MOODY'S
INVESTORS SERVICE

CREDIT OPINION
21 July 2016

Update

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RATINGS

Co-Operative Bank Plc

Domicile	United Kingdom
Long Term Debt	Caa2
Type	Senior Unsecured - Dom Curr
Outlook	Positive
Long Term Deposit	Caa2
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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Co-Operative Bank Plc

Semiannual Update

Summary Rating Rationale

We rate Co-Operative Bank's long-term bank deposits and senior unsecured debt at Caa2.

Despite negative pressures from the uncertainties in the operating environment post the UK referendum, the outlook on the Co-Operative Bank's ratings is positive, driven by a steady improving trend in credit fundamentals and gradual implementation of the restructuring plan.

We expect a prolonged period of uncertainty for the UK, following the outcome of the UK referendum, which will have negative implications for the country's medium-term growth outlook and could lead to: (1) weaker operating profitability due to slower domestic credit demand; (2) weaker credit quality due to a likely modest increase in unemployment and downward pressure on property prices in the UK; and 3) potentially higher and more volatile funding costs. These drivers will pressure revenues, asset quality and profitability metrics for all banks in the system, although some are more resilient to these strains. These factors led us to revise the outlooks on many UK banks and building societies ratings to negative from stable. We revised our outlook on the UK banking system itself to negative from stable at the same time.

Co-Operative Bank's BCA at caa2 continues to reflects these challenges as well as (1) its strengthened capital position; (2) the progress in reducing its non-core portfolio; (3) improved asset quality; and (4) a solid funding and liquidity position. The BCA also incorporates (1) the challenges the bank faces to implement a sustainable business model - via a business plan that involves significant execution risk; (2) our expectation of net losses continuing through to 2016 and 2017, eroding the bank's capital position; and (3) the potential for additional conduct remediation costs that could also have a negative effect on the bank's capital position.

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 probability 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 unsecured operating liabilities of the bank.

Credit Strengths

» Strengthened capital metrics;

» Low reliance on wholesale funding;

» Sufficient liquidity levels.

Credit Challenges

» Operating environment uncertainties following the outcome of the EU referendum;

» Weak asset quality driven by a large non-core portfolio;

» Negative profitability due to high cost base and legacy issues.

Rating Outlook

The outlook on all ratings is positive, reflecting our expectation that despite the challenges to profitability and asset quality brought upon by the uncertain operating environment, Co-Operative Bank will continue implementing its business restructuring plan and improving its credit fundamentals, albeit at a slower pace.

Factors that Could Lead to an Upgrade

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.

Factors that Could Lead to a Downgrade

The BCA could be downgraded as a result of (1) the bank's inability to maintain its regulatory capital ratios at adequate levels; (2) further delays in progress on 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.

Key Indicators

Exhibit 1

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

	12-15[2]	12-14[2]	12-13[2]	12-12[3]	12-11[3]	Avg.
Total Assets (GBP million)	29028.3	37582.9	43383.8	49772.8	48955.6	-12.2[4]
Total Assets (EUR million)	39386.1	48428.9	52146.5	61366.5	58608.1	-9.5[4]
Total Assets (USD million)	42784.9	58601.5	71854.8	80905.1	76081.8	-13.4[4]
Tangible Common Equity (GBP million)	1130.3	1792.7	1625.2	1444.6	2108.4	-14.4[4]
Tangible Common Equity (EUR million)	1533.6	2310.1	1953.5	1781.1	2524.2	-11.7[4]
Tangible Common Equity (USD million)	1666.0	2795.3	2691.8	2348.2	3276.7	-15.6[4]
Problem Loans / Gross Loans (%)	4.8	9.2	10.8	11.0	8.1	8.8[5]
Tangible Common Equity / Risk Weighted Assets (%)	15.2	14.2	10.8	8.1	10.4	13.4[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	69.9	103.5	131.1	178.7	115.5	119.7[5]
Net Interest Margin (%)	0.9	0.9	0.7	1.2	1.4	1.0[5]
PPI / Average RWA (%)	-3.6	-2.3	-1.7	1.6	1.0	-2.5[6]
Net Income / Tangible Assets (%)	-1.8	-0.4	-3.0	-0.7	0.1	-1.2[5]
Cost / Income Ratio (%)	197.5	167.5	150.6	61.2	74.5	130.3[5]
Market Funds / Tangible Banking Assets (%)	12.6	12.6	17.7	19.2	17.8	16.0[5]

Liquid Banking Assets / Tangible Banking Assets (%)	27.4	25.5	22.6	25.0	25.0	25.1[5]
Gross loans / Due to customers (%)	87.4	87.8	94.7	92.4	93.5	91.2[5]

[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
Source: Moody's Financial Metrics

Detailed Rating Considerations

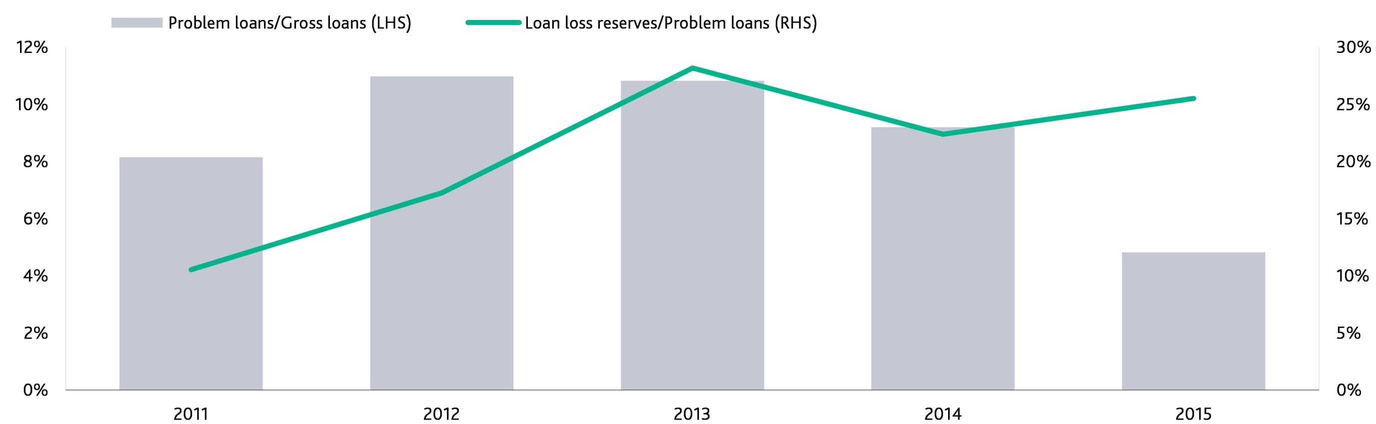
Weak asset quality, driven by a large non-core portfolio

The main reason for Co-Operative Bank's weak asset quality is its non-core portfolio, which accounted for about 25% of gross lending at end-2015. This portfolio includes corporate, Commercial Real Estate (CRE) and Optimum (residential mortgages) loans and is being run down. The non-core corporate book is concentrated with a relatively small number of borrowers and a large portion of the portfolio is CRE loans. As of December 2015, the book had a problem loan ratio of 16.3%, with 36% of impaired balances covered by provisions. Optimum, a closed book of residential mortgages, is highly vulnerable to economic downturn with 85% interest-only mortgages and an average LTV of 68%. As of end-2015, 10.3% of Optimum loans were impaired. In contrast, the core residential mortgage book had 1.1% of loans impaired and an average LTV of 49.7% at end-2015.

During the course of 2015 the bank executed two Optimum securitisation transactions for a total of £3.1 billion and achieved a £2.2 billion gross reduction in its non-core commercial portfolio. As a result, impaired loans fell by 60% to £961 million in December 2015 from £2.4 billion in December 2014, and the bank's problem loan ratio improved to 4.8% from 9.2%.

Impairment write-backs decreased to £48.6 million in 2015 from £173.2 million in 2014 while the bank's coverage ratio slightly improved to 25.5% as of end-2015, but still significantly below the level of its UK peers.

Exhibit 2
Problem loan ratio improved on the back of non-core asset sales; coverage remains relatively low



Source: Moody's Banking Financial Metrics

We expect a slow-down in the bank's asset quality improvements. Co-Operative Bank announced in April that in response to unfavorable market conditions it had agreed an updated turnaround plan with the Prudential Regulation Authority (PRA), which includes suspending its plans to deleverage the remaining Optimum assets. While the bank is committed to seek opportunities for asset sales subject to improved market conditions, we do not see these plans materialising in the near term given an increase in uncertainty and weakening economic environment following the UK's decision to leave the EU.

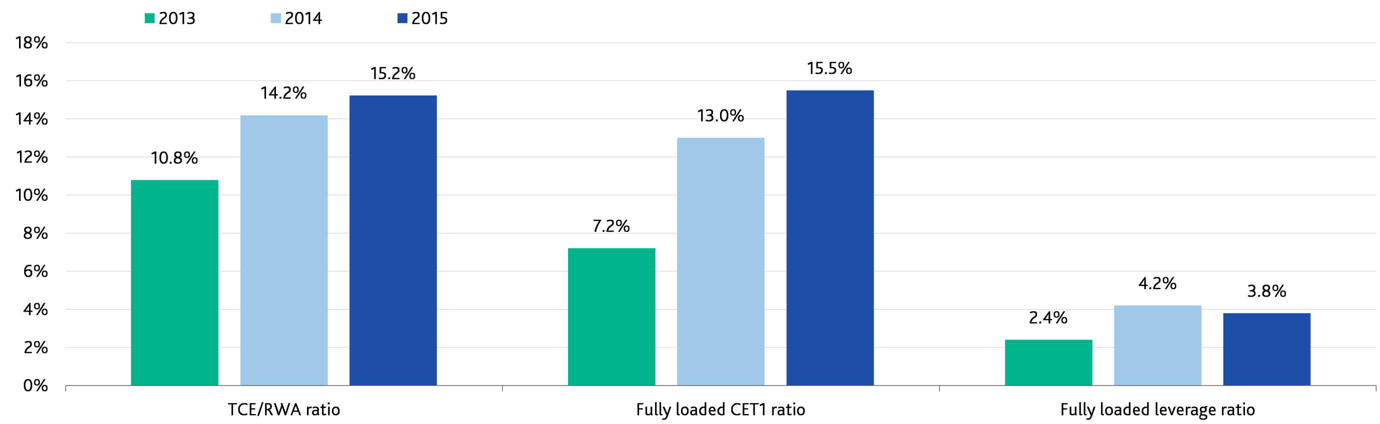
We assign an Asset Risk score of caa1 to reflect the downside risks in the non-core portfolio, pressures from the weakening operating environment as well as the execution risks inherent in the bank's transformation plan.

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 couple of years. In 2013, the bank successfully completed a Liability Management Exercise, generating £1.2 billion of CET1 capital before costs. This was followed by an issue of £400 million of common stock and a £313 million capital contribution from The Co-Operative Group in 2014. The bank's fully-loaded common equity tier 1 (CET1) ratio stood at 15.5% at end-2015, up from 13.0% at end-2014, primarily reflecting a £5.2 billion reduction in risk-weighted assets (RWA) as a result of asset deleveraging. In the same period, the fully loaded leverage ratio fell by 40 basis points to 3.8% as a £8.7 billion decrease in leverage exposure was offset by a £487.2 million deterioration in Tier 1 capital. We calculate Co-Operative Bank's Tangible Common Equity over Risk Weighted Assets at 15.2% at end-2015.

Exhibit 3

Co-Operative Bank's capital metrics have strengthened, but remain susceptible to stress



Source: Moody's Banking Financial Metrics and the bank's financial reports

The bank is reliant on regulatory forbearance for a sustained period of time particularly relating to the expectation of not being able 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's total capital requirement in 2015 of 17.7%, was composed of a Pillar 1 requirement of 8% and a Pillar 2A requirement of 9.7%, this being the highest among UK banks. Co-Operative Bank extended the timeline for its capital strategic plan, which includes meeting the minimum required 7% CET1 ratio throughout the planning period (2016-2020), sustainably meeting its ICG by 2019, complying with the PRA buffer and achieving a leverage ratio above 3.0% by the end of 2020. Having issued £250 million of MREL-eligible Tier 2 notes in 2015, Co-Operative Bank does not currently see any further MREL-qualifying instruments issuance feasible before 2018. The regulator, however, expressed a preference for an earlier MREL issuance, which Co-Operative Bank will seek an opportunity to do, although it will likely result in the bank postponing its deadline to comply fully with ICG and the PRA buffer.

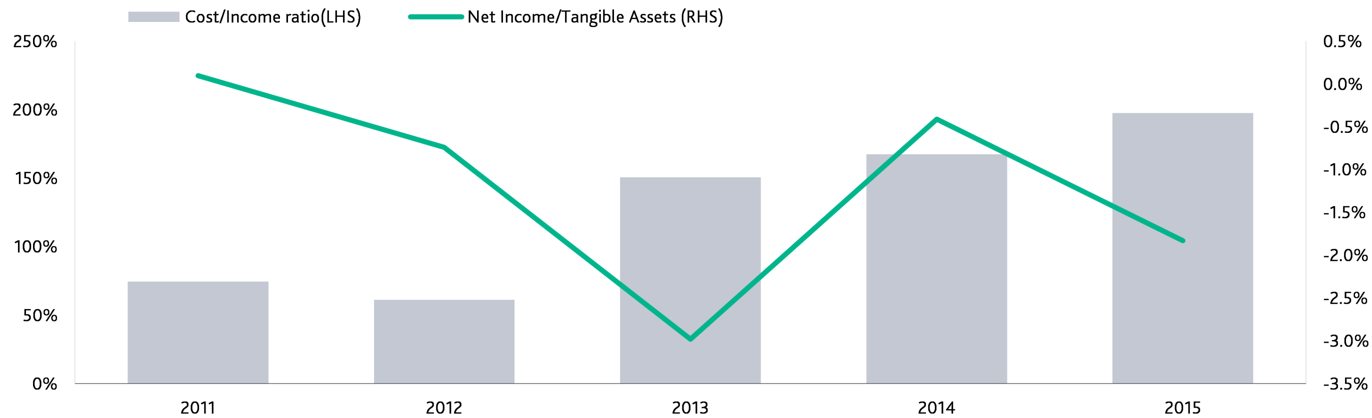
Uncertainty remains as to when the bank will start generating capital organically through earnings retention. Any further non-core portfolio disposals will likely generate losses, potentially making a negative contribution to capital, although the decrease should be partially offset by a reduction in the bank's RWAs. Given sizable investments in IT infrastructure and operational restructuring costs the bank is unlikely to return to profit in the near future. Therefore, despite the improvements in 2015, we continue to view Co-Operative Bank's capital position as vulnerable. The bank has limited room to absorb unexpected losses, including conduct-remediation costs and additional impairments caused by more adverse economic and market conditions.

We assign a Capital score of caa3 to reflect the vulnerabilities of the 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 2016 and 2017 due to low interest margins, an exceptionally high cost base and potential further impairment losses and conduct remediation charges. In 2015 Co-operative Bank reported a loss before tax of £610.6 million, compared to the £264.2 million pre-tax loss reported in 2014, reflecting weaker income generation, lower provision write-backs, losses on asset sales and increased conduct and legal charges. Weaker results also reflect in our Net Income to Tangible Asset ratio falling to -1.8% in 2015 from -0.4% in 2014.

Exhibit 4
High cost base impedes Co-Operative Bank's profitability



Source: Moody's Banking Financial Metrics

While a decrease in the asset base and a change in the mix and pricing of the deposit base led to the net interest margin (NIM) increasing by 20 basis points to 1.42% in 2015, as calculated by the bank, the ratio is still significantly below that of peers. Co-Operative Bank is expected to face further margin pressures following the UK's decision to leave the EU with rates now likely to stay lower for longer. In addition, lower credit demand could adversely affect business volumes. Amid weak interest income the bank will also see impediments to fee and commissions income, negatively affected by industry-wide cuts in card interchange rates, and significantly lower Link commission income following the disposals in the ATM estate. Impairment reversals, which were supporting the profitability in the past couple of years, show a decreasing trend (down by £124.6 million to £48.6 million in 2015), and will likely fall further as impairments pick up driven by weakening economic environment.

Operating expenses fell by 13% year-on-year to £491.9 million in 2015. The bank is implementing a cost reduction programme, but operating costs savings achieved are being offset by significant project expenses related to the bank's restructuring: the project costs accounted for £224.2 million in 2015. Combined with subdued income, this resulted in the bank's cost-income ratio increasing to 198% in 2015 from 167% in 2014, according to our calculations. 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 £120.4 million incurred in 2015. Conduct and legal charges (£193.7 million in 2015, related to additional provisions for Payment Protection Insurance claims and breaches of Consumer Credit Act), and asset disposals (£121.4 million) also had a negative impact on the bank's results.

Despite the more challenging operating environment, we think 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 expected 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 - 86% of total funding as of December 2015. The bank's loan-to-deposit ratio remains stable at 87% at end-2015 (gross customer loans as a percentage of customer deposits). Retail deposit balances were managed down by £5.8 billion during the course of 2015 to address surplus liquidity and to match the reduction in the balance sheet. Total customer deposits decreased to £22.8 billion from £29.9 billion in the same period.

The reliance on wholesale funding is low. As of end-2015, Co-Operative Bank had £3.6 billion of market funds and its Market Funds as a proportion of Tangible Banking Assets ratio stood at 12.6%, according to our calculations. At the beginning of 2016 the bank repaid the remaining balance on the Funding for Lending Scheme (FLS) facility. Co-Operative Bank issued £250 million of 10 year callable subordinated Tier 2 notes on 1 July 2015, reinstating its market access. In our opinion, 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 score reflects the improvements in the metric and the bank's return to market access, as well as recognising the still limited opportunities for the bank to achieve a varied mix of wholesale funding.

Co-Operative Bank maintains an ample stock of liquid assets reflected in a Liquid Banking Assets-to-Tangible Banking Assets ratio of 27.4% at end-2015 and leading to the assigned Liquid Resources score of a2. The bank's primary liquidity decreased over the past year by £2 billion to £4.5 billion at end-2015 as a result of liquidity management and adjustments for deleveraging. Total liquidity resources reduced to £11.4 billion, and, although proportionate to the balance sheet, the amount remains high (39% of total assets).

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 low susceptibility to event risk. The main risks to the system now stem from the economic uncertainty resulting from the UK's decision to leave the European Union (EU) and 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 structures have remained relatively stable in the past few years, with both capital and liquidity having strengthened and a reduced reliance on short-term wholesale funding. On balance sheet liquidity is further bolstered by contingent liquidity arrangements put in place by the Bank of England and by the firms themselves. The UK banking sector is relatively concentrated but the price-setting dominance of large banks is somewhat challenged by competition from the shadow and challenger banking market.

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 Prudential Regulation Authority and the Financial Conduct Authority into the bank's management activities over the period from mid-2009 to end-2013, released on 11 August 2015. 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 Preliminary Rating Assessment (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 Methodology and Scorecard Factors

Exhibit 5

Co-Operative Bank Plc

Macro Factors		
Weighted Macro Profile	**Very Strong -**	**100%**

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	8.3%	ba2	↓↓	caa1	Quality of assets	Operational risk
Capital						
TCE / RWA	15.2%	aa2	↓	caa3	Stress capital resilience	Nominal leverage
Profitability						
Net Income / Tangible Assets	-1.8%	caa3	↑	caa1	Return on assets	Earnings quality
Combined Solvency Score		baa3		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	27.4%	a2	←→	a2	Quality of liquid assets	
Combined Liquidity Score		a1		baa1		
Financial Profile				b2		
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		

Balance Sheet	**in-scope (GBP)**	**% in-scope**	**at-failure (GBP)**	**% at-failure**
Other liabilities	4,345	15.0%	5,942	20.6%
Deposits	22,809	79.0%	21,212	73.4%
Preferred deposits	20,528	71.1%	19,502	67.5%
Junior Deposits	2,281	7.9%	1,711	5.9%
Senior unsecured bank debt	405	1.4%	405	1.4%
Dated subordinated bank debt	460	1.6%	460	1.6%
Junior subordinated bank debt				
Preference shares (bank)				
Senior unsecured holding company debt				
Dated subordinated holding company debt				
Junior subordinated holding company debt				
Preference shares (holding company)				
Equity	867	3.0%	867	3.0%
Total Tangible Banking Assets	28,886	100%	28,886	100%

Debt class	De jure waterfall		De facto waterfall		Notching		LGF notching guidance versus 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 Assessment	11.9%	11.9%	11.9%	11.9%	3	3	3	3	0	b2 (cr)
Deposits	11.9%	4.6%	11.9%	6.0%	0	0	0	0	0	caa2
Senior unsecured bank debt	11.9%	4.6%	6.0%	4.6%	0	-1	0	0	0	caa2

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Counterparty Risk Assessment	3	0	b2 (cr)	0	B2 (cr)	--
Deposits	0	0	caa2	0	Caa2	Caa2
Senior unsecured bank debt	0	0	caa2	0	Caa2	--

Source: Moody's Financial Metrics

Ratings

Exhibit 6

Category	Moody's Rating
CO-OPERATIVE BANK PLC	
Outlook	Positive
Bank Deposits	Caa2/NP
Baseline Credit Assessment	caa2
Adjusted Baseline Credit Assessment	caa2
Counterparty Risk Assessment	B2(cr)/NP(cr)
Senior Unsecured -Dom Curr	Caa2
Commercial Paper -Dom Curr	NP
Other Short Term -Dom Curr	(P)NP

Source: Moody's Investors Service

REPORT NUMBER 1034603

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