FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms The Co-operative Bank at 'B+'; Outlook Stable

Fri 25 Mar, 2022 - 10:45 ET

Fitch Ratings - London - 25 Mar 2022: Fitch Ratings has affirmed The Co-operative Bank plc's Long-Term Issuer Default Rating (IDR) at 'B+', with a Stable Outlook and the Short-Term IDR at 'B'. The bank's Viability Rating (VR) has been affirmed at 'b'.

Fitch has withdrawn the bank's Support Rating of '5' and Support Rating Floor of 'No Floor' as they are no longer relevant to Fitch's coverage following the implementation of its updated Criteria in November 2021. In line with the updated criteria, we have assigned The Co-operative Bank a Government Support Rating (GSR) of 'no support' (ns).

KEY RATING DRIVERS

The Co-operative Bank's VR is below the 'bb' implied VR as we consider the bank's capitalisation and leverage (scored at 'b') to be weak, and this has a strong impact on our overall view of the bank's credit profile. The VR also reflects the bank's resilient franchise, healthy asset quality and improved profitability prospects. We consider its business model remains vulnerable to external pressures given strong competition in UK mortgage lending.

The Co-operative Bank's Long-Term IDR is one notch above its VR because we believe that there are sufficient resolution funds issued by The Co-operative Bank Finance plc, the bank's intermediate holding company (not rated), which afford additional protection to the bank's external senior creditors, in case of its failure.

Resilient Franchise: The bank's ethical focus has helped it to attract and retain customers, building resilience in its franchise. However, its business continues to face uncertainty, given its limited scale and lack of diversification. High costs continue to pose a challenge and put it at a disadvantage compared with other mortgage lending peers. The bank was successful in growing its loan book in 2021, taking advantage of wider mortgage margins and government-backed SME loan schemes, but its market share remains small, limiting its pricing power.

Healthy Asset Quality: Asset quality is healthy, with low arrears and moderate mortgage loan-to-value ratios. Government support measures for the housing market and the furlough scheme have supported loan health, with the bank reporting an impaired loan ratio of 0.3% at end-2021 (0.7% when including purchased originated credit-impaired loans, which are not all Stage 3). Given the low risk nature of its loans, we believe that loan deterioration through a downturn will be manageable, with an average four-year impaired loan ratio remaining below 2%.

Profitable from 2021: The Co-operative Bank became profitable in 2021 after nine years of losses thanks to its restructuring, strong business volumes combined with wider spreads in the mortgage market, significantly lower funding costs, and one-off items including rebates and tax credits. However, structural profitability remains weak, and is vulnerable to competitive pressures on asset margins, the bank's capacity to grow business and rising funding costs, including interest on additional debt buffers to be built from 2022. Nevertheless, we believe the bank is now better positioned over the medium term, supported by rising interest rates, and reduced operating costs.

Weak Capitalisation: The bank's common equity Tier 1 (CET1) ratio of 20.2% at end-2021 reflects the low risk weights assigned to mortgage loans under the bank's internal ratings-based approach and is due to fall to about 17% by end-2022 as a result of incoming regulatory changes. The bank's UK leverage ratio of 3.8% is due to fall to 3.6% at end-2022 and remains a constraint on growth. The Co-operative Bank is not bound by a minimum regulatory leverage requirement, but we believe the regulators would expect it to operate with at least 3.25%. The bank does not meet its PRA buffer but meets interim minimum requirement for own funds and eligible liabilities (MREL).

Resilient Customer Funding: The bank is predominantly retail-funded, with a resilient core deposit base. Access to wholesale markets is limited and largely consists of the recently issued MREL-eligible debt, Tier 2 debt and the Bank of England's Term Funding Scheme (TFSME) drawings for SMEs. Liquidity is healthy with large holdings of cash at the Bank of England boosted by the recent TFSME drawing, which raised its liquidity coverage ratio to 241% at end-2021.

No Support: The GSR reflects Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities if The Co-operative Bank becomes non-viable, in light of the legislation in place that is likely to require senior creditors to participate in losses for resolving the bank.

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RATING SENSITIVITIES

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 16% or if its UK leverage ratio falls towards 3.25%, with no clear actions to reverse the trend. This would likely be caused by faster than planned growth or an unexpected return to losses.

The Long-Term IDR is also sensitive to the bank being able to build up its end-state regulatory resolution buffer requirements as communicated by the Bank of England, which includes qualifying junior debt and internal subordinated debt down-streamed from its intermediate holding company, 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 MREL regulatory requirements.

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, and to demonstrate its ability to generate sufficient internal capital to allow it to grow and build up the scale it requires to compete efficiently with peers, while maintaining healthy buffers above minimum capital requirements. Upside potential will also be contingent on the bank being able to absorb the costs of issuing MREL-eligible debt to meet end-state requirements.

VR ADJUSTMENTS

The VR has been assigned below the implied VR due to the following adjustment reason: Weakest Link - Capitalisation and Leverage (negative)

The Operating Environment score has been assigned in line with the implied score. The Sovereign Rating was identified as a relevant negative factor in our assignment

The Business Profile score has been assigned below the implied score due to the following adjustment reason: Business Model (negative), Market Position (negative)

The Asset Quality score has been assigned below the implied score due to the following adjustment reasons: Underwriting Standards and Growth (negative), Concentration (negative)

The Capitalisation and Leverage score has been assigned below the implied score due to the following adjustment reasons: Leverage and Risk-Weight Calculation (negative), Capital Flexibility and Ordinary Support (negative)

The Funding and Liquidity score has been assigned below the implied score due to the following adjustment reason: Non-Deposit Funding (negative)

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.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR

The Co-operative Bank p.l.c.	LT IDR	B+ Rating Outlook Stable Affirmed	B+ Rating Outlook Stable
	ST IDR	B Affirmed	B
	Viability	b Affirmed	b
	Support	WD Withdrawn	5
	Support Floor	WD Withdrawn	NF
	Government Support	ns New Rating	

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 12 Nov 2021) (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.	EU,UK Endorsed

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Structured Finance: Covered Bonds Banks Structured Finance Europe

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