

21 JUL 2021

## Fitch Upgrades The Co-operative Bank to 'B+'; Outlook Stable

Fitch Ratings - London - 21 Jul 2021: Fitch Ratings has upgraded The Co-operative Bank Plc's Long-Term Issuer Default Rating (IDR) to 'B+' from 'B'. The Outlook is Stable. The bank's Viability Rating (VR) has also been upgraded to 'b' from 'b-'.

The upgrade largely reflects improved profitability prospects, after several years of losses, aided by government-support measures and a buoyant housing market. This will benefit the bank's capitalisation and reduce downside risks to strategic execution. At the same time, the bank's risk appetite and asset quality have proved more resilient than expected.

### Key Rating Drivers

IDRS and VR

The Co-operative Bank's VR is weighed down by weaker capitalisation than peers', particularly in light of the bank's limited ability to generate internal capital due to weak structural profitability, despite recent improvements. The VR also considers a low risk business model, which focuses on mortgage lending; healthy asset quality; sound liquidity; and a resilient deposit base, which provides the majority of funding.

The Co-operative Bank's franchise has been resilient through various stresses, utilising its ethical focus to attract and maintain customers but the business model continues to face uncertainty, particularly given its limited diversification and scale. Its weak competitive advantage than larger universal banking peers' stems from a high cost base, which we believe will continue to pose challenges over the longer term. The bank has been successful in achieving greater scale in 1Q21 with 5% growth in its loan book, as it increased exposure to SMEs via government-backed schemes and took advantage of wider asset margins in the mortgage space to increase low-risk exposure to these sectors.

Asset quality is a rating strength for The Co-operative Bank with its loan book clean-up largely complete. Government-support measures for the housing market and the furlough scheme have supported headline asset-quality metrics with the bank reporting an impaired loan ratio of 0.3% at end-1Q21 (0.8% when including purchased originated credit-impaired loans).

The bank's low-risk business model primarily underwriting owner-occupied mortgages, with limited SME and unsecured exposure should continue to hold up well once support measures expire with limited deterioration. We forecast the average four-year impaired loan ratio to rise but to remain

below 2% at end-2022, supporting an upward revision of the bank's asset-quality score to 'bbb+' from 'bbb-'.

The Co-operative Bank posted a profit in 1Q21 for the first time since 2011, albeit small at GBP4.9 million. This was largely supported by its restructuring, wider spreads in the mortgage market and a one-off refund for business rates. However, overall structural profitability remains weak and faces ongoing challenges such as an expected decrease in asset margins, which have been strong since 2H20, and pressure on interest income due to debt issuance to meet regulatory requirements in 2022.

Nevertheless, we believe the bank is now better positioned to remain structurally profitable over the medium term, supported by reduced operating costs and the completion of longstanding projects in recent years. All this supports our revised assessment of earnings and profitability to 'b-' from 'ccc+'. The positive trend on this factor highlights scope for further improvement as the bank benefits from the economic recovery in the UK and positions itself for further growth.

The Co-operative's Bank's common equity Tier 1 (CET 1) ratio of 19.9% at end-1Q21 reflects a low-risk business model and the low risk weights assigned to mortgage assets under the bank's internal ratings-based approach. Although the CET1 ratio is in line with peers', we view capitalisation as weaker than peers' as buffers above minimum regulatory capital requirements of 12.8% should be considered in light of improved but limited internal capital generation and growth plans. In our assessment of capitalisation, we also consider the bank's tighter leverage ratio of 3.9% which remains a constraint on growth. The Co-operative Bank currently meets interim minimum requirement for own funds and eligible liabilities (MREL) as set by the Bank of England (BoE).

The bank is predominantly retail-funded, with a resilient core deposit base through various stresses. Access to wholesale markets remains limited compared with peers' and is largely in the form of covered bonds, securitised funding and access to low-cost central-bank funding schemes. The BoE's Term Funding Scheme drawings for SMEs amounted to GBP1.75 billion at end-1Q21 and were staggered to reduce refinancing risks when funding matures. The bank's reliance on this funding is expected to materially increase asset encumbrance to the higher end versus mortgage lending peers'.

Liquidity is healthy with a large buffer of high-quality liquid assets (15% of total assets at end-1Q21). The bank's liquidity coverage ratio of 163% at end-1Q21 remained well above the regulatory requirement.

Fitch assigns a one-notch uplift to The Co-operative Bank's 'B+' Long-Term IDR to reflect the presence of resolution debt buffers, which provide protection to the bank's third-party senior creditors in case of failure. We calculate that these debt buffers, composed of Tier 2 debt as well as senior non-preferred debt issued by The Co-operative Bank Finance Plc, totalled 9.3% at 1Q21. We expect further MREL-eligible debt issuance to meet end-state MREL set by the BoE on a sustained basis.

The Short-Term IDR of The Co-operative Bank 'B' is the only short-term option mapping to the Long-Term IDR.

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 in resolving the bank.

## **RATING SENSITIVITIES**

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, which could manifest in a stable positive operating profit/risk-weighted assets ratio, while maintaining healthy buffers above capitalisation requirements.

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 14% with no discernible actions to reverse the trend or if pressure increases on the UK leverage ratio.

The Long-Term IDR is also sensitive to the bank remaining subject to the regulatory resolution buffer requirements as communicated by the BoE and maintaining a sustainable buffer amount, which includes qualifying junior debt and internal subordinated debt down-streamed from 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 regulatory resolution requirements.

### **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 in 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

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](http://www.fitchratings.com/esg)

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### Rating Actions

ENTITY/DEBT	RATING	RECOVERY	PRIOR	
The Co-	LT IDR	B+ ●	Upgrade	B ●

ENTITY/DEBT	RATING		RECOVERY	PRIOR
operative Bank p.l.c.				
	ST IDR	B	Affirmed	B
	Viability	b	Upgrade	b-
	Support	5	Affirmed	5
	Support Floor	NF	Affirmed	NF

#### RATINGS KEY OUTLOOK WATCH

POSITIVE	⊕	◊
NEGATIVE	⊖	◊
EVOLVING	◊	◆
STABLE	◐	

#### Applicable Criteria

[Bank Rating Criteria \(pub.28 Feb 2020\) \(including rating assumption sensitivity\)](#)

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