

18 May 2020 | Rating Changed Outlook to Negative

Fitch Revises Outlook to Negative on Credit Union Baywide & New Zealand Association of Credit Unions

Fitch Ratings-Sydney-18 May 2020:

Fitch Ratings has revised the Outlook to Negative, from Stable, on the Long-Term Issuer Default Rating (IDR) of Credit Union Baywide (CUB) and its fully owned subsidiary, New Zealand Association of Credit Unions (trading as Co-op Money NZ). At the same time, Fitch has affirmed the ratings at 'BB' and 'BB-', respectively.

We view the buffers in CUB's credit profile to be sufficient to withstand our base case scenario. However, the Outlook revision reflects significant downside risk to our base case expectations for the downturn. Details of the base case and downside case can be found at www.fitchratings.com/site/re/10120570

Key Rating Drivers

IDRS and VIABILITY RATING

CUB's Long-Term IDRs are driven by its Viability Rating, which in turn reflects its greater risk appetite relative to New Zealand banks and building societies. The higher risk appetite is reflected in a focus on riskier segments, such as higher loan/value mortgages and consumer lending, though CUB's risk controls are adequate for its size and consistent with similarly sized peers. This leaves CUB's financial profile susceptible to weakening in a downturn, such as the one that is emerging due to measures aimed at slowing the spread of the coronavirus.

Fitch has revised the outlook on the 'a-' operating environment score for New Zealand non-bank deposit takers to negative, from stable, to reflect the significant downside risk posed by the measures undertaken to slow the spread of the coronavirus pandemic. We are likely to revise this outlook to stable if our base case of a recovery starting in 2H20 eventuates. However, an outcome that is significantly weaker than our base case is likely to result in a lowering of the score to 'bbb+'.

The factor outlooks for asset quality (score of 'bb') and earnings (score of 'bb') have been revised to negative, from stable, to reflect our expectation of weakening.

CUB's impaired loan ratio has large buffers at the current score, but its higher risk appetite leaves its loan book susceptible to weakening in an economic downturn, as highlighted by the negative factor outlook. This reflects a higher exposure to non-mortgage consumer lending and higher loan/value ratio mortgages than most New Zealand bank and non-bank-deposit takers rated by Fitch. Large deterioration in asset quality metrics are unlikely before late 2020 due to actions taken by the government and authorities to support households, but we expect it to take a number of years for financial institutions to resolve their impaired loans once they begin to emerge.

This in turn is likely to weigh on earnings for at least the next two years. We expect impairment charges to rise sharply to address the asset-quality weakening, while low rates may pressure the net interest margin and keep loan growth negligible. CUB's earnings already faced headwinds prior to the pandemic due to costs associated with a merger with three other credit unions in May 2019 and the acquisition of Co-op Money NZ in November 2019.

CUB's capitalisation remains a weakness for the rating, with the factor score at 'bb-'. Fitch has revised the outlook on the factor score to stable, from positive, to reflect our expectation of further deterioration of capitalisation as a result of the downturn due to weaker asset quality and earnings. We had previously expected CUB to restore capital buffers to better align with management targets for capitalisation by mid-2021; this now appears unlikely to occur over the next two years. However, we believe CUB has sufficient capital buffers at the current score to withstand our base case scenario.

Customer deposits are likely to remain the main source of CUB's funding and there is headroom in the 'bb+' factor score. However, CUB, along with other New Zealand non-bank deposit takers, does not have access to the central bank as a lender of last resort, which leaves it susceptible to deposit outflows in a severe market downturn.

SUPPORT RATING AND SUPPORT RATING FLOOR

The Support Rating and Support Rating Floor reflect our view that, while support from the New Zealand sovereign (AA/Positive) is possible, it cannot be relied on. CUB is not part of the open bank resolution scheme, which allows for the imposition of losses on depositors and senior debt holders to recapitalise failed institutions. However, Fitch believes the existence of the scheme, in conjunction with CUB's low systemic importance, makes sovereign support doubtful.

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Co-op Money NZ's IDRs and Support Rating reflect a moderate probability of extraordinary institutional support from its shareholder, CUB. Fitch believes Co-op Money NZ is a strategically important part of CUB because it provides critical banking and transactional services on which CUB and other credit unions rely to operate their business. The revision in the Outlook on Co-op Money NZ reflects the same action taken on the Outlook of CUB.

Co-op Money NZ's Long-Term IDR is notched down once from that of CUB to reflect our view that, while Co-op Money NZ is important to CUB's operation, not all of its operations relate to the sale of products and services to members. Co-op Money NZ's operations also include sales to third parties, which are not integral to its members. As per Fitch's criteria, the notching also reflects our view that, while there are no plans to sell parts of Co-op Money NZ, CUB's franchise would not be fundamentally altered should this occur.

RATING SENSITIVITIES

IDRS and VIABILITY RATING

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

CUB's Long-Term IDR and Viability Rating could be downgraded if the economic environment deteriorates significantly beyond our baseline case scenario. We would expect to lower the operating environment score for New Zealand non-bank deposit takers to 'bbb+' under this downside scenario, which would result in a lowering of our assessment of many financial profile factors.

CUB's Long-Term IDRs and Viability Rating may also be downgraded even if the operating environment score remains unchanged if, individually or in combination:

- impaired loans/gross loans increase above 10% on a consistent basis;
- operating profit/risk-weighted assets fall below 0.25% for a sustained period; or
- the Fitch core capital ratio declines below 9.5% without a credible plan to replenish regulatory capital buffers.

CUB's Short-Term IDR would only be downgraded if the Long-Term IDR were downgraded to 'CCC+' or below.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

The Outlook on CUB's Long-Term IDRs may be revised to Stable if economic variables perform broadly in line with our base case. Under such a scenario, we would expect weakening of the financial profile to be sufficiently limited to ensure metrics broadly align with the Viability Rating of 'bb'.

An upgrade of the Viability Rating and Long-Term IDRs is unlikely in the short-term, as it would require a shallower downturn and sharper recovery than our base case combined with an improved risk appetite and capital buffers. An upgrade of the Short-Term IDR would require an upgrade of the Long-Term IDR to at least 'BBB-'.

SUPPORT RATING AND SUPPORT RATING FLOOR

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

The Support Rating and Support Rating Floor are sensitive to any change in assumptions around the propensity or ability of the New Zealand government to provide timely support. An increased propensity to support would be required for an upgrade, but appears unlikely given the resolution framework in place.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

The Support Rating and Support Rating Floor are already at the lowest level on Fitch's rating scales and cannot be downgraded further.

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Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

Positive rating action (either an upgrade or Outlook revision) on Co-op Money NZ's Long-Term IDR would occur if CUB's Long-Term IDR is upgraded and the propensity to support is unchanged. An upgrade of the Short-Term IDR and Support Rating would require CUB's Long-Term IDR to be upgraded by at least three notches, which appears unlikely.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

Co-op Money NZ's Long-Term IDR and Support Rating could be downgraded if CUB's Long-Term IDR is downgraded. Co-op Money NZ's Long-Term IDR could be downgraded by multiple notches if Fitch believed there was a reduced propensity from CUB to provide ongoing support to Co-op Money NZ.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions 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.

Public Ratings with Credit Linkage to other ratings

Co-op Money NZ's ratings are linked to the ratings of its owner, CUB.

ESG Considerations

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Credit Union Baywide; Long Term Issuer Default Rating; Affirmed; BB; RO:Neg

; Short Term Issuer Default Rating; Affirmed; B

; Local Currency Long Term Issuer Default Rating; Affirmed; BB; RO:Neg

; Local Currency Short Term Issuer Default Rating; Affirmed; B

; Viability Rating; Affirmed; bb

; Support Rating; Affirmed; 5

; Support Rating Floor; Affirmed; NF

New Zealand Association of Credit Unions; Long Term Issuer Default Rating; Affirmed; BB-; RO:Neg

; Short Term Issuer Default Rating; Affirmed; B
; Support Rating; Affirmed; 3

Contacts:

Primary Rating Analyst

Tim Roche,

Senior Director

+61 2 8256 0310

Fitch Australia Pty Ltd

Level 15 77 King Street

Sydney NSW 2000

Primary Rating Analyst

Jack Do,

Director

+61 2 8256 0355

Fitch Australia Pty Ltd

Level 15 77 King Street

Sydney NSW 2000

Secondary Rating Analyst

George Hong,

Director

+61 2 8256 0345

Secondary Rating Analyst

Tim Roche,

Senior Director

+61 2 8256 0310

Committee Chairperson

Heakyu Chang,

Senior Director

+822 3278 8363

Media Relations: Peter Hoflich, Singapore, Tel: +65 6796 7229, Email: peter.hoflich@thefitchgroup.com

Leslie Tan, Singapore, Tel: +65 6796 7234, Email: leslie.tan@thefitchgroup.com

Additional information is available on www.fitchratings.com

Applicable Criteria

[Bank Rating Criteria \(pub. 28 Feb 2020\)_\(including rating assumption sensitivity\)](#)

[Non-Bank Financial Institutions Rating Criteria \(pub. 28 Feb 2020\)_\(including rating assumption sensitivity\)](#)

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