MOODY'S
INVESTORS SERVICE

CREDIT OPINION
2 July 2019

Update

Rate this Research

**RATINGS**

**The Co-operative Bank plc**

| | |
|---|---|
| Domicile | United Kingdom |
| Long Term CRR | B2 |
| Type | LT Counterparty Risk Rating - Fgn Curr |
| Outlook | Not Assigned |
| Long Term Debt | Withdrawn |
| Type | Senior Unsecured - Fgn Curr |
| Outlook | Rating(s) WithDrawn |
| Long Term Deposit | B3 |
| Type | LT Bank Deposits - Fgn Curr |
| Outlook | Positive |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*

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# The Co-operative Bank plc

## Update following upgrade and positive outlook

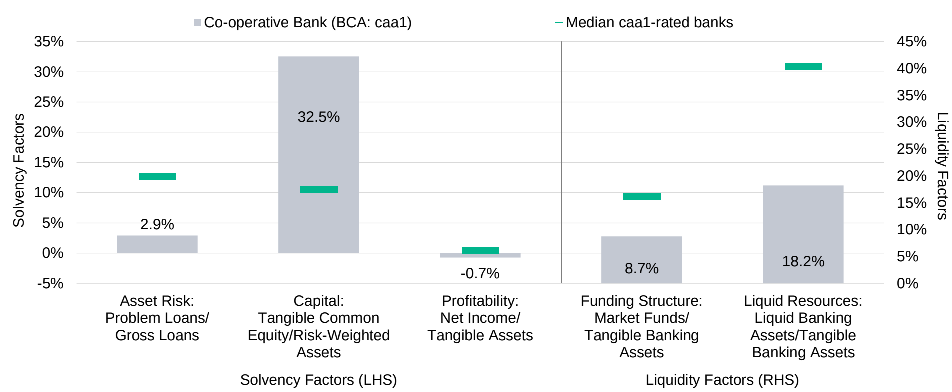
## Summary

The B3 long-term deposit ratings of The Co-operative Bank plc (The Co-operative Bank) reflect (1) the bank's standalone creditworthiness, expressed in its b3 standalone Baseline Credit Assessment (BCA); (2) its moderate loss-given-failure, which does not result in any uplift; and (3) our assessment of low probability of support from the Government of United Kingdom (Aa2 stable), which does not lead to any uplift.

The Co-operative Bank's BCA of b3 is driven by the bank's persistent losses and very high execution risk, which are only partially mitigated by a low stock of problem loans, following a substantial reduction in legacy portfolios, and high capital ratios.

Exhibit 1

**Rating scorecard - Key financial ratios**




*Source: Moody's Banking Financial Metrics*

## Credit strengths

» Low stock of problem loans

» High capital ratios

» Stable retail funding

## Credit challenges

» Weak profitability and inability to generate organic capital

» High susceptibility of capital to stress

» Very high execution risk

» Largely monoline business

» Limited loss absorption in the event of failure because of previous liability management exercises

## Outlook

The outlook on The Co-operative Bank's long-term deposit rating is positive. This reflects our view that execution risk will reduce in the coming years as the bank continues to deliver on its restructuring and investment plans.

## Factors that could lead to an upgrade

The Co-operative Bank's BCA could be upgraded following a materially reduced execution risk, which can be achieved by the completion of its separation from the Co-operative Group, improvements in the bank's IT infrastructure, and a return to sustainable internal capital generation through earnings.

An upgrade in the BCA would lead to an upgrade of the long-term deposit ratings. Substantial issuance of bail-in-able subordinated or senior debt, which would protect depositors from losses in a resolution scenario, could also lead to an upgrade of the long-term deposit ratings.

## Factors that could lead to a downgrade

The Co-operative Bank's BCA could be downgraded following a failure of its IT transformation, evidence that the bank will not be able to return to a sustainable level of net profitability in the medium-term, or a lower level of junior deposits.

A downgrade of The Co-operative Bank's BCA would lead to a downgrade of the bank's long-term deposit ratings.

## Key indicators

Exhibit 2

**The Co-operative Bank plc (Consolidated Financials) [1]**

| | 12-18[2] | 12-17[2] | 12-16[2] | 12-15[2] | 12-14[2] | CAGR/Avg.[3] |
|---|---|---|---|---|---|---|
| Total Assets (GBP Billion) | 23.1 | 24.5 | 27.4 | 29.0 | 37.6 | (11.5)[4] |
| Total Assets (USD Billion) | 29.4 | 33.1 | 33.9 | 42.8 | 58.6 | (15.8)[4] |
| Tangible Common Equity (GBP Billion) | 1.6 | 1.4 | 0.8 | 1.1 | 1.8 | (2.1)[4] |
| Tangible Common Equity (USD Billion) | 2.1 | 1.9 | 0.9 | 1.7 | 2.8 | (7.0)[4] |
| Problem Loans / Gross Loans (%) | 2.8 | 2.4 | 3.6 | 5.2 | 9.2 | 4.6[5] |
| Tangible Common Equity / Risk Weighted Assets (%) | 32.5 | 26.9 | 11.4 | 15.2 | 14.2 | 20.1[6] |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 29.0 | 27.4 | 79.4 | 74.6 | 103.5 | 62.8[5] |
| Net Interest Margin (%) | 1.5 | 1.0 | 0.8 | 0.9 | 0.9 | 1.0[5] |
| PPI / Average RWA (%) | -1.7 | -3.4 | -5.9 | -3.6 | -2.3 | -3.4[6] |
| Net Income / Tangible Assets (%) | -0.2 | -0.7 | -1.3 | -1.8 | -0.4 | -0.9[5] |
| Cost / Income Ratio (%) | 122.8 | 167.4 | 254.9 | 197.5 | 167.5 | 182.0[5] |
| Market Funds / Tangible Banking Assets (%) | 8.7 | 8.5 | 11.3 | 12.6 | 12.6 | 10.7[5] |
| Liquid Banking Assets / Tangible Banking Assets (%) | 18.2 | 28.4 | 26.0 | 27.4 | 25.5 | 25.1[5] |
| Gross Loans / Due to Customers (%) | 94.1 | 81.5 | 87.2 | 87.4 | 87.8 | 87.6[5] |

[1]All figures and ratios are adjusted using Moody's standard adjustments. [2]Basel III - fully-loaded or transitional phase-in; IFRS. [3]May include rounding differences due to scale of reported amounts. [4]Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5]Simple average of periods presented for the latest accounting regime. [6]Simple average of Basel III periods presented.

*Source: Moody's Investors Service; Company Filings*

## Profile

The Co-operative Bank plc (The Co-operative Bank) is a UK-based commercial bank that provides banking and related financial products and services to retail and corporate customers only in the UK. Most of its assets are residential mortgages, but the bank also provides loans to small and medium-sized companies, credit cards and consumer loans. Most of its funding comes from its retail clients via current accounts and savings accounts. As of 31 March 2019, The Co-operative Bank had total consolidated assets of £23 billion.

The Co-operative Bank was established in 1872 as the Loan and Deposit Department of the Co-operative Wholesale Society. In January 2009, the bank merged with Britannia Building Society (Britannia), the second-largest building society in the UK at the time.

In 2013 and in 2017, The Co-operative Bank underwent two liability management exercises, which led to a substantially higher Common Equity Tier 1 capital ratio and the creation of a new holding company, The Co-operative Bank Holdings Limited, which owns 100% of The Co-operative Bank's shares. The largest shareholders of the holding are now private equity firms and hedge funds. The main shareholder of the previous holding, The Co-operative Group, no longer has a stake in The Co-operative Bank or in The Co-operative Bank Holding Limited.

The Co-operative Bank will likely issue debt compliant with its minimum requirements for own funds and eligible liabilities out of the intermediate holding, The Co-operative Bank Finance p.l.c., which sits between The Co-operative Bank Holding Limited and The Co-operative Bank. In April 2019, the intermediate holding issued a £200 million Tier 2 bond.

## Detailed credit considerations

### Low stock of problem loans, with high execution risk

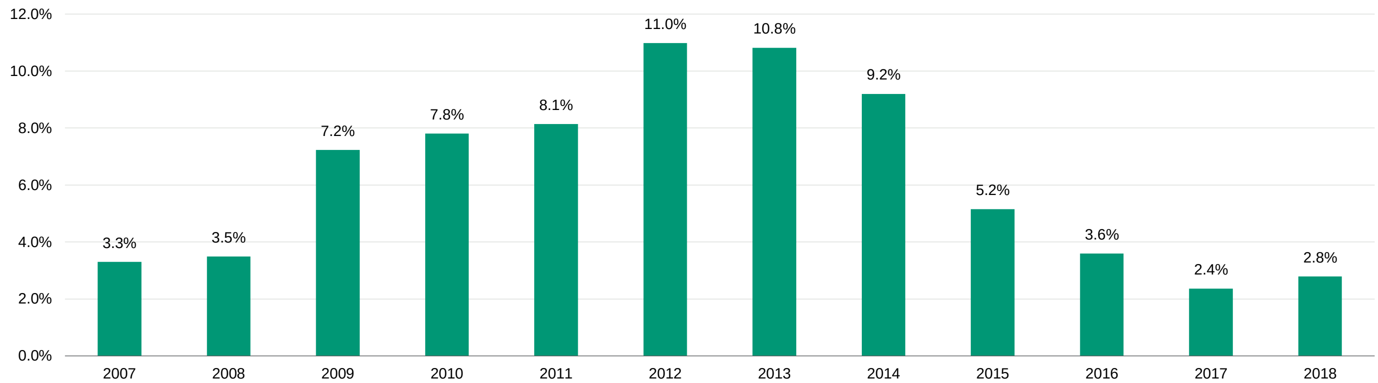
We assign an Asset Risk score of ba3 to the bank, seven notches below the a2 Macro-Adjusted score, to reflect the very high execution risk embedded in the bank's transformation plan and the downside risks in the remaining legacy portfolio. The Co-operative Bank's stock of problem loans has materially reduced. In December 2018, problem loans accounted for 2.8% of gross loans, down from the 11% peak in 2012, and mostly related to what remains of its legacy “Optimum” mortgage portfolio. The reduction was mainly driven by very large disposals made by the bank. In particular, the Optimum portfolio fell to £516 million in March 2019 from its peak of £7.9 billion in 2013 (see exhibit 3).

Nevertheless, the significant steps the bank is taking to reposition its balance sheet and to deliver a more sustainable business model entail a very high level of execution risk. In particular, the following key issues are still pending: complete separation from The Co-operative Group; the upgrade and streamlining of its IT infrastructure; and an update of IT systems to match its customers' changing behaviour and to enable the bank to improve its competitiveness against other UK banks. This transition, although progressing in line with the bank's expectations, could yet result in large unexpected costs, delays, or a disruption to service.

Exhibit 3

**Problem loans have significantly reduced**

**Problem loans as a percentage of gross loans**




*Source: Moody's Banking Financial Metrics*

### High susceptibility of capital to stress

The Co-operative Bank's Capital score is b1, 12 notches below the Macro-Adjusted score of aa1, to reflect the bank's lack of internal capital generation, high execution risk, limited buffers over regulatory requirements and vulnerability in a stressed scenario.

Capital has improved significantly in recent years, following a recapitalisation plan and the disposal of large portion of legacy assets. As of December 2018, the bank's tangible common equity/risk-weighted assets was 32.5%.

The total capital ratio as of March 2019, pro forma including a £200 million Tier 2 bond issued in April 2019, was 25.7%. This is equivalent to a £275 million above the bank's total capital requirement, which is low in the context of the bank's loss-making profile. The Co-operative Bank indicated that it is not in compliance with the undisclosed Prudential Regulation Authority buffer, which sits above its minimum regulatory requirements.

We expect the capital ratios of The Co-operative Bank to gradually reduce as the bank continues to make losses and the loan book grows. Notwithstanding the high ratios, we believe that The Co-operative Bank's capital is highly vulnerable to a stressed scenario, reflecting the bank's inability to generate capital internally and its exposure to high execution risk.

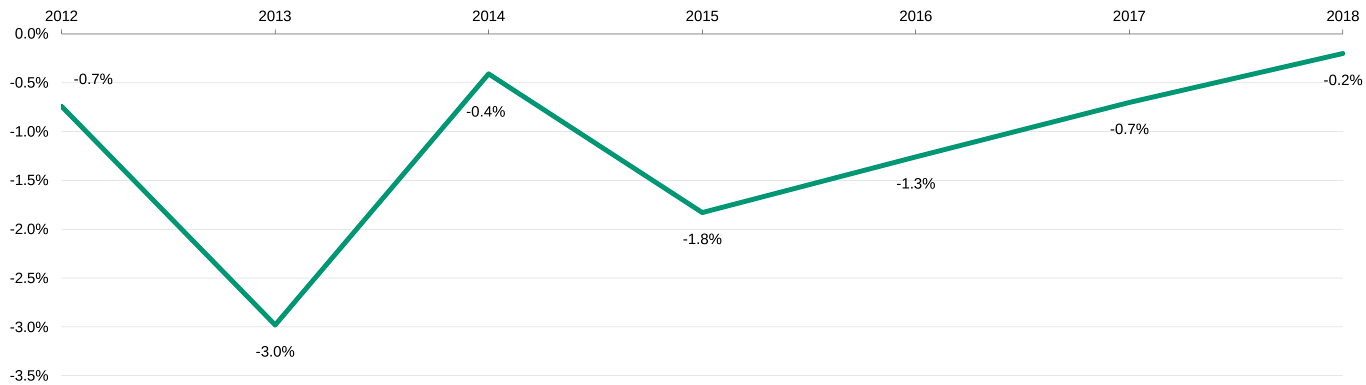
### Loss-making profile

We assign a Profitability score of caa3 to The Co-operative Bank, two notches below the Macro-Adjusted score, to reflect the bank's persistent losses.

Exhibit 4

**The Co-operative Bank has not turned a profit for many years**

**Net income/tangible assets**



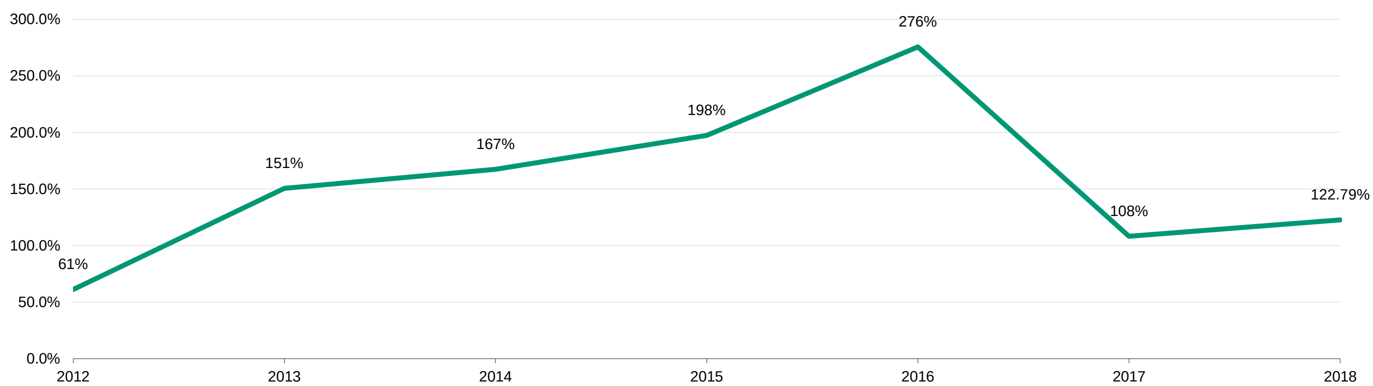

*Source: Moody's Banking Financial Metrics*

We expect The Co-operative Bank to continue to be loss-making in 2019 and 2020, with a negative pre-provision profit, albeit reduced from the past. Achieving a sustainable level of profitability from 2021 will still be challenging, given (1) dependence on rapid volume growth in a weakening economy, (2) the need to grow net interest income amidst declining margins in the UK residential mortgage business (almost 90% of The Co-operative Bank's loan book); and (3) an expected increase in the cost of funding due to the recent Tier 2 issuance, as well as future issuances to meet the bank's minimum requirements for own funds and eligible liabilities (MREL).

Exhibit 5

**High cost base impedes profitability**

**Cost-to-income ratio**




*Source: Moody's Banking Financial Metrics*

## Challenged market access at average market price

We assign a Funding Structure score of ba1 to The Co-operative Bank, six notches below the Macro-Adjusted score of a1, to reflect the bank's challenged access to the unsecured debt market at average market prices.

The Co-operative Bank is mostly funded through deposits (£18.7 billion), while securitisations and covered bonds are limited (£0.6 billion). In February 2018, the bank also took around £1 billion via the Bank of England's Term Funding Scheme. The reliance on wholesale funding was, therefore, low at 8.7% of tangible banking assets as of December 2018.

In April 2019, The Co-operative Bank issued a £200 million 10-year Tier 2 bond at a high 9.5% interest rate via the intermediate holding, The Co-operative Bank Finance p.l.c, to build its minimum requirements for own funds and eligible liabilities. We expect the bank to also issue unsecured debt from the intermediate holding level.

The stock of liquid assets is high at 18.2% of the bank's tangible banking assets, which is equivalent to a Macro-Adjusted score of a3. The liquidity coverage ratio is high at 154%.

### Largely monoline business, with high execution risk

The Co-operative Bank's Financial Profile score is ba3.

We apply a negative qualitative adjustment to reflect the lack of business diversification. Even though The Co-operative Bank provides a series of products to its retail clients, around 88% of the bank's loan book is composed of residential mortgages. The remainder of the bank's loan book is composed of corporate loans (6%), a legacy portfolio of residential mortgages (3%) and unsecured loans (2%).

We also apply a two-notch negative adjustment for Corporate Behaviour, to take into account high execution risk in the bank's restructuring plan and the lack, at present, of a sustainable business model.

## Support and structural considerations

### Loss Given Failure (LGF) analysis

The Co-operative Bank is subject to the UK implementation of the European Union Bank Recovery and Resolution Directive, which we consider to be an operational resolution regime.

Our advanced LGF analysis assumes 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 The Co-operative Bank and other retail-funded banks in the UK, we assume the proportion of deposits considered junior at 10%, relative to our standard assumption of 26%, because of the largely retail-oriented depositor base of the bank.

Our LGF analysis indicates that The Co-operative Bank's deposits are likely to face moderate loss-given-failure, driven by the residual equity that we expect in resolution, the recent Tier 2 bond, and the volume of deposits themselves. As a result, deposits receive no notching uplift relative to the bank's BCA.

### Government support considerations

We believe that there is a low likelihood of government support for The Co-operative Bank's wholesale deposits in the event of its failure, resulting in no uplift. This probability reflects the bank's minimal market share in the UK market and its nonsystemic nature compared with the country's largest banks.

### Counterparty Risk (CR) 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 (for example, swaps), letters of credit, guarantees and liquidity facilities.

#### The Co-operative Bank's CR Assessments are positioned at B1(cr)/Not Prime(cr)

The long-term CR Assessment is two notches above the bank's standalone BCA of caa1. The uplift results from the small buffer against default provided to the operating obligations by the residual equity that we expect in resolution, by the recent Tier 2 bond, and by deposits, because The main difference from our Advanced LGF approach that is used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than the expected loss. Therefore, we focus purely on subordination and do not take the volume of the instrument class into consideration.

The long-term CR Assessment does not include any further uplift, resulting from our expectation of low probability of government support.

### Counterparty Risk Ratings (CRRs)

Our CRRs are opinions on the ability of entities to honour the uncollateralised portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event that such liabilities are not honoured. CRR liabilities typically relate to transactions with unrelated parties. Examples of CRR liabilities include the uncollateralised portion of payables arising from derivative transactions and the uncollateralised portion of liabilities under sale and repurchase agreements. CRRs are not applicable to funding commitments or other obligations associated with covered bonds, letters of credit, guarantees, servicer and trustee obligations, and other similar obligations that arise from a bank performing its essential operating functions.

**The Co-operative Bank's CRRs are positioned at B2/Not Prime**

The long-term CRRs are one notch above the bank's standalone BCA of caa1. The uplift derives from the buffer against default provided to the operating obligations by the residual equity that we expect in resolution, by the recent Tier 2 bond, and by deposits. The long-term CRRs do not include any further uplift resulting from our expectation of low probability of government support.

## About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgement. When read in conjunction with our research, a fulsome presentation of our judgement is expressed. As a result, the output of our scorecard may materially differ from what 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 methodology and scorecard factors

Exhibit 6

**The Co-operative Bank plc**

| **Macro Factors** | | |
|---|---|---|
| **Weighted Macro Profile** | **Strong +** | **100%** |

| **Factor** | **Historic Ratio** | **Macro Adjusted Score** | **Credit Trend** | **Assigned Score** | **Key driver #1** | **Key driver #2** |
|---|---|---|---|---|---|---|
| Solvency | | | | | | |
| Asset Risk | | | | | | |
| Problem Loans / Gross Loans | 2.9% | a2 | ↑ | ba3 | Operational risk | |
| Capital | | | | | | |
| Tangible Common Equity / Risk Weighted Assets (Basel III - fully loaded) | 32.5% | aa1 | ←→ | b1 | Stress capital resilience | |
| Profitability | | | | | | |
| Net Income / Tangible Assets | -0.7% | caa1 | ←→ | caa3 | Earnings quality | |
| Combined Solvency Score | | a3 | | b2 | | |
| Liquidity | | | | | | |
| Funding Structure | | | | | | |
| Market Funds / Tangible Banking Assets | 8.7% | a1 | ↓ | ba1 | Lack of market access | |
| Liquid Resources | | | | | | |
| Liquid Banking Assets / Tangible Banking Assets | 18.2% | baa2 | ←→ | baa2 | Stock of liquid assets | |
| Combined Liquidity Score | | a3 | | baa3 | | |
| Financial Profile | | | | ba3 | | |
| Qualitative Adjustments | | | | Adjustment | | |
| Business Diversification | | | | -1 | | |
| Opacity and Complexity | | | | 0 | | |
| Corporate Behavior | | | | -2 | | |
| Total Qualitative Adjustments | | | | -3 | | |
| Sovereign or Affiliate constraint | | | | Aa2 | | |
| Scorecard Calculated BCA range | | | | b2 - caa1 | | |
| Assigned BCA | | | | b3 | | |
| Affiliate Support notching | | | | 0 | | |
| Adjusted BCA | | | | b3 | | |

| Balance Sheet | In-scope (GBP Million) | % In-scope | At failure (GBP Million) | % At failure |
|---|---|---|---|---|
| Other liabilities | 3,041 | 12.5% | 4,486 | 18.4% |
| Deposits | 20,635 | 84.5% | 19,191 | 78.6% |
| Preferred deposits | 18,572 | 76.1% | 17,643 | 72.3% |
| Junior Deposits | 2,064 | 8.5% | 1,548 | 6.3% |
| Equity | 732 | 3.0% | 732 | 3.0% |
| Total Tangible Banking Assets | 24,409 | 100.0% | 24,409 | 100.0% |

| Debt Class | De jure waterfall | | De facto waterfall | | Notching | | LGF Notching Guidance vs. Adjusted BCA | Assigned LGF notching | Additional notching | Preliminary Rating Assessment |
|---|---|---|---|---|---|---|---|---|---|---|
| | Instrument volume + subordination | Sub-ordination | Instrument volume + subordination | Sub-ordination | De jure | De facto | | | | |
| Counterparty Risk Rating | 9.3% | 9.3% | 9.3% | 9.3% | 1 | 1 | 1 | 1 | 0 | b2 |
| Counterparty Risk Assessment | 9.3% | 9.3% | 9.3% | 9.3% | 2 | 2 | 2 | 2 | 0 | b1(cr) |
| Deposits | 9.3% | 3.0% | 9.3% | 3.0% | 0 | 0 | 0 | 0 | 0 | b3 |

| Instrument Class | Loss Given Failure notching | Additional notching | Preliminary Rating Assessment | Government Support notching | Local Currency rating | Foreign Currency rating |
|---|---|---|---|---|---|---|
| Counterparty Risk Rating | 1 | 0 | b2 | 0 | B2 | B2 |
| Counterparty Risk Assessment | 2 | 0 | b1(cr) | 0 | B1(cr) | |
| Deposits | 0 | 0 | b3 | 0 | B3 | B3 |

[1]Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

*Source: Moody's Investors Service*

## Ratings

Exhibit 8

| Category | Moody's Rating |
|---|---|
| **THE CO-OPERATIVE BANK PLC** | |
| Outlook | Positive |
| Counterparty Risk Rating | B2/NP |
| Bank Deposits | B3/NP |
| Baseline Credit Assessment | b3 |
| Adjusted Baseline Credit Assessment | b3 |
| Counterparty Risk Assessment | B1(cr)/NP(cr) |

*Source: Moody's Investors Service*

REPORT NUMBER 1179747

## CLIENT SERVICES


| | |
|---|---|
| Americas | 1-212-553-1653 |
| Asia Pacific | 852-3551-3077 |
| Japan | 81-3-5408-4100 |
| EMEA | 44-20-7772-5454 |