

FITCH AFFIRMS CUB AND CUS AT 'BB'/ STABLE ON MERGER ANNOUNCEMENT

Fitch Ratings-Sydney-30 December 2018: Fitch Ratings has affirmed the ratings of Credit Union Baywide (CUB) and Credit Union South (CUS) following the announcement that both credit unions plan to merge with three other, smaller New Zealand credit unions - Aotearoa Credit Union (ACU), Credit Union Central and Steelsands Credit Union. A full list of rating actions is at the end of this rating action commentary.

The affirmation reflects our view that the proposed merger is unlikely to result in significant short-term changes to the credit profiles of either entity. CUB and CUS are by far the largest of the five merger partners, with combined total assets of about NZD511 million at 30 June 2018, accounting for 85% of the merged entity's asset base of NZD600 million. As such, we believe their current credit profiles are likely to be the main drivers of the credit profile of the merged entity. The merged entity will still constitute only a very small part of the New Zealand financial system and therefore have limited impact on Fitch's view of the company profile.

In the longer term, the merger should provide greater economies of scale and geographic diversification, although risks may also emerge due to the relatively large number of entities involved in the process and weaknesses in one of the smaller merger partners, ACU. ACU has breached the minimum capital ratio set out by its trust deed and has been advised by its trustee that it needs to seek a merger to address this. ACU is prevented from accepting new members in the interim.

The merger, announced in December 2018, is scheduled to be completed in mid-March 2019 at the earliest, and it remains subject to due diligence by all parties, as well as regulatory and member approvals. CUB will be the surviving entity following the merger.

KEY RATING DRIVERS

IDRS AND VIABILITY RATINGS

The Issuer Default Ratings (IDRs) of both CUB and CUS are driven by their respective Viability Ratings, which in turn reflect a greater risk appetite relative to most domestic peers. For more details on their ratings, see [Fitch Affirms Six New Zealand Financial Institutions](https://www.fitchratings.com/site/pr/10038467), published 20 July 2018.

The greater risk appetite relative to domestic peers is a feature of New Zealand's credit union sector and is therefore unlikely to change significantly following the merger. It manifests in a relatively large exposure to higher loan/value ratio mortgages and consumer loans, which could lead to weaker asset quality relative to other domestic peers in the event of an economic downturn.

The merger process poses some risks, although all five entities have recently adopted the same core banking system, operated by the New Zealand Association of Credit Unions (B+/Stable), which may alleviate some of the operational risks. Aligning strategy and culture without alienating existing member bases will be an important consideration for the rating. Both CUB and CUS have recent experience in merging with smaller credit unions, which may be of help during this process.

The merged entity is likely to face some short-term profit pressure as management focuses on the integration process, which may result in Fitch revising down its view on profitability and earnings following the merger. Profit has been pressured across the credit union sector more generally in 2018, in large part due to the implementation of the new core banking system.

SUPPORT RATINGS AND SUPPORT RATING FLOORS

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

RATING SENSITIVITIES

IDRS AND VIABILITY RATINGS

Standalone rating sensitivities for CUB and CUS can also be found in the commentary published 20 July 2018, Fitch Affirms Six New Zealand Financial Institutions.

Positive rating action for the merged entity would likely require a lower risk appetite, potentially through slower growth, lower risk underwriting standards and stronger risk controls. Sound management of the merger risks, such that member numbers are not materially reduced, and the formation of a cohesive culture across the entity will also be important to any positive rating action. This is likely to take several years to develop and observe so positive rating action does not appear imminent. The merger may also provide economies of scale, which could support longer-term profitability, although this is unlikely to drive an upgrade by itself.

Conversely, the merged entity's ratings could be downgraded if management is unable to properly manage the merger-related operational risks or embed a cohesive culture and strategy across the legacy businesses. This may result in weaker financial performance, including a loss of members, and place pressure on the risk appetite in an attempt to improve profitability. Risk appetite that is weaker than we expect and what we currently observe at CUB and CUS would also likely result in a downgrade. In addition, ratings pressure may emerge if the issues at ACU take significant management time to address, reducing the focus on the day-to-day operations of the entity.

SUPPORT RATINGS AND SUPPORT RATING FLOORS

The Support Ratings and Support Rating Floors are sensitive to any change in assumptions around the propensity of the New Zealand government to provide timely support.

The rating actions are as follows:

Credit Union Baywide

Long-Term Foreign-Currency IDR affirmed at 'BB'; Outlook Stable

Short-Term Foreign-Currency IDR affirmed at 'B'

Long-Term Local-Currency IDR affirmed at 'BB'; Outlook Stable

Short-Term Local-Currency IDR affirmed at 'B'

Viability Rating affirmed at 'bb'

Support Rating affirmed at '5'

Support Rating Floor affirmed at 'No Floor'

Credit Union South

Long-Term Foreign-Currency IDR affirmed at 'BB'; Outlook Stable

Short-Term Foreign-Currency IDR affirmed at 'B'

Long-Term Local-Currency IDR affirmed at 'BB'; Outlook Stable

Short-Term Local-Currency IDR affirmed at 'B'

Viability Rating affirmed at 'bb'

Support Rating affirmed at '5'

Support Rating Floor affirmed at 'No Floor'

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Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018)

<https://www.fitchratings.com/site/re/10044408>

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