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FITCH: CO-OP BANK CAPITAL RAISING FLAGS STRATEGY EXECUTION RISKS

Fitch Ratings-London-26 March 2014: Co-operative Bank's plan to raise GPB400m in additional capital highlights the execution risks of its revised strategy, Fitch Ratings says. The bank's five-year restructuring plan will take time to be capital generative, so it leaves little margin for error.

The latest capital raising comes only three months after the bank completed a GBP1bn debt-for-equity restructuring exercise as part of its GBP1.5bn recapitalisation plan. This would help restore the bank's capital position, which was negatively affected in 2013 by significant costs for conduct and legal issues, as well as costs associated with the separation of the bank from the Co-operative Group. The capital raising, announced on 24 March, could lift the bank's common equity Tier 1 ratio to around 9%, from the 7.2% it expects to report for end-2013.

But many challenges remain for Co-operative Bank's recovery plan.

The discovery of additional costs highlights corporate governance risks in a bank that is undergoing significant change. The costs for separation from the Co-operative Group are now GBP40m, but could rise. Conduct and legal costs are still a risk, despite the GBP400m charges in 2013.

We see very high execution risks for the bank's strategy, which calls for significant cost-cutting and balance sheet de-risking. The bank is likely to make losses as it restructures, especially as asset quality remains weak. It also needs to invest heavily in IT - as highlighted by its technical breaches of the Consumer Credit Act and included in the newly identified conduct and legal costs. Returning to profitability is likely to be some time away.

Disposing of the non-core book is likely to be particularly challenging. Non-core, non-prime and commercial loan portfolios show fair values well below their carrying values at end-1H13. This is likely to hinder the pace of deleveraging and expose the bank to material tail risk. It could cause a large spike in credit impairment charges.

A weakening of Co-op Bank's franchise is another risk. We believe that the reduction of the Co-operative Group's stake to 30% as a result of the debt restructuring could diminish the bank's small but stable domestic franchise and loyal customer base. The Co-operative Group's holding could be diluted further in the upcoming equity raising, potentially changing these dynamics further. Customers may also be affected by the conduct and legal issues identified.

Co-op Bank is thinly capitalised for these risks, even after the December debt restructuring and factoring in the latest capital raising and Co-operative Group's 2014 planned capital contributions of GBP263m. These factors are reflected in our 'B' rating and Negative Outlook.

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The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.

Applicable Criteria and Related Research:
The Co-operative Bank PLC
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=739175