MOODY'S
INVESTORS SERVICE

# Rating Action: Moody's takes action on Co-operative Bank ratings

Global Credit Research - 15 Feb 2017

**Senior unsecured debt downgraded to Ca, long-term deposits affirmed at Caa2, outlooks developing**

London, 15 February 2017 -- Moody's Investors Service has today affirmed Co-operative Bank Plc's long-term deposit rating at Caa2, and downgraded the senior unsecured debt ratings to Ca from Caa2. The outlook on both ratings was changed to developing from positive, reflecting Moody's expectation that efforts to address the current challenges the bank faces in terms of its solvency may result in a range of different outcomes. The short-term ratings were affirmed at Not Prime.

Moody's also downgraded the bank's standalone baseline credit assessment (BCA) to ca from caa2.

At the same time the bank's long-term Counterparty Risk Assessment (CR Assessment) was downgraded to Caa1(cr)from B2(cr), the short-term CR Assessment was affirmed at NP(cr).

The rating action follows the announcements made by the bank that its common equity tier 1 ratio will remain below 10% in the medium term (26 January 2017) and that, in light of its difficulty in generating capital organically, its board has agreed to commence a sale process to external parties (13 February 2017), as well as considering other options to build capital, such as equity injections by existing shareholders and/or a liability management exercise upon existing debt obligations.

A full list of affected ratings is at the end of this Press Release.

RATINGS RATIONALE

---RATIONALE FOR THE BCA

The downgrade of the bank's BCA to ca reflects Moody's view that the bank's standalone creditworthiness is increasingly challenged and that the bank will not be able to restore its declining capital position without external assistance. The bank has been loss-making for the last five years and, despite some improvement in cost management, Moody's expects it to remain so until 2018. The bank is also facing higher than anticipated transformation and conduct remediation costs while its interest income is pressured by the prolonged low interest rate environment.

Due to on-going losses, the bank expects its common equity tier 1 (CET1) ratio to fall below 10% and remain below its Individual Capital Guidance (ICG, i.e. Pillar 1 + 2A requirements set by the Bank of England) in the medium term. The bank has been benefitting from regulatory forbearance in relation to its compliance with its ICG and capital buffer requirements (Pillar 2B) since 2013. Although the regulator put out its own statement indicating that they had discussed the board's decision with the bank and welcomed the proposed sale, the likelihood of this forbearance remaining in place in the medium-term is not certain.

Although Moody's considers that a sale of the whole bank to strategic investors willing to recapitalise the bank would be positive for the bank's creditworthiness, the process has just been initiated and, in Moody's view, completion of a sale of the bank either as a whole or in part is not certain. Given the bank's weak profitability and remaining high stock of non-performing loans in its non-core porfolio, a sale of the bank as a whole may prove challenging, causing the bank's board to consider alternative options to restore its solvency. According to the bank such options could include raising equity from existing shareholders and/or a liability management exercise upon its outstanding public debt. As at June 2016, the bank had GBP405 million of senior unsecured debt outstanding, maturing in September 2017, together with GBP 456 million of subordinated debt (unrated) maturing after 2023. Moody's would likely consider a liability management exercise resulting in a diminished value relative to a debt obligation's original promise to be a default.

These developments suggest a high risk that the bank will be unable to restore its capital levels to required regulatory levels on a sustainable basis without recourse to external support or imposing losses on bondholders, challenges consistent with a BCA of ca.

--- RATIONALE FOR SENIOR DEBT AND DEPOSIT RATINGS

The downgrade of the senior unsecured debt rating to Ca reflects Moody's view that senior unsecured bond holders could experience losses in case of a bank failure or as part of a standalone liability management exercise. The rating agency believes that if such losses were to arise, they would likely be in the range of 35%-65%. In Moody's view, the remaining GBP 456 million of subordinated debt (unrated) outstanding as of June 2016 is unlikely to be sufficient by itself to address the capital shortfall and shield senior unsecured debt-holders from losses.

The affirmation of the long-term deposit rating at Caa2 is based on Moody's expectation that junior deposits are unlikely to incur losses at the same level as senior unsecured bond holders if they are included in a liability management exercise. The Caa2 rating is consistent with an expectation of losses of up to 20% of principal in the event of the bank's default.

RATIONALE FOR THE DEVELOPING OUTLOOK

The outlook on all ratings is developing, reflecting Moody's expectation that efforts to address the current challenges in terms of solvency may lead to one of a number of outcomes with different credit implications for the bank's creditors. In case of a successful sale or equity raising, restoring its capital without affecting debt holders, the long-term debt and deposit ratings would likely be upgraded. Conversely, a failure to raise capital, higher than expected losses on debt and deposits, or an increased likelihood of formal resolution proceedings may lead to rating downgrades.

RATIONALE FOR THE CR ASSESSMENT

As part of today's action, Moody's also downgraded the bank's long-term CR Assessment to Caa1(cr), three notches above the bank's BCA of ca. The CR Assessment is driven by the banks' standalone assessment and by the considerable amount of subordination from bail-in-able deposits and debt in the liability structure which the agency believes will allow the bank to continue to meet its operating obligations even if it were to default on certain debt liabilities.

WHAT COULD CHANGE THE RATINGS UP/DOWN

Given the low standalone BCA, scope for further downgrade is limited, but would be likely in the event that current attempts to restore the bank's solvency prove unsuccessful and the authorities place the bank into a resolution process. This or the prospect of larger-than-expected losses on senior unsecured debt or deposits would likely result in lower ratings.

The BCA could be upgraded if the bank demonstrates further progress in improving its capitalisation on a sustainable basis without resorting to a liability management exercise. A positive change in the BCA would likely lead to an upgrade in all ratings.

LIST OF AFFECTED RATINGS

Issuer: Co-Operative Bank Plc

..Downgrades:

....Long-term Counterparty Risk Assessment, downgraded to Caa1(cr) from B2(cr)

....Senior Unsecured Regular Bond/Debenture, downgraded to Ca Developing from Caa2 Positive

....Senior Unsecured Medium-Term Note Program, downgraded to (P)Ca from (P)Caa2

....Adjusted Baseline Credit Assessment, downgraded to ca from caa2

....Baseline Credit Assessment, downgraded to ca from caa2

..Affirmations:

....Short-term Counterparty Risk Assessment, affirmed NP(cr)

....Long-term Deposit Ratings, affirmed Caa2, outlook changed to Developing from Positive

....Short-term Deposit Ratings, affirmed NP

....Other Short Term, affirmed (P)NP

....Commercial Paper, affirmed NP

..Outlook Action:

....Outlook changed to Developing from Positive

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks published in January 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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