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Fitch Upgrades The Co-operative Bank to 'BB'; Outlook Stable

Fitch Ratings - London - 02 Feb 2023: Fitch Ratings has upgraded The Co-operative Bank plc's Long-Term Issuer Default Rating (IDR) to 'BB' from 'B+'. The Outlook is Stable. The bank's Viability Rating (VR) has also been upgraded to 'bb-' from 'b'.

The upgrade reflects Fitch's view that despite the weak economic outlook for the UK, the immediate risks to The Co-operative Bank's capitalisation and leverage have materially reduced, given the bank's significantly improved profitability and progress made with its restructuring. Improved internal capital generation, which has benefited from the rising interest rate environment, also supports our assessment of the bank's business model stability.

Key Rating Drivers

Compliant With Regulatory Buffers: The Co-Operative Bank's VR is one notch below the 'bb' implied VR because its business model, which we believe is vulnerable to competitive pressures, has a strong impact on its VR. The VR also reflects the bank's low-risk credit exposures, healthy impaired loans ratio, strengthened profitability, improved capitalisation as it now meets regulatory capital requirements, and reasonable funding and liquidity.

Resilient Franchise: The bank's ethical focus has helped it to attract and retain customers, building resilience in its franchise. However, the bank's limited scale, low market shares and lack of diversification weigh on its business model. Structural profitability has improved with effective cost management following the completion of the restructuring process in 2021, but costs remain relatively high compared with peers.

Mortgage Lending Dominates Assets: The Co-operative Bank has tightened its underwriting standards and risk controls, which are in line with other UK mortgage lenders primarily writing low-risk residential and buy-to-let mortgages with a small share of unsecured retail and higher loan-to-value (LTV) lending. We expect mortgage lending growth to be muted in 2023, given higher interest rates and housing market uncertainty. The average mortgage LTV in the portfolio (end-June 2022: 55.2%) provides a buffer against a moderate house price correction.

Healthy Asset Quality: Asset quality has remained healthy, with low arrears and moderate mortgage LTVs. The bank reported an impaired loan ratio of 0.3% at end-1H22 (or 0.7% when including purchased originated credit impaired loans). We expect the impaired loans ratio to rise to around 0.5% of gross loans by end-2024, mainly due to higher interest rates, the expected recession in 2023, and affordability pressures. Nevertheless, The Co-operative Bank is well positioned due to the low risk

nature of its loans and conservative underwriting standards.

Improved Structural Profitability: Profitability continued to improve in 1H22 with operating profit/risk-weighted assets of 2.6% (2021: 0.7%), supported by wider mortgage margins and a modest pass-through of interest rate increases to savers. However, asset margins remain vulnerable to competitive pressures and slowing growth in a more challenging housing market. Revenues are also sensitive to the bank's capacity to grow business and to rising funding costs. Nevertheless, we expect rising interest rates and reduced operating costs to underpin the bank's profitability.

Improved Capital Position: The Co-operative Bank's common equity Tier 1 (CET1) ratio of 19.3% at end-September 2022 reflects the low risk weights assigned to mortgage loans under the bank's internal ratings-based approach. The bank is now fully compliant with regulatory requirements and had resources in excess of end-state minimum requirements for own funds and eligible liabilities (MREL). The leverage ratio remained stable at 3.8% at end-September 2022 (end-2021: 3.8%), and is expected to modestly strengthen, putting the bank in a better position to gradually expand its balance sheet.

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 MREL-eligible debt, Tier 2 debt and the Bank of England's Term Funding Scheme with additional incentives for SMEs (TFSME). The bank was able to place an additional GBP250 million MREL issuance in April 2022. Liquidity is healthy with large holdings of cash at the Bank of England boosted by TFSME drawings, which raised the liquidity coverage ratio to 270% at end-September 2022.

The Short-Term IDR of 'B' maps to the only available option for a Long-Term IDR of 'BB' under Fitch's rating criteria.

Rating Uplift to Opco: 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, which afford additional protection to the bank's external senior creditors, in case of its failure.

No Support: The Government Support Rating (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.

Rating Sensitivities

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

The ratings could be downgraded if The Co-operative Bank recorded weaker-than-expected profitability or faster-than-planned growth that eroded buffers against CET1 and leverage ratio requirements, with no clear actions to restore them.

The Long-Term IDR is also sensitive to the bank being able to meet its end-state regulatory resolution buffer requirements, which includes qualifying junior debt and internal subordinated debt. 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 record of improved structural profitability, and to continue to demonstrate its ability to generate sufficient capital while maintaining healthy buffers above minimum capital and leverage requirements. In turn, stronger capital buffers that supported the bank's business growth, competitiveness and scale could support our business profile assessment and the bank's VR.

VR ADJUSTMENTS

The Viability Rating has been assigned below the implied Viability Rating due to the following adjustment reason(s): Business Profile (negative).

The operating environment score of 'aa-' is at the lower end of the range because it is constrained by the UK's sovereign rating of 'AA-/Negative (negative).

The business profile score of 'bb-' has been assigned below the 'bbb' category implied score due to the following adjustment reason: business model (negative), market position (negative).

The asset quality score of 'bbb+' has been assigned below the 'aa' category implied score due to the following adjustment reasons: concentration (negative).

The earnings and profitability score of 'bb-' has been assigned above the 'b' category implied score due to the following adjustment reasons: historical and future metrics (positive).

The capitalisation and leverage score of 'bb-' has been assigned below the 'aa' category 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 of 'bb+' has been assigned below the 'a' category 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. 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	BB 	Upgrade	B+ 
	ST IDR	B	Affirmed	B
	Viability	bb-	Upgrade	b
	Government Support	ns	Affirmed	ns

RATINGS KEY OUTLOOK WATCH

POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

[Bank Rating Criteria \(pub.07 Sep 2022\) \(including rating assumption sensitivity\)](#)

Additional Disclosures

[Solicitation Status](#)

Endorsement Status

The Co-operative Bank p.l.c. UK Issued, EU Endorsed

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