FitchRatings

Banks
Retail & Consumer Banks
United Kingdom

The Co-operative Bank p.l.c.

Update

Key Rating Drivers

Weak Capitalisation Weighs on Ratings: The Co-operative Bank p.l.c.'s Viability Rating (VR) accounts for the bank's capitalisation and leverage, which Fitch Ratings considers to be weak. It also reflects the bank's resilient franchise, healthy asset quality and improved profitability prospects. We believe its business model is vulnerable to external pressures given strong competition in UK mortgage lending. The VR is below the 'bb' implied VR because of the strong impact of capitalisation and leverage on our overall view of the bank's credit profile.

Long-Term IDR, One-Notch Uplift: The Co-operative Bank's Long-Term Issuer Default Rating (IDR) is one notch above its VR because we believe that there are sufficient resolution funds issued by The Co-operative Bank Finance plc, the bank's intermediate holding company (not rated), which afford additional protection to the bank's external senior creditors, in case of its failure.

Low Leverage Constraining Factor: The bank's common equity Tier 1 (CET1) ratio of 18.9% at end-June 2022 reflects the low risk-weights assigned to mortgage loans under its internal ratings-based approach. The CET1 ratio has fallen from 20.7% at end-December 2021 as a result of regulatory changes. The UK leverage ratio (end-1H22: 3.9%) is due to fall to 3.6% at end-2022 and remains a constraint on growth.

The Co-operative Bank is not bound by a minimum regulatory leverage requirement, but Fitch believes the regulators would expect it to operate with at least 3.25%. The bank now meets its PRA buffer and interim minimum requirement for own funds and eligible liabilities (MREL).

Resilient Franchise: The bank's ethical focus has helped it to attract and retain customers, building resilience in its franchise. However, its business continues to face uncertainty, given its limited scale and lack of diversification. High costs continue to pose a challenge and put it at a disadvantage against mortgage lending peers. The bank was successful in growing its loan book in 2021, taking advantage of wider mortgage margins and government-backed SME loan schemes, but its market share remains small, limiting its pricing power.

Profitable from 2021: The Co-operative Bank became profitable in 2021 after nine years of losses due to its restructuring, strong business volumes combined with wider spreads in the mortgage market, significantly lower funding costs, and one-off items including rebates and tax credits. However, structural profitability remains weak and is vulnerable to competitive pressures on asset margins, the bank's capacity to grow business and rising funding costs, including interest on additional debt buffers to be built from 2022.

Nevertheless, Fitch believes the bank is now better positioned over the medium term, supported by rising interest rates, and reduced operating costs.

Resilient Customer Funding: The bank is predominantly retail-funded, with a resilient core deposit base. Access to wholesale markets is limited and largely consists of the recently issued MREL-eligible debt, Tier 2 debt and the Bank of England's Term Funding Scheme with additional incentives for SMEs (TFSME) drawings for SMEs. Liquidity is healthy with large holdings of cash at the Bank of England boosted by the recent TFSME drawing, which raised its liquidity coverage ratio to 253% at end-June 2022.

Ratings

Foreign Currency

Long-Term IDR	B+
Short-Term IDR	B
Viability Rating	b
Government Support Rating	ns

Sovereign Risk (United Kingdom)

Long-Term Foreign-Currency IDR	AA-
Long-Term Local-Currency IDR	AA-
Country Ceiling	AAA

Outlooks

Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Foreign-Currency IDR	Negative
Sovereign Long-Term Local-Currency IDR	Negative

Applicable Criteria

Bank Rating Criteria (September 2022)

Related Research

Fitch Affirms The Co-operative Bank at 'B+'; Outlook Stable (March 2022)

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Rating Sensitivities

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

The ratings could be downgraded if The Co-operative Bank's CET1 ratio falls towards 16% or if its UK leverage ratio falls towards 3.25%, with no clear actions to reverse the trend. This would likely be caused by faster-than-planned growth or an unexpected return to losses.

The Long-Term Issuer Default Rating (IDR) is also sensitive to the bank being able to build up its end-state regulatory resolution buffer requirements as set by the Bank of England, which includes qualifying junior debt and internal subordinated debt down-streamed from its intermediate holding company, The Co-operative Bank Finance plc. The Long-Term IDR could be downgraded to the same level as the VR if the bank is no longer required or able to meet end-state MREL regulatory requirements.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

An upgrade would require the bank to sustain a longer record of improved structural profitability, and to demonstrate its ability to generate sufficient internal capital to allow it to grow and build up the scale it requires to compete efficiently with peers, while maintaining healthy buffers above minimum capital requirements. Upside potential is also contingent on the bank being able to absorb the costs of issuing MREL-eligible debt to meet end-state requirements.

Significant Changes from Last Review

1H22 Results

The Co-operative Bank reported an operating profit of GBP62 million in 1H22 (financial year ending 31 December 2021 (FY21): GBP31 million). Fitch calculated net interest margin (NIM) increased to 1.9% at end-June 2022 (FY21: 1.5%), benefitting from elevated mortgage margins and a modest pass-through of interest rate increases to savers following the Bank of England's rate rises. However, the loan book contracted by 0.6% during the period as the bank sought to preserve margins in an environment where rising inflation expectations continued to put upward pressure on swap rates. Loan impairment provision releases of GBP3 million (FY21: GBP1 million charge) benefitted from a change in the methodology for calculating impairment overlays on the broker-led mortgage portfolio, which were partially offset by overlays for the potential impact of rising affordability pressures.

Operating Environment on Negative; Increasing Macroeconomic Pressures

UK Banks, including the Co-operative Bank, benefitted from widening NIMs in 1H22 following successive UK base rate increases by the Bank of England. However, in contrast to peers, the bank was unable to benefit from the continued robust demand for mortgages during the period given elevated swap rates and upward pressure on funding costs. The effects of the war in Ukraine and global supply-chain disruptions are fuelling inflation, and Fitch expects a recession in the UK from 4Q22.

Fitch recently cut the UK growth forecast to -1.0% for 2023, compared to the -0.2% expected in Fitch's September Global Economic Outlook, despite the recently announced energy tariff support and the proposed tax cuts. This reflects tighter domestic financing conditions, the energy crisis, and economic downturns in the UK's main trading partners affecting exports. We expect the operating environment for UK banks to be more challenging going forward given increased pressure on borrowers and potential pressure on house prices and have therefore revised the outlook on the operating environment score to negative.

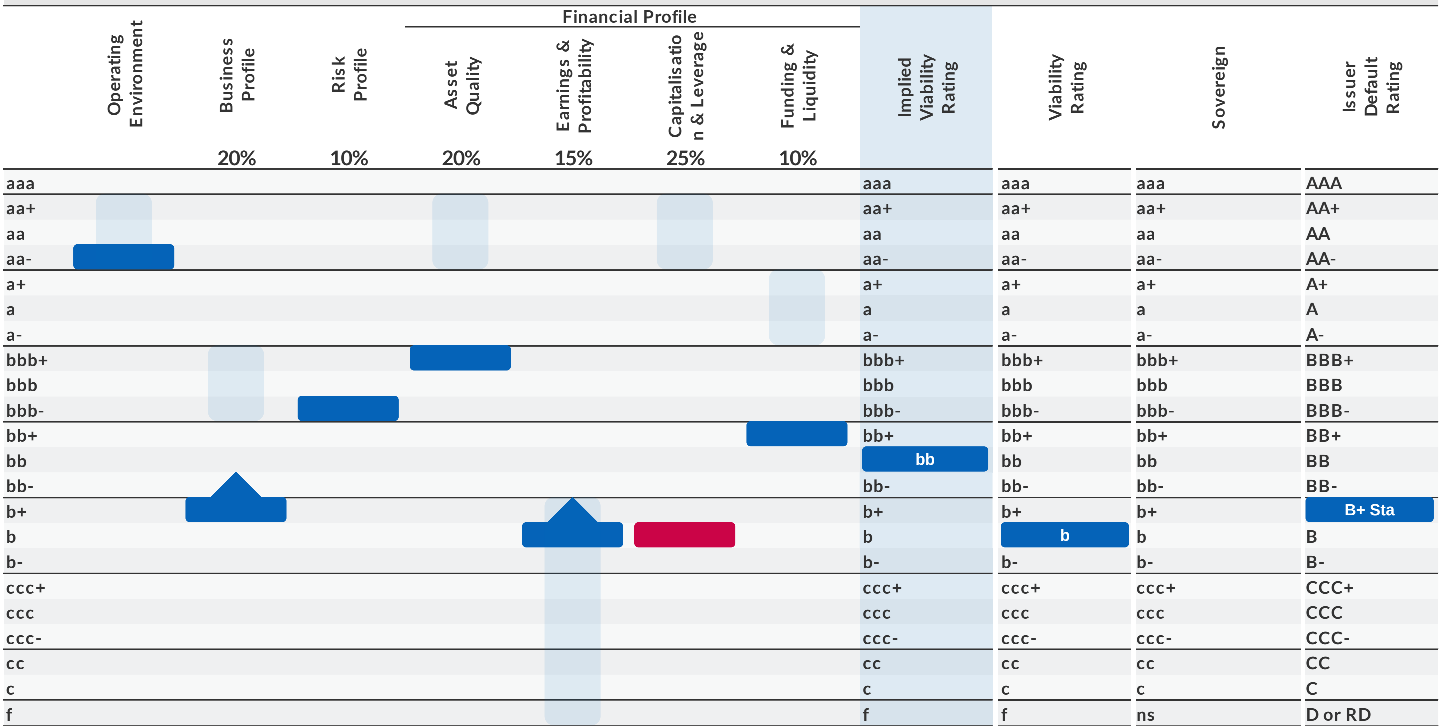
Rising rates provide uplift for banks' earnings in the short term and have resulted in stronger income growth at the Co-operative Bank as a result of wider-than-forecast NIM. However, Fitch expects an increase in the pass-through rate to customer deposits in 2023, with higher funding costs resulting in lower NIM into the medium term. Furthermore, weaker economic growth and affordability pressures for consumers will likely lead to asset quality deterioration.

Ratings Navigator

The Co-operative Bank p.l.c.

ESG Relevance:

Banks
Ratings Navigator



The Key Rating Driver (KRD) weightings used to determine the implied VR are shown as percentages at the top. In cases where the implied VR is adjusted upwards or downwards to arrive at the VR, the KRD associated with the adjustment reason is highlighted in red. The shaded areas indicate the benchmark-implied scores for each KRD.

*Since our latest review of the Co-operative Bank, the outlook on the 'aa-' operating environment score for domestic UK banks has been revised to negative from stable in line with the UK sovereign rating outlook.

VR - Adjustments to Key Rating Drivers

The VR has been assigned below the implied VR due to the following adjustment reason: weakest link – capitalisation and leverage (negative).

The business profile score of 'b+' has been assigned below the 'bbb' category implied score due to the following adjustment reason: business model (negative), market position (negative).

The asset quality score of 'bbb+' has been assigned below the 'aa' category implied score due to the following adjustment reasons: underwriting standards and growth (negative), concentration (negative).

The capitalisation and leverage score of 'b' has been assigned below the 'aa' category implied score due to the following adjustment reasons: Leverage and risk-weight calculation (negative), capital flexibility and ordinary support (negative).

The funding and liquidity score of 'bb+' has been assigned below the 'a' category implied score due to the following adjustment reason: non-deposit funding (negative).

Financials

Financial Statements

	30 Jun 22		31 Dec 21	31 Dec 20	31 Dec 19
	6 months - interim (USDm) Reviewed - unqualified	6 months - interim (GBPm) Reviewed - unqualified	Year end (GBPm) Audited - unqualified	Year end (GBPm) Audited - unqualified	Year end (GBPm) Audited - unqualified
Summary income statement					
Net interest and dividend income	252	208.2	323.9	266.9	310.0
Net fees and commissions	19	15.4	25.2	23.5	20.7
Other operating income	13	10.6	29.2	24.9	55.9
Total operating income	284	234.2	378.3	315.3	386.6
Operating costs	212	175.1	346.1	395.4	478.7
Pre-impairment operating profit	72	59.1	32.2	-80.1	-92.1
Loan and other impairment charges	-3	-2.8	1.1	21.6	-2.5
Operating profit	75	61.9	31.1	-101.7	-89.6
Other non-operating items (net)	n.a.	n.a.	n.a.	-2.0	-62.5
Tax	41	33.5	-166.2	-8.0	0.9
Net income	34	28.4	197.3	-95.7	-153.0
Other comprehensive income	-57	-47.4	80.2	-41.8	14.8
Fitch comprehensive income	-23	-19.0	277.5	-137.5	-138.2
Summary balance sheet					
Assets					
Gross loans	25,327	20,915.8	21,039.5	18,725.4	17,945.1
- Of which impaired	85	70.6	67.4	62.9	79.5
Loan loss allowances	40	32.7	37.4	42.9	26.7
Net loans	25,287	20,883.1	21,002.1	18,682.5	17,918.4
Interbank	286	236.6	191.5	536.2	474.3
Derivatives	115	95.0	158.0	324.0	285.9
Other securities and earning assets	1,461	1,206.9	1,226.1	1,172.5	1,651.9
Total earning assets	27,150	22,421.6	22,577.7	20,715.2	20,330.5
Cash and due from banks	6,829	5,639.6	5,696.9	3,877.8	2,153.5
Other assets	1,203	993.5	1,048.7	1,006.5	951.5
Total assets	35,182	29,054.7	29,323.3	25,599.5	23,435.5
Liabilities					
Customer deposits	24,922	20,581.2	21,135.9	20,365.8	18,996.9
Interbank and other short-term funding	571	471.5	327.6	2,066.4	1,143.7
Other long-term funding	7,317	6,042.9	5,805.4	1,137.0	1,071.7
Trading liabilities and derivatives	108	89.1	140.7	340.1	288.0
Total funding and derivatives	32,918	27,184.7	27,409.6	23,909.3	21,500.3
Other liabilities	166	137.1	161.8	215.8	323.4
Preference shares and hybrid capital	n.a.	n.a.	n.a.	n.a.	n.a.
Total equity	2,098	1,732.9	1,751.9	1,474.4	1,611.8
Total liabilities and equity	35,182	29,054.7	29,323.3	25,599.5	23,435.5
Exchange rate		USD1 = GBP0.82583	USD1 = GBP0.74438	USD1 = GBP0.745156	USD1 = GBP0.76211

Source: Fitch Ratings, Fitch Solutions, The Co-operative Bank p.l.c

Key Ratios

	30 Jun 22	31 Dec 21	31 Dec 20	31 Dec 19
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	2.6	0.7	-2.2	-1.9
Net interest income/average earning assets	1.9	1.5	1.3	1.5
Non-interest expense/gross revenue	74.8	91.5	125.4	123.8
Net income/average equity	3.3	12.2	-6.1	-9.0
Asset quality				
Impaired loans ratio	0.3	0.3	0.3	0.4
Growth in gross loans	-0.6	12.4	4.4	0.9
Loan loss allowances/impaired loans	46.3	55.5	68.2	33.6
Loan impairment charges/average gross loans	0.0	0.0	0.1	0.0
Capitalisation				
Common equity Tier 1 ratio	18.9	20.7	19.2	19.6
Tangible common equity/tangible assets	5.5	5.1	5.5	6.4
Basel leverage ratio	n.a.	3.1	3.4	3.9
Net impaired loans/common equity Tier 1	n.a.	3.3	2.2	5.6
Funding and liquidity				
Gross loans/customer deposits	101.6	99.5	92.0	94.5
Liquidity coverage ratio	252.9	241.8	193.4	173.7
Customer deposits/total non-equity funding	76.0	77.5	86.4	89.6
Net stable funding ratio	n.a.	141.4	138.2	139.1

Source: Fitch Ratings, Fitch Solutions, The Co-operative Bank p.l.c

Support Assessment

Commercial Banks: Government Support	
Typical D-SIB GSR for sovereign's rating level (assuming high propensity)	A or A-
Actual jurisdiction D-SIB GSR	ns
Government Support Rating	ns
Government ability to support D-SIBs	
Sovereign Rating	AA-/Negative
Size of banking system	Negative
Structure of banking system	Negative
Sovereign financial flexibility (for rating level)	Positive
Government propensity to support D-SIBs	
Resolution legislation	Negative
Support stance	Negative
Government propensity to support bank	
Systemic importance	Negative
Liability structure	Neutral
Ownership	Neutral

The colours indicate the weighting of each KRD in the assessment.
Higher influence Moderate influence Lower influence

The GSR reflects Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities if The Co-operative Bank becomes non-viable. This is because of UK legislation and regulations that provide a framework that is likely to require senior creditors to participate in losses after a failure.

Environmental, Social and Governance Considerations

FitchRatings **The Co-operative Bank p.l.c.** Banks Ratings Navigator

Credit-Relevant ESG Derivation

The Co-operative Bank p.l.c. has 5 ESG potential rating drivers

- The Co-operative Bank p.l.c. has exposure to compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security) but this has very low impact on the rating.
- Governance is minimally relevant to the rating and is not currently a driver.

			Overall ESG Scale
key driver	0	issues	5
driver	0	issues	4
potential driver	5	issues	3
not a rating driver	4	issues	2
	5	issues	1

Environmental (E)

General Issues	E Score	Sector-Specific Issues	Reference	E Scale
GHG Emissions & Air Quality	1	n.a.	n.a.	5
Energy Management	1	n.a.	n.a.	4
Water & Wastewater Management	1	n.a.	n.a.	3
Waste & Hazardous Materials Management; Ecological Impacts	1	n.a.	n.a.	2
Exposure to Environmental Impacts	2	Impact of extreme weather events on assets and/or operations and corresponding risk appetite & management; catastrophe risk; credit concentrations	Business Profile (incl. Management & governance); Risk Profile; Asset Quality	1

Social (S)

General Issues	S Score	Sector-Specific Issues	Reference	S Scale
Human Rights, Community Relations, Access & Affordability	2	Services for underbanked and underserved communities: SME and community development programs; financial literacy programs	Business Profile (incl. Management & governance); Risk Profile	5
Customer Welfare - Fair Messaging, Privacy & Data Security	3	Compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security)	Operating Environment; Business Profile (incl. Management & governance); Risk Profile	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Business Profile (incl. Management & governance)	3
Employee Wellbeing	1	n.a.	n.a.	2
Exposure to Social Impacts	2	Shift in social or consumer preferences as a result of an institution's social positions, or social and/or political disapproval of core banking practices	Business Profile (incl. Management & governance); Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Business Profile (incl. Management & governance)	5
Governance Structure	3	Board independence and effectiveness; ownership concentration; protection of creditor/stakeholder rights; legal /compliance risks; business continuity; key person risk; related party transactions	Business Profile (incl. Management & governance); Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Business Profile (incl. Management & governance)	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Business Profile (incl. Management & governance)	2
				1

How to Read This Page
ESG scores range from 1 to 5 based on a 15-level color gradation. Red (5) is most relevant and green (1) is least relevant.

The Environmental (E), Social (S) and Governance (G) tables break out the individual components of the scale. The right-hand box shows the aggregate E, S, or G score. General Issues are relevant across all markets with Sector-Specific Issues unique to a particular industry group. Scores are assigned to each sector-specific issue. These scores signify the credit-relevance of the sector-specific issues to the issuing entity's overall credit rating. The Reference box highlights the factor(s) within which the corresponding ESG issues are captured in Fitch's credit analysis.

The Credit-Relevant ESG Derivation table shows the overall ESG score. This score signifies the credit relevance of combined E, S and G issues to the entity's credit rating. The three columns to the left of the overall ESG score summarize the issuing entity's sub-component ESG scores. The box on the far left identifies some of the main ESG issues that are drivers or potential drivers of the issuing entity's credit rating (corresponding with scores of 3, 4 or 5) and provides a brief explanation for the score.

Classification of ESG issues has been developed from Fitch's sector ratings criteria. The General Issues and Sector-Specific Issues draw on the classification standards published by the United Nations Principles for Responsible Investing (PRI) and the Sustainability Accounting Standards Board (SASB).

Sector references in the scale definitions below refer to Sector as displayed in the Sector Details box on page 1 of the navigator.

CREDIT-RELEVANT ESG SCALE

How relevant are E, S and G issues to the overall credit rating?

5	Highly relevant, a key rating driver that has a significant impact on the rating on an individual basis. Equivalent to "higher" relative importance within Navigator.
4	Relevant to rating, not a key rating driver but has an impact on the rating in combination with other factors. Equivalent to "moderate" relative importance within Navigator.
3	Minimally relevant to rating, either very low impact or actively managed in a way that results in no impact on the entity rating. Equivalent to "lower" relative importance within Navigator.
2	Irrelevant to the entity rating but relevant to the sector.
1	Irrelevant to the entity rating and irrelevant to the sector.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.