FitchRatings

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Fitch Revises Outlook on Credit Union Baywide and Subsidiary to Stable

Fitch Ratings - Sydney - 01 Mar 2021: Fitch Ratings has revised the rating Outlook on Credit Union Baywide (CUB) and its fully owned subsidiary, New Zealand Association of Credit Unions (NZACU), to Stable from Negative. At the same time, Fitch has affirmed the Long-Term Issuer Default Ratings (IDRs) on CUB and NZACU at 'BB' and 'BB-', respectively. All other ratings have also been affirmed.

The revision in the Outlook to Stable reflects that downside risks, particularly around the outlook for asset quality, have abated substantially since we originally revised CUB's Outlook to Negative in May 2020. At the time we viewed the buffers in CUB's credit profile to be sufficient to withstand our base case scenario and we continue to hold this view.

Key Rating Drivers

CUB'S 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 other 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 acceptable and consistent with similarly sized peers. This means CUB's financial profile is likely to be more volatile through an economic cycle than its non-credit union peers.

The ratings also capture CUB's moderate franchise, despite being New Zealand's largest credit union, and geographic concentration in parts of New Zealand, although the latter improved following the merger with three other credit unions in 2019.

The factor outlooks for asset quality (score of 'bb') and operating environment (score of 'a-') have been revised to stable, from negative, and the factor outlook for funding and liquidity has been revised to positive, from stable, as part of this review. Our outlook on the earnings and profitability score of 'bb' remains on negative, however.

We expect some weakening in CUB's asset-quality metrics during 2021 as support measures are reduced or removed, but large buffers mean deterioration that is moderately worse than our base case can be absorbed at the current score, resulting in the factor outlook revision to stable. The assigned factor score is lower than the score implied by Fitch's Bank Rating Criteria to reflect CUB's risk appetite, which we expect to add to volatility and result in higher impaired-loan ratios through a cycle relative to most peers. CUB's impaired loans/gross loans ratio was relatively stable during the financial year ended June 2020 (FY20), ending the year at 2.3%.

We expect CUB to return to profitability in FY21 following losses in FY19 and FY20. However, CUB's profitability remains weaker than most peers and we view the headroom at the current factor score as limited, so we have maintained a negative factor outlook. We expect the low rate environment to pressure earnings across the system. In addition, CUB faces risk that costs associated with its 2019 merger and the restructuring of NZACU are more persistent and larger than currently expected in our base case. Maintaining consistent and sustainable profitability is important for a mutually owned entity like CUB as retained earnings are the main source of new capital.

CUB's capitalisation is a weakness for the rating, with the factor score remaining at 'bb-' with a stable outlook. The score captures the small absolute size of the capital base, limited sources of fresh equity as a mutual organisation and only modest headroom above minimum regulatory capital requirements. CUB's total regulatory capital ratio, the only regulatory ratio required to be calculated for non-bank deposit takers (NBDTs), was 10.2% at December 2020, a buffer of about 220bps over the regulatory minimum of 8%. CUB may be required to consolidate NZACU for regulatory capital purposes as part of the subsidiary's restructuring - this would see the total regulatory capital ratio fall close to 9% on a proforma basis. We believe this will be the low point for CUB's total capital ratio and that management has a credible plan to improve capitalisation. We have retained a stable outlook on the factor score as a result.

We expect customer deposits to remain the main source of CUB's funding and the credit union has managed liquidity well through the pandemic, leaving headroom in the 'bb+' factor score. We have revised the factor outlook to positive from stable to reflect the likelihood that we would upgrade this score if metrics can be maintained at current levels. The factor score also considers CUB's lack of access to the central bank as a lender of last resort, which combined with a moderate franchise leaves it susceptible to deposit outflows in a severe funding market shock.

Fitch has revised the outlook on the 'a-' operating environment score for New Zealand NBDTs to stable, from negative. This score is currently one notch lower than the score assigned to New Zealand banks due to the less comprehensive regulatory framework applied to NBDTs. However, New Zealand is in the process of aligning regulation of all deposit takers under one framework, after which we would consider aligning the NBDT operating environment score with that of New Zealand banks. This, combined with reduced downside risk to the economic outlook due to New Zealand being relatively successful in combatting the coronavirus, mean it is unlikely we would lower the score to 'bbb+'. We have revised the outlook accordingly.

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.

SUBSIDIARY

NZACU's IDRs and Support Rating reflect a moderate probability of extraordinary institutional support from its shareholder, CUB. Fitch believes NZACU 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 businesses. The revision of the Outlook on NZACU reflects the same action taken on the Outlook of CUB.

NZACU's Long-Term IDR is notched down once from that of CUB to reflect our view that, while NZACU is important to CUB's operation, some of its operations relate to the sale of products and services to third parties.

NZACU is currently undergoing a restructuring, with a planned move to a corporate structure from the current association structure. Fitch expects to assign ratings to the new corporate structure and withdraw ratings from NZACU once this process is complete.

RATING SENSITIVITIES

CUB's IDRS and VIABILITY RATING

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

CUB's Long-Term IDRs and Viability Rating may be downgraded if its regulatory capital ratios continue to weaken, possibly as a result of ongoing merger and restructuring activity that negatively impacts profitability.

The Long-Term IDRs and Viability Rating may also be downgraded if there is an increase in risk appetite, potentially aimed at increasing market share and profitability, that led to greater volatility in the financial profile through the cycle.

The above scenarios may be reflected in a combination of the following:

- 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:

An upgrade of the Viability Rating and Long-Term IDRs is unlikely in the short term, as it would require an improved risk appetite, resulting in more stable asset quality through a cycle, and an increase in capital ratios towards levels reported by NBDT peers. The latter is likely to be reflected in a Fitch core capital ratio sustained above 14%, which we would view as being more consistent with a high 'bb' capitalisation and leverage score.

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 and CUB's small size relative to the overall financial system in New Zealand.

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 on NZACU's Long-Term IDR would occur if CUB's Long-Term IDR is upgraded and the propensity to support remains unchanged. The Long-Term IDR may also be upgraded if we viewed NZACU as a core subsidiary of CUB, which may occur if the subsidiary exited parts of the business that target third parties - however, this appears unlikely.

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:

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

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.

Public Ratings with Credit Linkage to other ratings

NZACU's IDRs are linked to CUB's IDRs.

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
Credit Union Baywide	LT IDR	BB	Affirmed		BB
	ST IDR	B	Affirmed		B
	LC LT IDR	BB	Affirmed		BB
	LC ST IDR	B	Affirmed		B
	Viability	bb	Affirmed		bb
	Support	5	Affirmed		5
	Support Floor	NF	Affirmed		NF

ENTITY/DEBT	RATING			RECOVERY	PRIOR
New Zealand Association of Credit Unions	LT IDR	BB-	Affirmed		BB-
	ST IDR	B	Affirmed		B
	Support	3	Affirmed		3

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

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)

Additional Disclosures

Solicitation Status

Endorsement Status

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