FitchRatings

22 Jul 2020 | Affirmation

Fitch Maintains The Co-operative Bank's 'B-' on RWN

Fitch Ratings-London-22 July 2020:

Fitch Ratings is maintaining The Co-operative Bank's Long-Term Issuer Default Rating (IDR) of 'B-' and Viability Rating (VR) of 'b-', on Rating Watch Negative (RWN). A full list of ratings is below.

The RWN reflects heightened risks to the bank's ratings from further deterioration in the economic environment. Fitch believes that the bank has only a limited margin of safety before requiring additional capital.

Fitch forecasts UK GDP to fall 9% in 2020, with unemployment rising to 6.8% by end-2020 and remaining above this level in 2021. This expectation is based on the assumption that the gradual lifting of pandemic-containment measures since the beginning of July will result in a sharp rebound in GDP growth in 2021. However, we see material downside to these economic forecasts, which also assume a smooth Brexit transition.

Fitch expects to resolve the RWN in 2H20, when we have greater visibility of the impact of the current health crisis on the bank's performance, regulatory requirements, and expansion plans.

Key Rating Drivers

IDRs and VR

The Co-operative Bank's IDRs and VR primarily reflect the vulnerability of capital to losses given that the bank is structurally loss-making. Earnings generation and capital erosion are two factors of high importance to the ratings. The ratings also incorporate heightened execution risk as the bank continues to grow its business and restructure amid economic uncertainties and competitive pressures in the market, resulting in uncertainty over the business model's viability. The ratings also consider the bank's healthy loan quality, adequate liquidity and resilient franchise.

The bank reported high regulatory capital ratios at end-1Q20 (common equity Tier 1 (CET1) ratio: 18.3%; total capital ratio: 22.6%) but these are expected to fall on additional losses as well as risk-weighted asset (RWA) inflation, due to increased risk weightings of its assets. Capital requirements for the bank, as a share of RWAs, at end-1Q20 were CET1 of 10.9% and a total capital requirement (TCR) of 14.5%, to which a capital conservation buffer (CCoB) of 2.5% is added - which must be met with CET1. This provides the bank with some limited headroom, estimated at GBP243 million at end-1Q20, before breaching its capital requirements.

The buffer over capital requirements has been supported by setting the pillar 2A capital requirement to a nominal amount instead of as a share of RWAs, lower risk weights for government-backed loans, transitional arrangements on the application of IFRS9 and a temporary reduction of the countercyclical buffer to 0%.

The bank's Basel leverage ratio of 3.8% at end-1Q20, although not binding until 2021, presents a material constraint on the ability to grow its business.

The Co-operative Bank recorded a pre-tax loss of GBP27 million in 1Q20 and we expect a greater loss for the full year on lower revenues from lower business volumes and a lower base rate, as well as higher loan impairment charges. We expect the bank to control costs by delaying or cancelling planned investments, implementing a hiring freeze and reducing variable pay. We view the bank's planned return to profitability in 2022 as ambitious.

Execution of the business turnaround had been moderately successful pre-coronavirus with the sectionalisation of its pension scheme, its completed separation from The Co-operative Group, and consequently the reduction of its Pillar 2A requirement to 6.54% in 2019 from 15% in 2017. Loan growth had been in line with plans, and asset quality has shown significant improvement, with material deleveraging of legacy assets (5% of assets at end-1Q20).

The Stage 3 loans/ gross loans ratio was 0.4% at end-2019 (1.4% including purchased or credit - impaired loans) which is in line with peers', although we expect some moderate asset-quality deterioration as higher unemployment and lower economic growth affect the borrower's ability to service mortgage loans. Government initiatives such as mortgage loan payment holidays and the job retention scheme may delay or alleviate some pressure but we see an underlying increase in credit risk associated with borrowers.

The Co-operative Bank continues to be primarily funded by granular deposits, which have shown resilience through various stresses. We consider on-balance sheet liquidity adequate given additional access to contingent liquidity from the Bank of England, if required. Refinancing the outstanding term funding scheme (TFS) balances of GBP960 million at end-1Q20 should be manageable due to the new TFSME scheme, which, in addition to base-rate cuts and lower competition for deposits should reduce the bank's funding costs. We view the bank's access to wholesale funding as weak.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

The Co-operative Bank's SR of '5' and SRF of 'No Floor' reflect Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities in the event the bank becomes non-viable, because in our opinion the legislation and regulation implemented in the UK is likely to require senior creditors to participate in losses for resolving the bank. In addition they reflect the lack of systemic importance of the bank.

RATING SENSITIVITIES

IDRs and VR

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Ratings will likely be downgraded if the bank is unable to address the economic impact of the pandemic on growth prospects or show an improvement in profitability. We will also likely downgrade the bank if it does not improve its resilience by increasing the headroom over its minimum regulatory capital requirements, or if prospects to generate sustainable operating profit and therefore the outlook for its longer-term viability do not improve.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

In the event that the bank is able to withstand rating pressure arising from the pandemic, the most likely trigger for an upgrade would be evidence of medium-term earnings and capitalisation resilience. This will require some evidence of success in executing its turnaround plan, by returning to structural profitability.

The Co-operative Bank is an operating company and may benefit from a combination of internal MREL (minimum requirement for own funds and eligible liabilities) and qualifying junior debt buffer amounting to over 10% of RWAs, on an ongoing basis. Once we gain certainty around the timing and the ability of the bank to reach this target we would likely rate the IDR one notch higher than the VR to reflect added protection this buffer gives to senior creditors in case of the bank's failure.

SR AND SRF

Fitch does not expect any changes to the SR and the SRF due to legislation requiring senior creditors to participate in losses for resolving The Co-operative Bank.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

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, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

The Co-operative Bank p.l.c.; Long Term Issuer Default Rating; Rating Watch Maintained; B-; RW: Neg
; Short Term Issuer Default Rating; Rating Watch Maintained; B; RW: Neg
; Viability Rating; Rating Watch Maintained; b-; RW: Neg
; Support Rating; Affirmed; 5
; Support Rating Floor; Affirmed; NF

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Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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Endorsement Status

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