The Co-operative Bank p.l.c. (/gws/en/esp/issr/80360030)

FitchRatings

Fitch Maintains The Co-operative Bank's IDR on Rating Watch Evolving; Downgrades VR to 'c'

Fitch Ratings-London-30 June 2017: Fitch Ratings has maintained UK-based The Co-operative Bank p.l.c.'s (Co-op Bank) 'B-' Long-Term Issuer Default Rating (IDR) on Rating Watch Evolving (RWE) and revised the Rating Watch on its 'B' Short-Term IDR to Negative (RWN) from Evolving. We have downgraded Co-op Bank's Viability Rating (VR) to 'c' from 'cc'. A full list of rating actions is at the end of this rating action commentary.

The rating actions follow the announcement by of a capital raising plan by Co-op Bank. Under the plan, which is subject to approval by shareholders and regulatory approval by the PRA and other parties, capital will be increased by approximately GBP700 million by way of a capital increase and the conversion of subordinated debt (unrated) into equity.

The RWE on the Long-Term IDR reflects Fitch's opinion that the rating may be upgraded, affirmed or downgraded. If the transaction is completed as outlined, the bank's Long-Term IDR could be upgraded or affirmed, depending on Fitch's assessment of the credit profile of the newly recapitalised bank. However, execution of the transaction is not certain, and a failure to execute it will increase the risk of losses being suffered by senior bondholders, which would result in a downgrade of the Long-Term IDR. It is possible that even after recapitalisation, the bank's risk profile could result in a downgrade of the Long-Term IDR and a VR below 'b-'.

The RWN on the Short-Term IDR reflects Fitch's opinion that the rating could be affirmed or be downgraded if the transaction does not proceed. We have revised the Rating Watch from Evolving it is unlikely that the Long-Term IDR would be upgraded to investment grade, which would be necessary for an upgrade of the Short-Term IDR to a category higher than 'B' under our criteria.

The downgrade of the VR reflects Fitch's view that failure of the bank under Fitch's definitions is imminent because the proposed conversion of subordinated debt would be considered a distressed debt exchange (DDE) under our criteria. The subordinated debt offers will represent a DDE because i) they will result in a material reduction in terms (equity conversion or, for some retail investors cash consideration for less than principal); and ii) Fitch believes them to be necessary to avoid resolution or insolvency. We expect to downgrade the VR to 'f' if and when the proposed scheme to increase capital has been completed.

We have removed the Support Rating (SR) from Rating Watch Positive (RWP) as the bank has not found a new shareholder to support the bank, which was a potential scenario when it announced its sale plans in February 2017.

KEY RATING DRIVERS
IDRS, VR AND SENIOR DEBT
The VR primarily reflects clear deficiencies in the bank's capital, which has been eroded because of losses and the plan to strengthen capitalisation by approximately GBP700 million by way of both a capital increase and the DDE of subordinated debt. Our assessment of capitalisation has a high influence on the bank's VR.

The bank has a niche but overall moderate franchise in the UK. Its asset quality is weaker than many UK peers but has been improving, in line with a reducing risk appetite, improved risk controls, a benign operating environment, and due to legacy asset deleveraging. The bank's customer deposits and loan/deposit ratios were broadly stable in 2016 but may be prone to sudden changes in sentiment. Our view of management and strategy reflects the difficulties it has encountered in executing its recovery plan. However, these considerations all have a lower influence on the bank's VR at present.

Co-op Bank's CET1 ratio was 11% at end-2016 but the bank expected this to fall and to remain below 10% over the medium term, unless it raised capital externally. We understand that despite the new capital injection (itself broadly equivalent to 10% of end-2016 risk weighted assets), the bank remains in regulatory forbearance, as it does not meet its Individual Capital Guidance and PRA Buffer. Part of the broader proposed capital raising scheme agreed with stakeholders, but not yet voted on, is a clear allocation of the assets and liabilities of the Pension Scheme which is currently joint with the Co-operative group (The Co-operative Pension Scheme, or PACE). 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 (14.5% at the last disclosure), and is a part of the bank meeting its capital requirements over the life of the plan.

After recapitalisation, we expect the bank's VR and Long-Term IDR to remain under pressure from weak structural profitability, which is correlated with the need to invest further in systems to improve efficiency, risk controls and generate new better quality and higher yielding mortgage loans. Impaired loans have reduced materially, but the bank has retained a high proportion of non-conforming mortgages in its Optimum loan portfolio and its available for sale portfolios. Furthermore, reserve coverage of impaired loans is low and renders the bank's capital somewhat vulnerable to falling real estate prices.

Co-op Bank's Long-Term IDR and senior debt are rated three notches above the VR to reflect Fitch's view that the probability that senior creditors will have to bear losses is lower than the probability of failure for the bank given the newly announced scheme to recapitalise the bank without imposing losses on senior bondholders. With the exception of our assessment of 'capitalisation and leverage' ('c') and 'earnings and profitability ('b-'), all VR factors are currently assessed as being above Co-op Bank's Long-Term IDR.

Co-op Bank's senior debt is rated in line with its 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 its low systemic importance.

RATING SENSITIVITIES
IDRS, VR AND SENIOR DEBT
Co-op Bank's VR is primarily sensitive to the conversion of junior debt into equity and the material injection of external capital, which Fitch would consider a combination of a DDE and extraordinary capital support, both of which would initiate the bank's failure according to our definitions. At that point we expect to downgrade the VR to 'f' before upgrading it to a level commensurate with the bank's subsequent risk profile and capitalisation.

Co-op Bank's IDRs and senior debt ratings would be downgraded if i) the scheme does not proceed in its current form and a senior debt distressed debt exchange or regulatory intervention becomes more likely; or ii) if the proposed capital injection is insufficient to provide the bank with sufficient resilience to absorb further losses before it can become structurally profitable.

Alternatively we could affirm the bank's Long-Term IDR at 'B-' or upgrade it if the capital raised is sufficient for the bank to continue to operate and meet its regulatory capital requirements including buffers in the medium-term.

Fitch expects to resolve the RWE once the capital is raised and a clear plan on how capital will be used is provided.

SUPPORT RATING AND SUPPORT RATING FLOOR
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:

Long-Term IDR: 'B-' maintained on RWE
Short-Term IDR: 'B'; Rating Watch revised from Evolving to Negative
Viability Rating: downgraded to 'c' from 'cc'
Support Rating: affirmed at '5', removed from RWP
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes' Long-Term rating: 'B-'/'RR4', maintained on RWE
Senior unsecured notes' Short-Term rating: 'B', Rating Watch revised from Evolving to Negative

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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)

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