FitchRatings

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

Fitch Ratings-London-08 November 2016: Fitch Ratings has affirmed The Co-operative Bank Plc's (Co-op Bank) Long-Term Issuer Default Rating (IDR) at 'B' and Viability Rating (VR) at 'b'. The Outlook on the Long-Term IDR is Stable. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS
IDRS, VR AND SENIOR DEBT
Co-op Bank's IDRs and VR reflect our expectation of a continued erosion of its capital through losses, counterbalanced by a stabilisation of its franchise, improving underwriting standards and asset quality, and relatively sound liquidity. We believe the bank will continue to maintain sufficient capital to remain viable, but its margin of safety is limited and vulnerable to a change in economic or business conditions.

We expect the bank to continue to report losses until at least 2017. As a result, we expect its already weak capital to reduce further and to remain well below its Individual Capital Guidance (ICG) set by the UK regulator, until at least 2019. Its ability to generate profits is under pressure from low base rates and high costs, and following the June 2016 EU referendum, from a highly uncertain and possibly weakening economic environment in the UK.

At the same time, the bank continues to face the challenge of having to make further investments in its IT systems and risk controls, both of which require greater investment than originally envisaged. The highest risk the bank faces is its ability to fund all the investments it needs from its current capital base. Alongside weak earnings capacity, we believe that its ability to raise external capital is limited.

The structural profitability of its core business should begin to improve from 2018, particularly once it completes unwinding the fair value adjustments associated with its 2009 merger with Britannia Building Society. These have had a large negative impact on the bank's net interest margin and profitability in 2016 and will continue to impinge profitability in 2017. However, as these reduce the profitability of its core business should begin to improve.

Nonetheless, a return to profitability is highly correlated with its ability to generate new, better quality and higher yielding mortgage loans and for operating costs to continue to reduce. Costs are particularly important given the bank's strategic focus on building up a low-risk mortgage book to form the majority of its loan portfolio.

To improve efficiency the bank has to make further significant investments in IT systems, to improve automation, digitalisation and improve risk controls. It will also have to embed its risk management framework across the organisation.

The bank has made some improvements since its turnaround strategy was announced. Asset quality has improved significantly, with impaired loans falling to just 4.4% of gross loans at end-1H16. The bank achieved this by selling non-core assets and thanks to benign economic conditions, with low levels of unemployment and rising house prices. The latter have helped Co-op Bank's asset performance, particularly given the high proportion of non-conforming mortgages (in its Optimum loans and its available for sale portfolios) in its books. However, reserve coverage of impaired loans remains lower than average, and renders the bank's capital somewhat vulnerable to falling real estate prices.

The bank has also made some improvements in its underwriting standards and new mortgages are of better quality.

Co-op Bank's funding and liquidity profile have remained relatively sound. Funds are largely obtained from customer deposits, mostly retail but also from SMEs. Primary liquidity was held at a reasonable 12.7% of total assets at end-1H16, which is in line with the sector, and is of good quality. In addition, the bank has significant access to contingent sources. However, we continue to believe that access to funding and liquidity is correlated with banks' capital positions.

We expect the bank's current CET1 ratio of 13.4% (end-1H16) to reduce by end-2016 and again by end-2017, unless it is able to reduce risk weighted assets further in a capital accretive way during the period. While this continues to place it in regulatory forbearance in terms of guidance, our base case is that it will not break minimum capital requirements. Nonetheless, it is vulnerable to potentially worse economic conditions (higher unemployment, falling house prices) or higher IT requirements, either of which could place the bank at risk of failure.

The bank's senior debt is rated in line with its IDR, reflecting Fitch's expectations of average recovery prospects for senior debt holders in the event of default or resolution (Recovery Rating of 'RR4').

The bank's junior debt is not sufficient to allow for a higher IDR than its VR.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)
Co-op Bank's SR and SRF reflect Fitch's view that senior creditors cannot rely on extraordinary support from the UK authorities in the event the group becomes non-viable given the resolution legislation in place as well as its low systemic importance. In our opinion, it is likely that on resolution, the bank's senior creditors will be required to participate in losses to resolve the bank.

RATING SENSITIVITIES
IDRS, VR AND SENIOR DEBT
Co-op Bank's ratings could be negatively affected by larger than expected one-off losses and a continued erosion of capital, without an improvement in the profitability of the core franchise, or materially higher than budgeted investment needs.

The ratings could also be downgraded if management does not continue to unwind the legacy portfolio and improve risk management and other IT infrastructure, as this could mean that the bank's business model becomes structurally unprofitable. A material weakening of the economic environment in the UK could also lead us to question the viability of the business model.

Positive rating action is highly unlikely until the bank improves underlying profitability and capital generation, and risk control measures strengthen further.

Senior debt is also sensitive to our assessment of recoveries that the bank's senior debt holders could expect in the case of default.

SUPPORT RATING AND SUPPORT RATING FLOOR
An upgrade of the SR and upward revision of the SRF would be contingent on a positive change in the sovereign's propensity to support its banks. While not impossible, this is highly unlikely, in Fitch's view.

The rating actions are as follows:
Long-Term IDR affirmed at 'B'; Outlook Stable
Short-Term IDR affirmed at 'B'
Viability Rating affirmed at 'b'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'No Floor'
Senior unsecured notes' Long-term rating affirmed at 'B'/'RR4'
Senior unsecured notes' Short-term rating affirmed at 'B'

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Applicable Criteria
Global Bank Rating Criteria (pub. 15 Jul 2016) (https://www.fitchratings.com/site/re/884135)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1014477)
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