FITCH UPGRADES THE CO-OPERATIVE BANK TO 'B'; OUTLOOK STABLE

Fitch Ratings-London-23 August 2018: Fitch Ratings has upgraded UK-based The Co-operative Bank p.l.c's Long-Term Issuer Default Rating (IDR) to 'B' from 'B-'. The Outlook is Stable. The Viability Rating (VR) has been upgraded to 'b' from 'b-'. A full list of rating actions is at the end of this rating action commentary.

The upgrade of the VR reflects progress in The Co-operative Bank's restructuring and recapitalisation, which we believe have improved the financial strength of the bank. This includes the successful deleveraging of the bulk of the remaining legacy Optimum portfolio of lower-quality mortgage assets in October 2017 with a net loss of GBP7.8 million, as well as progress in improving modelling and pension risks, which drove the UK regulator to reduce The Co-operative Bank's Pillar 2a requirements.

The reduced requirement, combined with fewer risk-weighted assets (RWAs) as a result of the Optimum deleveraging and recapitalisation measures by the bank's shareholders in September 2017, allowed the bank to meet regulatory capital requirements, including the Pillar 2a and combined buffer requirement, at end-2017, one year ahead of the bank's target.

KEY RATING DRIVERS

IDRS, VR AND SENIOR DEBT

The Co-operative Bank's IDRs and VR primarily reflect that the bank remains loss making due to pressure on the net interest margin (NIM), given stiff competition in UK retail banking, low base rates, and an enlarged cost base. The bank reported a pre-tax loss of GBP174 million for 2017 and NIM of 122bp (down from 140bp for 2016). Fitch expects a return to underlying profitability over the medium-term, with statutory profitability likely to take longer given further planned investment spending.

The Co-operative Bank's ratings also reflect improved capitalisation with greater headroom to absorb moderate capital erosion, although capitalisation remains vulnerable to significant losses. Core business growth has been limited but a return to significant growth could also put capitalisation pressure on RWAs.

We believe that execution risk has declined due to measures successfully undertaken in 2017, which benefitted from benign economic conditions, but weak restructuring progress prior to this means that management has yet to build a consistent execution track record. Execution risk also remains high given ongoing investment needs in strengthening the bank's risk controls and IT infrastructure, which will incur further medium-term costs. The Co-operative pension scheme was sectionalised in August 2018, reducing the bank's pension risk. The bank is also working to separate its IT systems from the Co-operative Group, targeted for completion by 3Q19.

We believe that management has a good degree of depth and experience relative to The Co-operative Bank's complexity but that heightened management turnover since 2013 means that the bank's corporate culture may have shifted as a result; we understand from management that strengthening the corporate culture is an area of focus for the bank's new CEO.

The bank's franchise is resilient and benefits from a loyal customer base, although its size makes The Co-operative Bank only a moderate player and a price-taker in the UK retail market. Asset quality has improved from deleveraging, a strengthened risk appetite and improving risk controls, including increased automation in the credit risk underwriting and monitoring process. End-2017 impaired loans totalled 2.4% of the loan book, down from 3.7% at end-2016. The Co-operative Bank's funding profile has been broadly resilient, despite damage to the brand in 2013, 2014 and 2017, and remains in our view reasonably stable.

The Co-operative Bank's senior debt is rated in line with the IDR, reflecting Fitch's expectations of average recovery prospects (Recovery Rating of 'RR4') for senior debt holders in the event of default or resolution.

SUPPORT RATING AND SUPPORT RATING FLOOR
The Co-operative Bank's Support Rating (SR) and Support Rating Floor (SRF) reflect Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities in the event the bank is declared non-viable given resolution legislation in place as well as the bank's low systemic importance.

RATING SENSITIVITIES
IDRS, VR AND SENIOR DEBT
The ratings of The Co-operative Bank are mainly sensitive to its ability to strengthen its structural profitability, and an upgrade of the bank's ratings could result from improved and sustainable earnings.

The ratings could be downgraded if the bank is not able to successfully implement its outstanding areas of restructuring or if business growth accelerates without an adequate risk control infrastructure in place. A failure to improve structural profitability or to stem losses in the next two to three years, which would cause an erosion in capital, could also result in a downgrade of the bank's VR and IDRs.

Downward rating pressure could also arise from structural deterioration in profitability, through tighter margins and higher loan impairment charges. Weaker asset quality, due to a material weakening of the operating environment in the UK if the economic effect of the UK's decision to leave the EU is particularly severe, will also lead to a negative rating action.

SUPPORT RATING AND SUPPORT RATING FLOOR
A positive change in the UK sovereign's propensity to support senior bondholders would be necessary for an upgrade of the SR and an upward revision of the SRF which, in Fitch's view, is highly unlikely.

The rating actions are as follows:

Long-Term IDR: upgraded to 'B' from 'B-'; Outlook Stable
Short-Term IDR: affirmed at 'B'
Viability Rating: upgraded to 'b' from 'b-'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured programme's long-term rating: upgraded to 'B'/'RR4' from 'B-'/'RR4'
Senior unsecured programme's short-term rating: affirmed at 'B'

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Applicable Criteria
Bank Rating Criteria (pub. 22 Jun 2018)
https://www.fitchratings.com/site/re/10034713

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