUGH IMPROVING, ASSET QUALITY DRIVEN BY A LARGE NON-CORE PORTFOLIO

Co-Operative Bank's problem loan ratio has been gradually decreasing since 2012 and, according to our calculations, stood at 9.3% in December 2014 (10.8% in December 2013). The main source of problem loans is the non-core portfolio, which accounted for about GBP10.8 billion (41% of gross lending) at end-2014. This portfolio includes corporate, Commercial Real Estate (CRE) and Optimum (residential mortgages) loans and it is currently being run down. The non-core corporate book is concentrated with a relatively small number of borrowers and a large portion of the portfolio are CRE loans. As of December 2014, the book had an impaired loan ratio of 27.6%, of which 33% are covered by provisions. Over a half or 52% of CRE loans were in default as at end-2014.

Optimum, a closed book of residential mortgages, is highly vulnerable to economic downturn with nearly 80% interest-only mortgages and an average LTV of 73.1%, and 7% of the loans have LTV in excess of 100%. As of end-2014, 13.8% of Optimum loans were impaired. In contrast, the core residential mortgage book had 1.1% of loans impaired and an average LTV of 50.5% at end-2014.

In 2014 Co-Operative Bank's non-core portfolio declined to GBP10.3 billion from GBP12.5 billion in 2013, resulting in a corresponding reduction of GBP1.4 billion of RWA. The bank is also committed to the accelerated disposal of Optimum. In May 2015 it agreed a sale of GBP1.5 billion of the book.

Following the decline in the size of its non-core portfolio, the bank registered a significant decrease in impairment charges. A write back of provisions of GBP173.2 million was recorded in 2014 compared to a charge of GBP516.2 million in 2013 primarily driven by the net impairment write back of GBP168.2 million in the non-core business. At the same time, the bank's coverage ratio declined amid the increases in Housing Price Index and the improving economic conditions. The bank's coverage ratio at 22.4% as of end-2014 is relatively low compared to the UK system average of 49% according to our calculations.

We assign an Asset Risk score of caa1, three notches below the macro-adjusted score of b1 to reflect the downside risks in the non-core portfolio.

STRENGTHENED CAPITAL POSITION, BUT REMAINS VULNERABLE TO A NUMBER OF RISKS

Co-Operative Bank has made significant progress in strengthening its capital base over the past two years. In 2013, the bank successfully completed a Liability Management Exercise, generating GBP1.2 billion of CET1 capital before costs. This was followed by an issue of GBP400 million of common stock and a GBP313 million capital contribution from The Co-Operative Group in 2014. Combined with a GBP2.4 billion reduction in total Risk Weighted Assets (RWA) on the back of asset sales, this led to a significantly improved capital position at end-2014. The Bank reported a CRD IV fully loaded CET1 ratio of 13% at end-2014 compared to 7.2% at end-2013, and the equivalent leverage ratio of 4.3%, a significant increase from 2.4% a year earlier. Co-Operative Bank's Tangible Common Equity over Risk Weighted Assets stood at 14.1% at end-2014.

Despite the recent improvements, the bank's capital levels still face material downside risk given the challenges arising from its investment and restructuring plans. Furthermore, in December 2014, the Prudential Regulation Authority (PRA) released the results of its stress test for large UK banks and building societies, and Co-Operative Bank was the only institution to fail the test, reporting a stressed capital ratio of -2.6%. As a result, a revised capital plan for the bank was agreed with the regulator, which involves accelerating the process of deleveraging its non-core portfolio to increase capital and solvency levels. The particular focus is on the accelerated disposal of Optimum portfolio, which showed to be significantly affected under the PRA's severe stress scenario assumptions. The securitisation of GBP1.5 billion of the book agreed in May is estimated to increase the pro-forma end-2014 CET1 ratio by about 0.9% to 13.9%.

The reduction of the non-core portfolio could potentially make a negative contribution to capital given the expected losses on asset sales, although the reduction in capital should be partially offset by a reduction in the bank's RWAs. However, we believe that the favourable operating environment in the UK will likely provide opportunities for the bank to dispose of some assets in a capital accretive way. There is also uncertainty as to when the bank will start generating capital organically through earnings retention. Given sizable investments in IT infrastructure and operational restructuring costs it is unlikely to return to profit in the near future.

We further note that the bank is reliant on regulatory forbearance for a sustained period of time particularly relating to its failure to consistently comply with its Individual Capital Guidance (ICG), non-compliance with internal credit risk modelling requirements and the need to upgrade IT infrastructure to comply with applicable standards. The bank has 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.

On 11 August, the PRA and the Financial Conduct Authority (FCA) released the results of their investigation into the bank's management activities over the period from mid-2009 to end-2013. Although the regulators identified a number of serious failings in the bank's previous controls and risk management and in its handling of its relationship with the authorities, it decided not to levy a fine of around GBP120 million because it could have interfered with the financial resilience of the bank and the ability to successfully execute its turnaround plan accepted by the PRA in December 2014. We note that the outcome of the investigation removes the uncertainty around the possible financial implications of the investigation. However, the PRA advised that even absent the financial penalty the censure could weigh negatively on the outcome of any future investigations into the bank.

We assign a Capital score of caa3 to reflect the vulnerabilities of the existing capital position.

PROFITABILITY IS NEGATIVE AND WILL LIKELY REMAIN SUBDUED IN THE NEAR TERM

We believe the bank is unlikely to return to profitability in 2015 and 2016 due to low interest margins, an exceptionally high cost base and potential further impairment losses and conduct remediation charges. We however note the size of the reported losses has been gradually declining. The bank reported a pre-tax loss of GBP264.2 million in 2014, compared to a loss before taxation of GBP632.8 million in 2013 and GBP652.4 million in 2012. The improvement was mainly driven by the write-back of credit impairment losses on non-core assets and reductions in provisions for customer redress.

Net interest income increased 9.6% year-on-year to GBP345.0 million in 2014 driven by the reduced cost of funding as the bank managed down its most expensive term deposits base and undertook re-pricing actions on other types of customer accounts. Net interest margin increased to 0.84% from 0.67% (Moody's calculation) over the same period. We note the margin is still relatively weak and significantly below that of the peers.

Operating expenses remained broadly unchanged year-on-year at GBP852.6 million. Combined with subdued income, this resulted in the bank's cost-income ratio increasing to 166.8% in 2014 from 150.6% in 2013, according to our calculations. The bank is implementing a cost reduction programme, but operating costs savings achieved have been offset by significant project expenses related to the bank's reorganization. The project costs accounted to GBP227million in 2014 and additional expenses of about GBP450 million are expected to be incurred over the course of 2015 and 2016. In addition to the transitory project costs the bank's profitability continues to be affected by the unwind of the fair value adjustments associated with the merger with Britannia Building Society with GBP83.9 million incurred in 2014.

Despite a number of impediments to profitability, we believe that profitability metrics will show a gradual improvement as legacy assets and conduct costs are resolved. We assign a Profitability score of caa1 to reflect these improvements.

THE BANK'S RELIANCE ON WHOLESALE FUNDING IS LOW AND CURRENT LIQUIDITY LEVELS ARE SUFFICIENT

Co-Operative Bank's funding profile remains a relative strength and customer deposits continue to be its primary source of funding - 88% of total funding as of December 2014. The bank's loan-to-deposit ratio remains stable and stood at 86.7% at end-2014 (gross customer loans as a percentage of customer deposits). Retail deposits balances were managed down by GBP2.2 billion during the course of 2014 to address surplus liquidity and match the reduction in the balance sheet. Total customer deposits decreased to GBP29.9 billion from GBP33.0 billion in 2013.

The reliance on wholesale funding is low and decreasing. As of end-2014, the bank had GBP4.1billion of market funds, a substantial decline comparing to GBP7.6 billion in 2013 and GBP9.7 billion in 2012. According to our calculations, the bank's Market Funds as a proportion of Tangible Banking Assets stood at 12.6% at the end-2014. On 1 July 2015 Co-Operative Bank issued GBP250 million of 10 year callable subordinated Tier 2 notes, reinstating its market access. The bank also made use of the Funding for Lending Scheme (FLS) facility in the first half of 2013, drawing GBP900 million. GBP350 million of the FLS liability was repaid in 2014, with the remaining amount not expected to be repaid until March 2017. We note that despite the return to market, obtaining wholesale funding on favourable terms currently remains a challenge for the bank.

We assign a Funding Structure score of baa3. The assigned score reflects the improvements in the metric and the bank's return to market access, as well as recognises still currently limited opportunities for the bank to achieve a varied mix of wholesale funding. It further incorporates our view that certain types of customer deposits in the funding structure are relatively less stable.

Co-Operative Bank maintains an ample stock of liquid assets reflected in a Liquid Banking Assets-to-Tangible Banking Assets ratio of 25.5% at end-2014 and leading to the assigned Liquid Resources score of a2. The bank's total liquidity resources increased to GBP12.1 billion (32% of total assets) in December 2014 from GBP11.2 billion (26%) in December 2013. Primary liquidity has decreased over the past year by GBP424.4 million to GBP6.6 billion at end-2014 as a result of liquidity management. Secondary liquidity largely comprises assets eligible for discounting with central banks and has increased by GBP1.4 billion to GBP5.6 billion.

Co-Operative Bank's resulting financial profile score is b2.

We apply a negative qualitative adjustment reflecting expected lack of business diversification since Co-Operative Bank has announced that going forward it will primarily focus on its retail franchise. We believe that on a forward looking basis, as the bank disposes of its corporate and commercial assets, its business model will be characterized by the following mono-line characteristics:

85% of the loan book is made of residential mortgages;

80% of revenues comes from one source.

We also apply a two-notch negative adjustment for Corporate Behaviour. Although we believe that the current management team has developed a realistic de-risking and restructuring plan, the institution continues to face a number of challenges given past control failures. This is evident from the results of the investigation by the PRA and the Financial Conduct Authority (FCA) into the bank's management activities over the period from mid-2009 to end-2013, released on 11 August. The regulator identified that during this period the bank was in breach of Principle Three of the Principles for Businesses which requires a firm to have an adequate and effective risk management framework. Co-Operative Bank failed to design, maintain and oversee appropriately its three lines of defence risk management model. In addition to risk management and control failures, the bank failed to act in a transparent and co-operative manner with the regulator and did not provide timely disclosures on important changes in the bank's senior management. We, however, note these areas are already in the process of remediation as part of the bank's restructuring plan.

The assigned BCA of caa2 is positioned in the middle of a scorecard-calculated BCA range of caa1-caa3.

NOTCHING CONSIDERATIONS

LOSS GIVEN FAILURE (LGF)

Co-Operative Bank is subject to the UK implementation of the EU Bank Resolution and Recovery Directive (BRRD), which we consider to be an Operational Resolution Regime. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, and a 5% run-off in preferred deposits. These are in line with our standard assumptions. Particular to Co-Operative Bank, we assume the proportion of deposits considered junior at 10%, relative to our standard assumption of 26%, due to largely retail-oriented depositor base of the bank.

Our LGF analysis indicates that the bank's deposits are likely to face a moderate loss-given-failure rate 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 PRA for the deposits in line with the adjusted BCA at caa2.

Senior unsecured debt is also likely to face a moderate loss-given-failure rate according to our LGF analysis and its PRA of caa2 is at the same level as the adjusted BCA.

GOVERNMENT SUPPORT

The implementation of the BRRD has caused us to reconsider the potential for government support to benefit certain creditors. In the case of the Co-Operative Bank, whose systemic importance has reduced, we now expect a low probability of support for deposits resulting in no uplift from the PRA.

COUNTERPARTY RISK ASSESSMENT

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

The Co-Operative Bank's CR Assessment is positioned at B2(cr)/NP(cr), three notches above the Adjusted BCA of caa2, based on the cushion against default provided to the senior obligations represented by the CR Assessment by more subordinated instruments - including junior deposits and senior unsecured debt. The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss, therefore we focus purely on subordination and take no account of the volume of the instrument class.

The CR Assessment does not benefit from any additional notches of uplift due to government support, in line with our assumptions of a low probability of UK Government support for Co-Operative Bank's senior obligations in the event of failure.

About Moody's Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard 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

Macro Factors	
Weighted Macro Profile	**Very Strong -**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	10.4%	b1	↑	caa1	Sector concentration	Quality of assets
Capital						
TCE / RWA	14.2%	aa3	↓↓	caa3	Stress capital resilience	Nominal leverage
Profitability						
Net Income / Tangible Assets	-1.4%	caa3	↑	caa1	Return on assets	Earnings quality
Combined Solvency Score		ba1		caa2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	12.6%	a1	←→	baa3	Market funding quality	Deposit quality
Liquid Resources						

Liquid Banking Assets / Tangible Banking Assets	25.5%	a2	←→	a2	Quality of liquid assets	
Combined Liquidity Score		a1		baa1		

Financial Profile	**b2**

Qualitative Adjustments	**Adjustment**
Business Diversification	-1
Opacity and Complexity	0
Corporate Behavior	-2
Total Qualitative Adjustments	**-3**

Sovereign or Affiliate constraint	Aa1

Scorecard Calculated BCA range	**caa1 - caa3**

Assigned BCA	**caa2**

Affiliate Support notching	**0**

Adjusted BCA	**caa2**

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency rating**	**Foreign Currency rating**
Deposits	0	0	caa2	0	Caa2	Caa2
Senior unsecured bank debt	0	0	caa2	0	Caa2	Caa2

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.