

Rating Action: Moody's downgrades Clydesdale Bank's senior debt rating to Baa2/P-2; outlook stable.

Global Credit Research - 23 Aug 2013

London, 23 August 2013 -- Moody's Investors Service has today downgraded the long-term bank deposit and senior debt rating of Clydesdale Bank plc to Baa2 from A2, and the short-term debt and deposit rating to Prime-2 from Prime-1, following Moody's lowering of the bank's baseline credit assessment (BCA) to ba1 from baa1.

The lowering of the BCA reflects Moody's view that Clydesdale faces longer-term structural challenges from its weakened franchise and past risk-management/control weaknesses. The rating takes into consideration the bank's efforts to address these challenges by strengthening its risk management and controls framework and improving efficiency through a cost reduction program, but Moody's believes that these measures will take some time to be effective, while at the same time the bank remains exposed to ongoing short-term pressures. These include (1) a business loan portfolio whose asset quality remains under pressure; and (2) low profitability, which reduces the bank's financial flexibility.

At the same time, Moody's downgraded the bank's subordinated debt and the programme rating for undated subordinated debt to Baa3 and (P)Baa3, respectively, from Baa1 and (P)Baa1. The outlook is stable on all ratings.

RATINGS RATIONALE

--- LONGER-TERM CHALLENGES

Moody's believes that the bank's franchise as a retail and selective business lender has been materially weakened, following a strategic pull-back from commercial real estate (CRE) lending and other areas of business lending, an action prompted by ongoing losses which required injections of capital by its parent, National Australia Bank (NAB, rated Aa2 stable; B-/a1 stable) and the ultimate transfer of the GBP 5.6 billion CRE portfolio at book value to NAB's balance sheet.

As a result of NAB's intervention, the bank is well-capitalised and has substantial liquid assets, and we see no immediate threat to creditors from its near-term challenges. However, the weakness of its franchise and uncertainty over its future strategic direction, alongside NAB's stated intention to sell the bank over the medium term, leaves Clydesdale in an uncertain position. Moreover, the losses incurred on the CRE portfolio highlight historical failures of risk management and governance, and the strengthening of these areas, while under way, in Moody's view is challenging and will take several years to be fully effective. The bank's efforts to address these shortcomings and develop a more coherent long-term strategy are complicated by the short term pressures referred to below.

--- SHORT-TERM PRESSURES HEIGHTEN EXECUTION RISK

The ongoing short-term pressures that the bank continues to face -- despite the removal of the CRE portfolio and the parent's repeated capital injections -- exacerbate the execution risk associated with these longer-term challenges. Moody's believes that there are two key short-term pressure points:

(1) The risk of further deterioration in the quality of the remaining business loan portfolio.

While arrears and gross impairments have declined since the removal of GBP 5.6 billion of the bank's CRE portfolio in October 2012, the business loan portfolio, excluding CRE, has continued to deteriorate in the six months to March 2013 (gross impaired assets increased 30% over the period), as increases in arrears and gross impairments highlight, despite a stabilisation of the broader UK economy.

(2) Continued low profitability, which reduces the bank's financial flexibility.

Clydesdale's low profitability reduces the bank's financial flexibility to absorb impairment provisions, write-offs and further provisions for conduct related matters which Moody's expects to continue to consume a majority of the bank's pre-provision income at least in the short-term. The banks' poor efficiency, as measured by the cost to income ratio (H1 '13: 70%) is a chief factor behind Clydesdale's low profitability. Due to the banks' strategic review

exercise, cost cutting and headcount reduction are expected to help improve the banks' efficiency over the medium term. These reductions in footprint and scale of the business, which are being pursued to improve this efficiency, are not without execution risks, however.

Despite weak profitability, the BCA of ba1 is underpinned by both Clydesdale's provisioning levels, which are above UK banking system peers, and its capitalisation levels, which Moody's expects should be sufficient to absorb losses under its anticipated stress scenario, resulting in a limited risk that further parental support may be needed.

The ba1 BCA is further underpinned by Clydesdale's retail mortgage activities, which provide a lower-risk earnings anchor. The portfolio is positioned conservatively versus peers, with relatively low arrears levels, low loan-to-value ratios and is well diversified across the UK housing market. Potential downside pressure from the mortgage lending portfolio could stem from either the buy-to-let lending (20% of total mortgage lending) or the interest-only loans (40% of total) within the portfolio.

--- SUPPORT ASSUMPTIONS

The rating action also reflects Moody's assumption of a continued high probability of parental support for Clydesdale from NAB in the event of need, as evidenced by the support measures that NAB has taken in the course of the last two years. While public commentary by senior management at NAB indicates an ambition to sell its UK business and a limited strategic commitment to the UK market, Moody's expects that NAB will remain supportive to Clydesdale if required in order to preserve value in its UK subsidiary and protect its own balance sheet and P&L. Clydesdale's small size relative to NAB (approximately 7% of consolidated assets) further reinforces this point.

Clydesdale's senior ratings no longer incorporate ratings uplift from an assumption of systemic support being forthcoming in the event of need. This reflects the bank's smaller footprint following removal of its commercial real-estate portfolio and pullback among challenged business lending sectors.

WHAT COULD MOVE THE RATING UP/DOWN

An upgrade of Clydesdale's ratings is unlikely in the short-to-medium term given (1) the diminished franchise strength; (2) execution risks associated with the present restructuring; and (3) remaining pressures within the business loan portfolio.

Further negative pressure on Clydesdale's BCA would be likely to stem from a significant decline in profitability or further deterioration in asset quality. A sale to a less highly rated entity would likely exert downward pressure on the adjusted BCA and senior ratings.

The principal methodology used in this rating was Global Banks published in May 2013. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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