FitchRatings

Fitch Affirms Six New Zealand Financial Institutions

Fitch Ratings-Sydney-20 July 2018: Fitch Ratings has affirmed the ratings of six New Zealand non-bank deposit taking financial institutions. The agency has also assigned Long- and Short-Term Local-Currency Issuer Default Ratings (IDRs) to Credit Union South.

- Nelson Building Society (NBS);
- Wairarapa Building Society (WBS);
- First Credit Union (FCU);
- Credit Union Baywide (CUB);
- Credit Union South (CUS);
- Christian Savings Limited (CSL)

A full list of rating actions can be found at the end of this commentary.

The affirmation of the institutions' IDRs and Viability Ratings (VRs) reflects Fitch's view that these institutions are likely to broadly maintain their financial profiles and market positions over the next two years, which support the Stable Outlook. Fitch maintains a negative sector outlook for New Zealand. This reflects rising macroeconomic risks, driven by high levels of household leverage and elevated house prices.

All six have modest franchises with small system market shares, meaning they are generally price takers. However, their competitive positions are typically stronger in their local or niche markets. Most of the institutions maintain capital ratios above their larger bank peers, which Fitch considers prudent due to their smaller absolute size and with the exception of CSL, limited access to new common equity. Customer deposits are the primary source of funding for these institutions as they generally have limited access to wholesale funding sources and do not have access to the Reserve Bank of New Zealand's repo facility.

A number of the institutions have experienced strong growth in recent years, which has in some cases resulted in weaker capitalisation, and funding and liquidity profiles. However, Fitch believes changing market conditions, macroprudential rules for banks, and slowing credit growth could result in moderating growth rates for these entities.

KEY RATING DRIVERS
IDRS AND VIABILITY RATINGS

NBS
NBS is a small, regionally focused mutual institution. The society benefits from strong community support through its service-orientated model, although it remains susceptible to competition, and has limited pricing power. NBS's core business is residential mortgages with a low loan-to-value ratio. Strong loan growth over the last three years does not appear to have been at the expense of weakening underwriting. NBS's risk profile has increased in recent years due to growth in consumer lending, but exposure to this segment remains below peers.

Asset quality ratios are strong, and Fitch expects impairments to remain low over the the next 12-24 months. NBS's small size exposes it to single-name borrower concentration risk; geographical concentration is also high, albeit less so than some of its domestic peers. Increased profitability from its expanding portfolio and size could partially be offset by fierce competition and increasing regulatory and operational costs. The growth in consumer loans is likely to bring some additional volatility to earnings through a cycle.

NBS's Fitch Core Capital ratio is below its peers but this is partly offset by the high level of preference shares, which act as a form of loss-absorbing capital. Capitalisation has come under pressure due to strong growth, making NBS more susceptible to shocks. NBS's funding structure is sound, comprising entirely of member deposits. Geographic deposit concentration is high, reflecting its business model. NBS's liquidity is appropriately managed and its on-balance-sheet liquidity position compares favourably with most domestic peers.

WBS
WBS's Viability Rating reflects its asset quality and risk appetite. This is partly offset by its small franchise and product offering, and higher concentration risk relative to peers. WBS's property investment portfolio has historically provided stable rental returns, but adds potential volatility through fair-value market adjustments.

WBS's conservative risk appetite is reflected in its minimal historical losses and low loan/value mortgages across its loan book, which supports asset quality. Strong loan growth has resulted in earnings growth and a reduction in the cost-to-income ratio. However, moderating loan growth rates could pressure profit growth over the next 12-24 months.

Loan growth over the last four years has outpaced increases in equity levels and resulted in a reduction in capital ratios. However, WBS remains adequately capitalised with a satisfactory level of buffers over its regulatory minimum requirements for its size, and is likely to maintain current levels. WBS's funding structure is sound, comprising mainly of member deposits but geographic deposit concentration is high, reflecting its business model. WBS's modest on-balance-sheet liquidity is stable and appropriately managed.

FCU
FCU's ratings reflect its higher risk appetite relative to most other deposit-taking institutions in New Zealand. As a result, Fitch believes asset quality is likely to be more volatile through the cycle. The ratings also take into account the credit union's modest profitability for its risk profile and its strong capital ratios and liquid-asset holdings relative to peers.

The credit union's higher risk appetite is evident through its geographic concentration and its loan portfolio composition. Consumer loans, which have a higher risk profile relative to residential mortgages, make up about 45% of FCU's loan portfolio, which is unlikely to change for the foreseeable future. Additionally, FCU's concentration of residential mortgages with a loan/value ratio greater than 80% is higher than most peers.

Fitch believes the earnings and profitability of FCU are low relative to the nature of its business and the risks undertaken, limiting its ability to absorb higher loan losses and generate capital. We think FCU's operational risk will remain elevated in the short term as the change to a new core banking system requires some adjustment and it is also in the process of switching some product providers. Poor implementation may have a negative impact on its franchise but the move could provide profitability upside if successfully implemented.

Fitch expects FCU to maintain capital and liquidity positions above its peers over the medium term, which offsets some of its risks although the gap may narrow modestly if targeted loan growth is achieved.

CUB
CUB's Viability Rating reflects its greater risk appetite relative to most domestic peers, with a focus on growth, and higher loan/value mortgages and consumer lending. This increases exposure to weaker performance in a poor economic cycle. CUB's risk controls are adequate for its size and consistent with regional peers.

The credit union remains adequately capitalised for its risk profile with sufficient buffers above regulatory minimums. CUB has limited sources of new capital outside retained earnings, similar to other mutual institutions. Ongoing growth continues to exceed growth in retained earnings, which could lead to pressure on regulatory capital ratios if growth is sustained.

CUB's funding and liquidity ratios appear adequate for its credit profile. CUB remains fully funded by retail deposits, which has displayed significant growth alongside their loan book. CUB has a weaker deposit franchise relative to larger peers, which may see higher outflows to banks in a stressed economic cycle.

CUS

CUS's loan portfolio reflects a greater risk appetite relative to domestic peers, with a heavy focus on consumer lending. This is likely to lead to weaker asset quality in the event of an economic downturn in comparison with peers. CUS's risk controls are adequate for its size and consistent with regional peers.

CUS's earnings have been variable through cycles, reflecting its risk profile. The credit union maintains a strong net-interest margin relative to peers, reflecting a riskier loan mix, but profitability is modest due to a high cost base. Fitch expects technology investment and changes to cost structure will support profitability in the future.

CUS's risk-weighted capital ratios appear sound relative to its risk profile, but remain under pressure due to loan growth and low levels of profitability.

CSL

CSL has improved its risk appetite in recent years through tighter risk controls and underwriting although it continues to lag some larger peers, partly reflecting its niche focus on church lending, higher concentration and business model. Strong growth in recent years has mainly been driven by structural changes to the organisation rather than through aggressive lending practices.

CSL's earnings and profitability remain modest but were stronger than Fitch's expectations in the financial year ended 31 August 2017 (FY17), driven by greater management focus on performance and loan growth. Fitch expects CSL's earnings and profitability to continue improving at a gradual rate over the next two years with key challenges from rising investment expenditure and expense growth.

CSL's capitalisation improved significantly towards the end of 2017 due to a restructuring that facilitated the introduction of new shareholders and common equity. Notwithstanding this, CSL's Fitch Core Capital ratio remains towards the lower end of broader peers and is likely to remain stable over the next 12 months.

CSL's lending activities are fully funded by a combination of church and household deposits and reinvestment rates remain strong in 2018. CSL's loan/deposit ratio remains stronger than most of its peers.

SUPPORT RATINGS AND SUPPORT RATING FLOORS
The Support Rating and Support Rating Floor of these six 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 RATING

NBS
NBS's IDRs and Viability Rating would be sensitive to an increase in its risk appetite, possibly from weaker underwriting or continued strong growth, which could result in a deterioration of its asset quality, profitability or capitalisation. NBS is reliant on retained earnings to fund its strong loan growth due to its mutual structure. The issue of preference shares is limited to 50% of NBS's capital base. The institution's capitalisation is a constraining factor on its rating.

WBS
WBS's IDR is capped in the 'BB' range due to its limited franchise, small absolute capital base, concentration risks and limited access to additional liquidity sources such as the central bank's repo facility. WBS's IDRs and Viability Rating would be sensitive to an increase in its risk appetite, possibly from weaker underwriting or continued strong growth, which could result in a deterioration of its asset quality, profitability or capitalisation.

FCU
FCU's IDRs and Viability Rating are sensitive to a change in the credit union's risk appetite and earnings. Ratings may be upgraded if there is a sustained improvement in risk appetite, possibly through lower-risk underwriting or a stronger risk-control framework, while maintaining strong capital ratios and high liquidity. Positive rating action may also occur if earnings become more commensurate with the level of risk assumed by FCU.

Alternatively, ratings are likely to face downward pressure if there is a weakening in FCU's risk appetite, possibly due to a deterioration in underwriting standards that increases the risk of significant deterioration or greater volatility in key financial metrics.

CUB
A positive rating action on CUB's IDRs and Viability Rating would depend on an

improved risk appetite, possibly through slower and lower-risk underwriting or a stronger control framework. Conversely, a downgrade may result if risk appetite increases substantially.

CUS
A positive rating action on CUS's IDRs and Viability Rating would rely on tangible improvements to company profile, profitability, and risk appetite throughout the operating cycle. A negative rating action would result from a further decline in profitability, funding and liquidity, and capital ratios, or if risk appetite increases.

CSL
Negative rating action may be taken if CSL's capitalisation were to decline significantly or if risk appetite weakens through a loosening in underwriting standards, controls or excessive growth. Positive rating action on the IDR and VR would require further improvement in CSL's company profile or a sustained increase in earnings and profitability.

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:

Nelson Building Society
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'

Wairarapa Building Society
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'

First Credit Union:

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 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 assigned at 'BB'; Outlook Stable
Short-Term Local-Currency IDR assigned at 'B'
Viability Rating affirmed at 'bb'
Support Rating affirmed at '5'
Support Rating Floor affirmed at 'No Floor'

Christian Savings Limited
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. 22 Jun 2018) (https://www.fitchratings.com/site/re/10034713)

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