

FITCH MAINTAINS THE CO-OPERATIVE BANK'S 'B' IDR ON RWN; AFFIRMS VR

Fitch Ratings-London-30 July 2019: Fitch Ratings has maintained The Co-operative Bank p.l.c.'s 'B' Long-Term Issuer Default Rating (IDR) on Rating Watch Negative (RWN). At the same time Fitch has affirmed The Co-operative Bank's Viability Rating (VR) at 'b'.

A full list of rating actions is at the end of this rating action commentary.

Fitch placed the Long-Term IDR on RWN on 1 March 2019 (see "Fitch Places Long-Term IDRs of 19 UK Banking Groups on RWN"), to reflect the heightened uncertainty over the ultimate outcome of the UK's exit from the European Union and the increased risk that a disruptive 'no-deal' Brexit could result in negative action on UK banks, most likely with Negative Outlooks being assigned.

Fitch expects to resolve the RWN on the UK's scheduled exit from the EU. In the event a Brexit agreement is concluded, all else being equal, we would resolve the RWN and assign a Stable Outlook.

KEY RATING DRIVERS

IDRs and VR

The Co-operative Bank's IDRs and VR primarily reflect the vulnerability of the bank's capital to continued losses. It also incorporates heightened execution risk as the bank continues to restructure in the context of economic uncertainties and competitive pressures in the market. The ratings also reflect the improvements the bank has been making on its risk controls and its resilient franchise.

The Co-operative Bank reported a pre-tax loss of GBP141 million in 2018 and we expect that the bank will remain loss-making for the next two to three years. This is due to tight margins and the bank's ongoing investment in IT systems and digital capabilities. Profitability benefits from cyclically low impairment charges, and progress in growing revenue, strengthening the net interest margin and improving cost efficiency in line with the bank's strategy are key to returning to profitability and mitigating increased through-the-cycle impairments. We consider profitability to be a factor of higher importance to the bank's VR.

We also view capitalisation as a higher-importance factor to The Co-operative Bank's VR. The bank's sound common equity Tier 1 (CET1) ratio of 22.3% at end-2018 benefits from recent capital raises and several years of legacy asset deleveraging (particularly the securitisation of a large portion of the legacy Optimum portfolio in 2017) and provides headroom to absorb moderate losses. While the CET1 ratio now meets regulatory requirements, partly thanks to a reduced Pillar 2a requirement in 2018, we understand that the bank is not fully in line with its minimum capital guidance as set by the PRA, but retains a significant surplus to its overall capital requirements. The capital ratios, which are due to fall over the next three to four years, remain vulnerable to significant unexpected losses.

The bank's franchise is resilient and benefits from a loyal customer base, although its size makes it a modest player and a price-taker in the UK retail market. Wholesale market funding is limited and focuses on secured issuances although the bank successfully issued GBP200 million Tier 2 debt in April 2019.

Asset quality continues to improve and deleveraging progress means that legacy assets now form a small proportion of the loan book. The core book is mainly comprised of moderate-loan/value prime mortgage loans. Deleveraging and supportive economic conditions have driven a continued

decline in impaired loans (Stage 3 loans accounted for 1% of end-2018 loans, while Stage 3 and POCI loans formed 2.8%) to be closer in line with UK mortgage lending peers. We expect asset quality to benefit from a strengthened risk appetite and improving risk controls in the medium term. This includes increased automation in the credit risk underwriting and monitoring process, although the strengthened risk framework has yet to be tested under conditions of strong core loan growth.

The Short-Term IDR maps 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 group becomes non-viable, both due to its low systemic importance and 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 group.

RATING SENSITIVITIES

IDRs and VR

The Long-Term IDR is primarily sensitive to the manner in which the UK leaves the EU as indicated by the RWN, which reflects the heightened probability that Fitch will assign a Negative Outlook in the event of a disruptive 'no-deal' Brexit. We believe that in an adverse Brexit scenario, the bank would face severe headwinds affecting its ability to execute its strategy and return to profitability in the medium term.

The IDR and the VR could be downgraded if the bank is not able to successfully implement the outstanding areas of restructuring or if business growth accelerates without an adequate risk control infrastructure in place. A failure to improve structural profitability or to stem losses in the next two to three years, which would cause an erosion of capital, could also result in a downgrade.

An upgrade of the bank's ratings will require evidence of a sustained improvement of its structural profitability.

SUPPORT RATING AND SUPPORT RATING FLOOR

Fitch does not expect any changes to the SR and the SRF given the low systemic importance of the bank as well as the legislation in place that is likely to require senior creditors to participate in losses for resolving The Co-operative Bank.

The rating actions are as follows:

Long-Term IDR: 'B' maintained on RWN

Short-Term IDR: affirmed at 'B'

Viability Rating: affirmed at 'b'

Support Rating: affirmed at '5'

Support Rating Floor: affirmed at 'No Floor'

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Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018)

<https://www.fitchratings.com/site/re/10044408>

Short-Term Ratings Criteria (pub. 02 May 2019)

<https://www.fitchratings.com/site/re/10073011>

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