

FITCH AFFIRM THE CO-OPERATIVE BANK PLC AT 'B'; OUTLOOK NEGATIVE

Fitch Ratings-London-05 December 2014: Fitch Ratings has affirmed The Co-operative Bank Plc's (Co-op Bank) Issuer Default Ratings (IDR) and senior debt ratings at 'B' and its Viability Rating (VR) at 'b'. The Outlook on the Long-term IDR is Negative.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS - IDRS, VR AND SENIOR DEBT

The IDRs are driven by Co-Op Bank's standalone credit profile as reflected in its VR. The ratings reflect the continued pressure on Co-op Bank's capital from a poorly performing loan book and the operating losses it is likely to report for at least the next two years. The pressure is exacerbated by structural and operational challenges it faces in the execution of its turnaround strategy. The long-term senior debt's rating is in line with the bank's Long-term IDR.

Asset quality is weak. Co-op Bank's loan book includes a high proportion of poorly performing and non-core residential (prime and adverse) and buy-to-let mortgage loans, as well as corporate loans backed by commercial real estate. These loans suffer from a combination of high arrears, low yields, and weak reserve coverage. We believe that the ability of management to deleverage rapidly and effectively will be challenging and is contingent on the operating environment remaining favourable.

Given that the turnaround will take time to materialise it also gives rise to significant tail risk, impairing profitability over the medium-term. However, tail risk could be reduced if the bank is able to accelerate the sale of its non-core assets, in line with its recent announcement. This in turn could be positive for the bank's ratings in the medium-term.

Impaired loans, net of reserves, were a high 118% of Fitch Core Capital at end-1H14. The quality and structure of the loan book makes the bank's capitalisation vulnerable to a weakening of the UK's real estate prices and to changes in interest rates, both of which are significant risks in the highly indebted UK household sector, despite the current favourable environment.

The high level of net impaired loans and property-focused loan book also renders the bank susceptible to failing the Prudential Regulatory Authority (PRA) stress test in December 2014.

Although the bank's capitalisation improved in 9M14, we consider it low in the context of the challenges and risks the bank faces. These include large-scale disposals and deleveraging, the development of its retail and SME franchise, investment in significantly underdeveloped systems, improving risk controls, and significantly reducing branch network costs. A focus on costs will be an important element in returning the bank to profitability given that its ability to generate revenues is severely curtailed by a currently low-yielding legacy book and a focus on building up secured retail loans, where yields are traditionally low.

RATING SENSITIVITIES - IDRS, VR AND SENIOR DEBT

Negative rating action could be triggered by large-scale losses and capital erosion incurred through its restructuring. It could also arise in the event of further damage to its franchise (either reputational or by the inability to re-launch its core business) to the extent that funding and liquidity are materially affected.

A continued erosion of capital through high credit impairment charges without an improvement in the profitability of the core franchise, or materially higher-than-budgeted investment needs could also negatively affect ratings.

Given the Negative Outlook, positive rating action is not our base case at this stage and is unlikely until the bank reduces further the tail risk inherent in its assets and improves underlying profitability and capital generation. An acceleration of the non-core run down could ultimately be positive for ratings if tangible progress is made in reducing tail risk.

The long-term senior debt rating and the Recovery Rating of 'RR4' are sensitive to i) a change in the bank's Long-term IDR and ii) to a weakening of assumptions around asset values and in the event of a default and/or to changes in the mix of the bank's liabilities that increases the proportion of retail and other preferred creditors.

KEY RATING DRIVERS AND SENSITIVITIES - SUPPORT RATING AND SUPPORT RATING FLOOR

The bank's Support Rating of '5' and Support Rating Floor of 'No Floor' have been affirmed and reflect Fitch's opinion that support cannot be relied upon, given the bank's low systemic importance. Fitch does not expect any change to these ratings.

The rating actions are as follows:

Long-term IDR: affirmed at 'B'; Negative Outlook
Short-term IDR: affirmed at 'B'
Viability Rating: affirmed at 'b'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes' Long-term rating: affirmed at 'B'/'RR4'
Senior unsecured notes' Short-term rating: affirmed at 'B'

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Additional information is available on www.fitchratings.com.

Applicable criteria, Global Financial Institutions Rating Criteria (31 January 2014) is available at www.fitchratings.com.

Applicable Criteria and Related Research:

Global Financial Institutions Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=732397

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