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Fitch Upgrades The Co-operative Bank to 'B'; Negative Outlook

Fitch Ratings - London - 18 Jan 2021: Fitch Ratings has upgraded The Co-operative Bank Plc's Long-Term Issuer Default Rating (IDR) to 'B' from 'B-' and removed it from Rating Watch Negative (RWN). Fitch has also affirmed the bank's Viability Rating at 'b-' and Short-Term IDR at 'B'. The Outlook on the Long-Term IDR is Negative.

The upgrade of the IDR reflects Fitch's view that the issuance by The Co-operative Bank's holding company parent, The Co-operative Bank Finance Plc, of GBP200 million of senior debt in November 2020, provides an additional layer of protection to the bank's senior creditors in the case of failure of the bank. The senior debt qualifies for minimum requirements of own funds and eligible liabilities (MREL) and has been downstreamed in a way that ranks it subordinate to The Co-operative Bank's other senior creditors, but remains senior to the bank's subordinated liabilities. The Co-operative Bank Finance Plc heads up the group's resolution group.

Fitch has removed The Co-operative Bank's ratings from RWN because it believes that the bank's vulnerability to further material capital losses has decreased due to improving economic conditions, as well as actions it has taken to improve its structural profitability. We believe that the bank's need to grow and restructure its business amid economic uncertainties, combined with expected pressures on asset quality and capital, continue to put pressure on its ratings. Fitch has therefore assigned the bank's Long-Term IDR a Negative Outlook.

Key Rating Drivers

IDRs and VR

The Co-operative Bank's VR primarily reflects the vulnerability of capital to further losses as well as higher risk-weighted assets (RWA) as a result of regulatory changes and economic conditions. The bank is still structurally loss-making, although this is slowly improving. Earnings generation and capital erosion are two factors of high importance to the ratings. The ratings also consider the bank's healthy loan quality, adequate liquidity and resilient franchise.

The Co-operative Bank's business model is focused on low-risk mortgage lending with limited unsecured and SME lending. Although the business model is now on more stable footing, we still believe there are questions around the long-term direction of the business from a risk and a scale perspective as its cost base is currently too high for the level of revenues it generates.

Earnings benefited from strong volume growth in mortgages in 2H20 as well as wider mortgage lending yields, thanks to resilient housing and mortgage markets. At the same time, the bank has been able to reduce its funding costs, largely thanks to the availability of the extended Term Funding Scheme from the Bank of England (TFSME), as well as cuts in its operating cost base and investment spend. The outlook for profitability has stabilised

Funding costs are negatively affected by the issuance of its GBP200 million MREL-compliant debt at the end of 2020. However, in accordance with a consultation paper published at end-December 2020, the regulators are expected to extend by up to a year the timeline by which the bank needs to raise the additional MREL, estimated at around GBP350 million, that it requires under its end-state resolution plans.

Asset quality remains healthy, with low levels of default and impairments, and near finalisation of its loan book restructuring. Nonetheless, in light of the expected rise in unemployment, Fitch expects a rise in impaired loans from 2021. Given the healthy loan book, we expect this deterioration to be manageable.

We consider capitalisation to be weak. Capital ratios have remained stable, with a reported common equity Tier 1 ratio of 19.1% at end-3Q20, which is above minimum requirements (13.5% including buffers). This subsequently fell further to 12.7% in 4Q20. However, challenges for capitalisation include large scale RWA inflation resulting from regulatory changes, additional losses for 2020, and deteriorating economic conditions. In our opinion, the bank's capitalisation is low and vulnerable to larger than expected moves in both RWA and losses. The bank's Basel III leverage ratio, 3.6% at end-3Q20, is low compared with peers.

The Co-operative Bank operates a deposit-led funding model with limited reliance on wholesale funding outside of central bank and other secured funding. The bank had a loan-to-deposit ratio of 91% at end-3Q20. Customer deposits account for the majority of funding and have been resilient through various stresses, providing the bank's funding profile with some stability. The bank has repaid all outstanding low cost TFS funding, had drawn GBP1 billion of TFSME at end-3Q20 and should be able to further draw down at least an additional GBP1 billion based on Fitch's calculations.

We believe that following the issuance of senior MREL-compliant debt the additional protection provided to the operating company's senior creditors warrants a one-notch uplift of the Long-Term IDR as this MREL-eligible debt will eventually be sufficient to restore the bank's viability in case of failure. The bank plans to issue further MREL-qualifying debt under its resolution plan to meet the current end-state requirements of the resolution authority, the Bank of England.

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, the SR and the SRF reflect the lack of systemic importance of the bank.

RATING SENSITIVITIES

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

The Negative Outlook on the bank's Long-Term IDR reflects the continuing risks the bank faces as a result of the economic fallout arising from the pandemic. Although the economic outlook shows signs of improvements as a result of reaching a trade deal between the EU and UK, in addition to the vaccine rollout, material uncertainties remain, including the depth and maturity of additional lockdown measures. The bank's ratings are therefore primarily sensitive to the implications of these uncertainties on its financial factors, including profitability and capitalisation.

In addition, the bank's ratings will likely be downgraded if it is unable to show further improvement in profitability or to execute its rehabilitation plans.

The Long-Term IDR is also sensitive to the bank remaining subject to the regulatory resolution buffer requirements as communicated by the Bank of England and maintaining a sustainable amount of such buffers, which include 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.

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

In the event that the bank withstands rating pressure arising from the pandemic, the most likely trigger for a revision of the Outlook to Stable or an upgrade of the ratings would be evidence of medium-term earnings and capitalisation resilience. This would require some tangible success in executing its turnaround plan, including building up its loan base and increasing revenues, while maintaining a tight grip on costs and loan impairment charges. Ultimately, the bank will need to improve its access to capital, either through internal generation or from external sources if it is to improve the viability of its business model.

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 sectorspecific 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

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
The Co-operative Bank p.l.c.	LT IDR	B	Upgrade		B-
	ST IDR	B	Affirmed		B
	Viability	b-	Affirmed		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)

Additional Disclosures

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Endorsement Status

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