FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades The Co-operative Bank p.l.c. to 'BB+'; Outlook Positive

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Fitch Ratings - London - 19 Jan 2024: Fitch Ratings has upgraded The Co-operative Bank p.l.c.'s Long-Term Issuer Default Rating (IDR) to 'BB+' from 'BB'. The Outlook is Positive. The bank's Viability Rating (VR) has also been upgraded to 'bb' from 'bb-'.

The upgrade reflects Fitch's view that the bank has extended its record of structural profitability and increased its capital and leverage buffers. It also reflects substantial progress in its transformation programme and in improving cost efficiency.

The Positive Outlook reflects Fitch's view that the ratings could be upgraded if the business profile continues to strengthen, operating profitability improves further, in particular against competitive and macro-economic pressures, while maintaining adequate capital buffers.

KEY RATING DRIVERS

Rating Uplift to Opco: The Co-operative Bank's Long-Term IDR is one notch above its VR because resolution funds issued by The Co-operative Bank Holdings plc, the bank's ultimate holding company, afford additional protection to the bank's external senior creditors, in case of its failure.

Business Profile Drives VR: The VR is two notches below the 'bbb-' implied VR because the bank's business profile, which continues to be subject to strategic execution risk and competitive pressures, has a strong impact on our assessment. The VR also reflects the bank's low-risk credit exposures, healthy impaired loans ratio, strengthening profitability, improved capitalisation and reasonable funding and liquidity.

Transformation Progress Supports Business Model: The Co-operative Bank's limited scale, low market shares and lack of diversification weigh on its business model, notwithstanding its ethical focus that supports its franchise. The bank's acquisition of Sainsbury's Bank's GBP0.5 billion mortgage portfolio in 3Q23 helped to increase its scale moderately. Progress in upgrading the bank's savings and mortgage platforms in 2023 should further improve cost efficiency from 2024.

The bank has recently entered exclusive merger talks with Coventry Building Society (Coventry; A-/ Stable). The talks are in early stages. The impact of a merger on The Co-operative Bank's ratings would depend on the structure of the transaction and the resulting impact on the bank's business profile, financial metrics and any support available from a new owner.

Mortgage Loans Underpin Risks: The Co-operative Bank primarily underwrites low-risk owner-occupied and buy-to-let residential mortgages, with a small share of unsecured retail and higher loan-to-value (LTV) lending. We expect muted mortgage lending growth in 2024, due to a subdued housing market and high interest rates. The average mortgage LTV in the portfolio has increased slightly to 55% at end-3Q23 (end-2022: 54%), but remains low and provides a buffer against moderate house price falls.

Resilient Asset Quality: The Co-operative Bank's impaired loan ratio of 0.7% at end-3Q23 (or 0.4% when excluding purchased originated credit-impaired (POCI) loans) reflects its robust asset quality. We expect the ratio (including POCI loans) to rise to around 1% by end-2025, mainly due to high interest rates and affordability pressures. Low-risk mortgage loans and conservative underwriting standards should support asset quality.

Continued Improvements in Profitability: The Co-operative Bank's operating profit/risk-weighted assets (RWAs) ratio of 2.5% in 1H23 (2022: 2.8%) is significantly stronger than its four-year average (-0.2%), reflecting the bank's turnaround from a period of losses. We forecast operating profit to moderate in 2024 due to a contracting loan book and rising loan impairment charges, before it recovers in 2025 as investment benefits feed through and as impairments normalise. Structural hedge income should help mitigate rising funding costs.

Stronger Capital Position: The Co-operative Bank's common equity Tier 1 ratio of 20.1% at end-September 2023 reflects mortgage loans' low risk-weights (RWA density: 18% at end-1H23) under the bank's internal ratings-based approach. It remains compliant with regulatory requirements, and has resources in excess of end-state minimum requirements for own funds and eligible liabilities (MREL). Its UK leverage ratio increased slightly to 4.2% at end-September 2023 (end-2022: 4%), creating additional capacity for the bank to gradually expand its balance sheet.

Stable Retail Funding: The bank is mainly retail deposit-funded, with 78% of non-equity funding sourced through a fairly resilient core deposit base at end-3Q23. Access to wholesale markets has improved, and funding largely consists of MREL-eligible debt, Tier 2 debt, RMBS and the Bank of England's Term Funding Scheme with additional incentives for SMEs. Liquidity is healthy, with a liquidity coverage ratio of 222% at end-3Q23.

The bank's Short-Term IDR of 'B' is the only available option for a Long-Term IDR of 'BB+' under Fitch's rating criteria.

RATING SENSITIVITIES

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

The Outlook on the Long-Term IDR could be revised to Stable if the bank's business profile and profitability do not improve as expected, for example due to competitive pressure on revenues or delays to improving cost efficiency.

The ratings could be downgraded from materially weaker profitability or faster-than-planned growth that erode capital buffers, with no clear actions to swiftly restore them. Weak strategic execution driven by intense competition could put the VR under pressure.

The Long-Term IDR is also sensitive to the bank's ability to meet its end-state resolution buffer requirements, which include qualifying junior debt and internal subordinated debt. The Long-Term IDR could also 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

We are likely to upgrade the ratings if the bank's business profile improves further, demonstrated by continued successful strategic execution and improving structural profitability. An upgrade would also require the bank maintaining sufficient capital buffers above their regulatory minimum capital requirements.

VR ADJUSTMENTS

The VR of 'bb' is below the 'bbb-' implied VR due to the following adjustment reason: business profile (negative).

The operating environment score of 'aa-' is in line with the 'aa' category implied score. Sovereign rating was identified as a relevant negative factor in the assessment.

The business profile score of 'bb' is below the 'bbb' category implied score due to the following adjustment reasons: business model (negative), market position (negative).

The asset quality score of 'bbb+' is below the 'aa' category implied score due to the following adjustment reason: concentrations (negative).

The capitalisation and leverage score of 'bb+' is below the 'aa' category implied score due to the following adjustment reason: leverage and risk-weight calculation (negative).

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
The Co-operative Bank p.l.c.	LT IDR	BB+ Rating Outlook Positive	Upgrade	BB Rating Outlook Stable
	ST IDR	B	Affirmed	B
	Viability	bb	Upgrade	bb-
	Government Support	ns	Affirmed	ns

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 01 Sep 2023) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

The Co-operative Bank p.l.c.	UK Issued, EU Endorsed

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