

New Zealand-based Credit Union Baywide Assigned 'BB/B' Ratings; Outlook Stable

Counterparty Credit Rating

BB/Stable/B

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Overview

- Credit Union Baywide (CUB) is a New Zealand-based credit union with a solid geographic niche in the Hawkes Bay region of the North Island.
- We have assigned our 'BB' long-term counterparty credit rating to CUB.
- The outlook is stable, factoring in changes to the composition of CUB's loan book but also expectations that liquidity will be bolstered and any mergers will fit with CUB's current strategy and profile.

Rating Action

On Oct. 27, 2009, Standard & Poor's Ratings Services assigned its 'BB' long-term counterparty credit rating to Credit Union Baywide and, at the same time, assigned its 'B' short-term counterparty credit rating. The outlook is stable.

Rationale

Credit Union Baywide (CUB) benefits from a solid geographic niche in the credit union sector. CUB's traditional base is in the Hawkes Bay region of New Zealand. It has incrementally expanded by increasing its branch network and via recent mergers with other credit unions, but it has limited its operations to the east and south of New Zealand's North Island. This geographic identity and its status as a mutual have translated into a relatively large base. Membership loyalty can be seen in high reinvestment rates, even during late 2008 when New Zealand nonbank deposit-taking institutions were suffering an industry-wide lack of confidence.

Although small in absolute terms, CUB's capital ratios support its credit quality particularly given the moderate risks associated with its loan book. Although only NZ\$25 million, adjusted total equity is more than 16% of assets—close to or slightly greater than

peers with a similar risk profile. The loan portfolio comprises low-risk mortgages (about 45%) and higher risk personal lending (55%) but no commercial property lending. Key asset-quality indicators are satisfactory when assessed against the credit-risk profile, with nonperforming assets at 1.4% of the total. Further, there is no significant single-name concentration; the largest 20 borrowers account for only 5.5% of total loans and 30% of adjusted total equity.

CUB's increased focus on personal loans—and simultaneous reduction in owner-occupied first lending—represents a strategic shift that Standard & Poor's believes increases credit risk, albeit while boosting returns. CUB intends to increase exposure, particularly to personal loans for motor vehicles, partly funded by securitizing existing mortgages. Based on current trends, the mix of loans will therefore change from 45% mortgages and 55% personal lending to 30% and 70%, respectively. This will increase credit risk, but this risk is partly ameliorated because some of the proceeds of reduced mortgages will be used to boost liquidity through holdings of high-quality investments.

In general, Standard & Poor's views acquisitions as increasing risk in the short term, despite the long-term strategic fit of such acquisitions. The industry in New Zealand is likely to face further consolidation and CUB is well placed to be a driving force. While such mergers can deliver benefits (growth, synergies, diversification) they introduce risks associated with bringing together systems, processes, and cultures. For a credit union such as CUB, there's also the longer term risk that a merger could weaken member loyalty—a key strategic advantage—by diluting the institution's small-community feel. To date, CUB has managed these risks by merging only with other credit unions in the south and east of the North Island.

Like other mutuals, CUB's flexibility is limited. Retained earnings are the only source of capital. Seeking further capital funding from members would not be practical; rather, the emergence of capital pressures for all mutuals often results in managed takeovers by larger credit unions.

Short-term credit factors

CUB's liquidity is adequate relative to needs. Cash and cash equivalents account for less than 10% of total assets, which is low in absolute terms. There is no other committed source of liquidity; an overdraft facility with the NZACU is uncommitted. Further, free liquidity is somewhat diminished as some of these assets relate to holdings by the NZACU to fund transaction flows and there is some risk associated with holding almost all liquidity in the form of deposits with the unrated NZACU. However, through retained earnings, easing loan growth, and the proceeds of securitization, CUB aims to bring liquidity levels back to a more robust 12%-15% of assets.

CUB has a good history of depositor support from its member base and liquidity was assisted by the system stability brought about through the depositor guarantee from New Zealand's government.

Outlook

The stable outlook factors in the changing composition of the loan book toward relatively more risky personal loans, and away from mortgages, but with the expectation that growth in personal loans will be slowed if delinquencies prove higher than anticipated. Also underpinning the stable outlook is the expectation that some of the proceeds of securitization will be used to bolster liquidity. A key underpinning assumption is also that any mergers will be small, relative to group size, and a strategic fit with CUB's existing profile as a credit union focused on the south and southeast of the North Island.

A significant departure from these assumptions could result in downward ratings pressure. In particular:

- A significant increase in problem assets beyond the mild increase already expected given the change in loan portfolio mix, especially if personal lending is not slowed in response;
- A more aggressive adjustment in the portfolio mix than the 30% mortgage and 70% personal already expected;
- A merger with a larger organization of weaker credit quality, or a merger with an organization outside CUB's credit union sector or area of geographic expertise;
- Failure to maintain capital ratios at current healthy levels;
- A significant operations risk event (resulting in an actual or potential loss of more than NZ\$5 million); or
- A significant reduction in current liquidity levels due to, say, problems with NZACU (where almost all liquidity is held) or depositor flight.

CUB's upward rating prospects are limited in the medium term and would require a step change in key elements of its credit profile. These might include:

- A material increase in absolute capital base; and/or
- Further geographic diversification through low-risk mergers; and/or
- Further significant strengthening in capital adequacy ratios from their already strong levels, although this is less likely for a mutual organization.

Related Research

Criteria | Corporates | General: Principles Of Corporate And Government Ratings, published June 26, 2007.

Ratings List

New Rating; CreditWatch/Outlook Action

Credit Union Baywide

Counterparty Credit Rating BB/Stable/B

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