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ISSUER COMMENT

The Co-operative Bank's £400 Million Equity Placement Is Credit Positive

From Credit Outlook

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Last Friday, The Co-operative Bank Plc (Caa2 negative, E/ca negative[1]) announced it had successfully placed £400 million of core equity Tier 1 capital (CET1) through the issue of 200 million ordinary shares. The placement is credit positive for Co-operative Bank's bondholders because it will allow the bank to strengthen its capital position and remain a going concern. Moreover, the capital raise will allow Co-operative Bank to restore its capital back to that which it outlined as the starting point of its four- to five-year turnaround strategy.

The placement adds approximately 250 basis points to the bank's Capital Requirements Directive IV (CRD IV) CET1 ratio, which on a pro forma basis will be approximately 9.8%, according to information provided by the bank. The capital placement was necessary after Co-operative Bank reported a £1.3 billion operating loss following the bank excluding the profit generated by an exchange of junior instruments for equity and subordinated bonds that the bank and Co-operative Group (unrated) issued in December 2013. The higher-than-expected loss was mainly driven by £412 million of additional conduct remediation charges, including those related to mis-selling payment protection insurance and interest rate swaps, violations of the UK's consumer credit act and customer redress related to mortgage products.

Although Co-operative Bank continues to benefit from regulatory forbearance from the UK's Prudential Regulation Authority in connection to its non-compliance with its individual capital guidance, we believe that the bank will aim to maintain a material cushion in excess of the minimum 7% CRD IV CET1 ratio that the PRA requires. However, we do not expect the bank to be profitable over the next two to three years owing to its high cost base and high investment requirements in IT infrastructure. Therefore, improvements in capital ratios will have to come from further capital raises or from capital accretive asset disposals and because the bank has limited room for error, we think that the bank's recovery plan remains highly exposed to execution risk.

What is Moody's Credit Outlook?

Published every Monday and Thursday morning, Moody's Credit Outlook informs our research clients of the credit implications of current events.

1 The bank ratings shown in this report are The Co-operative Bank's deposit rating, its standalone bank financial strength rating/baseline credit assessment and the corresponding rating outlooks.

Following the capital raising, Co-operative Group's stake in the bank will decline to approximately 20% from 30%. The separation between Co-operative Bank and Co-operative Group is having relevant consequences for the cost structure of the bank, as evidenced by the £39.4 million of costs associated with the process in 2013. In addition, the reduced ownership increases the uncertainty of Co-operative Group's participation in any future capital raises. However, the CRD IV CET1 ratio's improvement to 9.8% will provide management with some flexibility to manage unexpected losses as it continues an extensive review of legacy issues, particularly those related to processes, procedures and documentation.

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