FITCH AFFIRMS THE CO-OPERATIVE BANK PLC; OFF RATING WATCH

Fitch Ratings-London-04 September 2017: Fitch Ratings has affirmed The Co-operative Bank plc's (Co-op Bank) Long-Term Issuer Default Rating (IDR) and senior debt ratings at 'B-' and removed them from Rating Watch Evolving (RWE). The Outlook on the Long-Term IDR is Stable. A full list of rating actions is at the end of this rating action commentary.

The rating action follows the recapitalisation of the bank through a combination of fresh capital and the conversion of Tier 2 debt into equity, altogether raising around GBP700 million before expenses.

Fitch has also downgraded Co-op Bank's Viability Rating (VR) to 'f' before upgrading it to 'b-'. The downgrade reflects the bank's failure according to our definitions, as subordinated debt holders were subject to burden-sharing through the mandatory conversion of their notes into equity (or in the case of retail investors, into cash). This conversion qualifies as a distressed debt exchange (DDE) under our criteria since it represents a material reduction in terms (equity conversion or, for some retail investors cash consideration for less than principal).

The subsequent upgrade of the VR reflects Fitch's view of the bank's restored viability following the recapitalisation. However at 'b-' the VR also reflects the vulnerability of the bank to a turnaround of the business to ensure that it becomes structurally profitable and that capital erosion will remain within the estimates under its recovery plans.

KEY RATING DRIVERS
IDRS, VR AND SENIOR DEBT

Following the downgrade of the VR to 'f' and subsequent upgrade to b-', Co-op Bank's IDR is now aligned with its VR and the ratings are driven by the bank's standalone creditworthiness.

The VR primarily reflects our view that after being recapitalised, the bank's viability has been restored but remains under pressure from still negative pre-impairment profitability. This is driven by tight margins and high costs related to the need to invest further in systems to improve efficiency and risk controls. Furthermore, the bank needs to generate higher-yielding loans without increasing risk unduly. .

The bank's CET1 ratio is expected to improve to 22%-23%, following the recapitalisation, from 9.8% at end-1H17. Its leverage position, which had deteriorated significantly as a result of its losses, is expected to improve materially (leverage ratio likely to have risen to around 5% from 2.4% at end-1H17). Nonetheless, the bank will remain in regulatory forbearance, as it will still not meet its individual capital guidance unless and until it issues GBP250 million Tier 2 debt instruments, which management expects by 4Q18

Part of the broader proposed capital-raising scheme agreed with stakeholders is a clear allocation of the assets and liabilities of the pension scheme, which is currently held jointly with Co-operative Group. A clear allocation of which pension scheme assets and liabilities are allocated to the bank and the removal of the bank's obligation to support the pension liabilities of the rest of the group should result in a lower Pillar 2A requirement, which is now particularly high (15.1% at the last disclosure). This in turn could create some capital flexibility and allow the bank to expand its lending operations and help alleviate profitability pressure.

Losses are also likely to be generated from continued deleveraging from some legacy loans (the so-called Optimum portfolio, made up of non-conforming loans originated by the Britannia Building Society before it was acquired). Impaired loans have reduced materially since the bank's first recapitalisation, but the Optimum loan portfolio and other legacy loans are very low yielding and could generate losses on sale/deconsolidation.

Furthermore, reserve coverage of impaired loans is low and renders the bank's capital somewhat vulnerable to falling real estate prices.

The bank has an overall moderate franchise in the UK and limited pricing power. Its asset quality has improved and is in line with a declining risk appetite, improved underwriting standards, a benign operating environment, and legacy asset deleveraging. The bank's customer deposits and loan/deposit ratios were broadly stable in 2016/1H17 but continue to be prone to sudden changes in sentiment.

Co-op Bank's senior debt is rated in line with the IDR, reflecting Fitch's expectations of average recovery prospects for senior debt holders in the event of default or resolution (Recovery Rating of 'RR4').

SR AND SUPPORT RATING FLOOR (SRF)
Co-op Bank's SR and SRF reflect Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities in the event it is declared non-viable given resolution legislation in place as well as the bank's low systemic importance.

RATING SENSITIVITIES
IDRS, VR AND SENIOR DEBT
The VR, IDRs and senior debt ratings are sensitive to Co-op Bank's ability to implement successfully the bank's revised recovery plan. A failure to improve structural profitability or to stem losses as outlined in its medium-term plan will likely result in a downgrade of the bank's VR and IDRs. In such circumstances, it would be unlikely that the bank could meet its regulatory capital requirements in the medium-term.

Ratings could be upgraded if the bank successfully reduces legacy loans, invests in systems and is able to achieve a turnaround in structural profitability before significant renewed erosion of capital.

SR AND SRF
A positive change in the UK sovereign's propensity to support senior bondholders that would be necessary for an upgrade of the SR and an upward revision of the SRF is, in Fitch's view, highly unlikely.

The rating actions are as follows:

The Co-operative Bank plc
Long-Term IDR affirmed at 'B-'; off RWE; Outlook Stable
Short-Term IDR affirmed at 'B', off Rating Watch Negative (RWN)
Viability Rating downgraded to 'f' from 'c' and subsequently upgraded to 'b-'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'No Floor'
Senior unsecured notes' long-term rating affirmed at 'B-'/'RR4', removed from RWE
Senior unsecured notes' short-term rating affirmed at 'B', removed from RWN

Contact:

Primary Analyst
Claudia Nelson
Senior Director
+44 20 3530 1191
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Aabid Hanif
Associate Director
+44 20 3530 1786

Committee Chairperson
James Watson
Managing Director
+7 495 956 6657

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Distressed Debt Exchange Rating Criteria (pub. 13 Jun 2017)
https://www.fitchratings.com/site/re/898948
Global Bank Rating Criteria (pub. 25 Nov 2016)
https://www.fitchratings.com/site/re/891051