

Southern Cross Building Society Assigned 'BB' Rating, Stable Outlook; First New Zealand Building Society Rated By S&P

Counterparty Credit Rating

BB/Stable/B

Primary Credit Analysts:

Gavin Gunning
Melbourne
(61) 3-9631-2092
gavin_gunning@
standardandpoors.com

Secondary Credit Analysts:

Brendan Flynn
Melbourne
(61) 3-9631-2042
brendan_flynn@
standardandpoors.com

RatingsDirect Publication Date

Aug. 27, 2009

Overview

- SCBS is the first building society in New Zealand to be rated by Standard & Poor's.
- SCBS has been assigned 'BB' long-term and 'B' short-term ratings.
- A stable outlook has been assigned.

Rating Action

On Aug. 27, 2009, Standard & Poor's Ratings Services assigned its 'BB' long-term and 'B' short-term ratings to Southern Cross Building Society (SCBS), New Zealand's third-largest building society. The rating outlook is stable.

Rationale

The ratings on New Zealand-based SCBS partly reflect our opinion of the concentration of SCBS's customers in the higher-risk sectors of rural and commercial lending. SCBS's 10-largest customers are all in the rural and commercial mortgage sectors. Furthermore, in the current economic recession, there has been an increase in SCBS's nonperforming assets (NPAs). Standard & Poor's believes the building society's NPAs have the potential to remain high in the near term, which will have a constraining effect on the 'BB' long-term rating. These risks are mitigated by SCBS's sizeable portfolio of lower-risk residential loans, manageable loan-to-value (LVR) ratios, and proactive management of the portfolio in the weakening environment, including a reduction in higher-risk exposures.

Given SCBS is undergoing a cultural and strategic change and faces an uncertain operating environment, the building society is exposed to a degree of risk. Standard & Poor's expects the non-bank deposit-taker (NBDT) sector in New Zealand to continue to

consolidate. In preparing for this changing industry environment, SCBS demutualized in 2007 and significantly changed its board and senior management, bringing a more profit-focused culture to the group. Nevertheless, we believe risks could increase if SCBS's new strategy is not carefully managed and its loyal customer base becomes disenfranchised. However, unlike some peers, SCBS is free of related-party concerns. What's more, its governance framework, which has been revamped under the new board and management, compares favorably to many other entities in the sector.

The ratings on SCBS benefit from the building society's solid funding base. SCBS is fully funded by retail deposits, which have proven to be fairly resilient. Most deposits are term rather than call deposits, which has a moderate lengthening effect on SCBS's liability profile, and re-investment rates on term deposits are typically around 80%-90%. In addition, SCBS has no significant depositor concentration.

SCBS's capital ratios are sound. Equity has been steadily increasing in recent years, while the size of the loan book has reduced. The level of equity provides a buffer against losses associated with higher impaired assets. Nevertheless, the absolute level of ATE is small relative to international standards and SCBS's largest exposures.

Although SCBS operates in a highly competitive sector, it has built an enduring franchise that is supported by a loyal customer base. SCBS, which has been operating since 1923 and is New Zealand's third-largest building society, has developed a solid niche and associated customer loyalty. Its operations are somewhat diversified throughout the north island of New Zealand, with some concentration in the higher-income and higher-growth Auckland region. Mitigating these strengths, however, are risks associated with SCBS's marginal market position in the highly competitive New Zealand financial services sector.

Short-term credit factors

Liquidity is very good, in our view, and reduces potential short-term rating risks for SCBS. Management has proactively boosted liquidity as part of a strategy to reduce risk in the current economic environment. Liquid assets have increased materially since June 2007. Like its peers, the future removal of the New Zealand government's guarantee scheme for retail deposits presents some risk to SCBS; however, we believe this is likely to be manageable, as the "stickiness" of its deposits appears to be largely driven by brand loyalty.

Outlook: Stable

Merger and acquisitions (M&A) activity is one of the most likely factors that could change the ratings on SCBS, either up or down. Given the dynamic state of the NBDT sector in New Zealand in general, and SCBS's more outward-looking approach since demutualization, Standard & Poor's believes SCBS could be involved in M&A in coming years. The implications of M&A for the SCBS ratings—if any—would depend on a number of factors, including the credit quality of the other party or parties; the degree to which the other entity reinforces SCBS's credit strengths and addresses SCBS's credit weaknesses; the likely mix of cultures (of staff, customers, and systems); the degree to which efficiency benefits can be delivered and transition risks managed; and funding considerations.

A weakening of SCBS's financial profile—most likely due to the negative effects of a weaker-than-expected economic outlook on asset quality and earnings—could lead to a lowering of the 'BB' rating. Standard & Poor's believes credit losses could ease from existing levels, albeit remaining materially higher than historical rates, over the next year or two. The rating should

remain robust if credit losses ease from current levels, even if losses remain in excess of historical trends; however, the rating could be lowered if either credit losses or NPAs increase from current levels. The small absolute capital size also leaves SCBS exposed to a significant operational risk event. If returns provided to owners were more aggressive, it could also result in a reassessment of the ratings.

There is limited upside potential to the ratings in the current economic environment. In our opinion, SCBS's most immediate challenge is to solidify the 'BB' rating in the wake of material asset quality weakness during the economic downturn. In the longer term, it is unlikely that SCBS would reach our 'BBB' investment-grade rating category without a dramatic increase in capital, and a contemporaneous de-risking of its loan book. An increase to 'BB+' may be possible in the medium-to-long term if economic conditions improve, industry volatility moderates, and SCBS strengthens its business and financial profiles. An indicator of improving rating prospects could be if credit losses ease to historical levels or lower, in conjunction with a compositional shift in SCBS's loan book as planned toward lower-risk-weighted residential assets.

Related Research

This article is based in part on the following criteria article: Rating Finance Companies, published on March 18, 2004.

Ratings List

New Rating; CreditWatch/Outlook Action

Southern Cross Building Society

Counterparty Credit Rating BB/Stable/B

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation area, select Find a Rating, then Credit Ratings Search.

Published by Standard & Poor's, a Division of The McGraw-Hill Companies, Inc. Executive offices: 1221 Avenue of the Americas, New York, NY 10020. Editorial offices: 55 Water Street, New York, NY 10041. Subscriber services: (1) 212-438-7280. Copyright 2009 by The McGraw-Hill Companies, Inc. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by Standard & Poor's from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, Standard & Poor's or others, Standard & Poor's does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or the result obtained from the use of such information. Ratings are statements of opinion, not statements of fact or recommendations to buy, hold, or sell any securities.

Standard & Poor's uses billing and contact data collected from subscribers for billing and order fulfillment purposes, and occasionally to inform subscribers about products or services from Standard & Poor's, our parent, The McGraw-Hill Companies, and reputable third parties that may be of interest to them. All subscriber billing and contact data collected is stored in a secure database in the U.S. and access is limited to authorized persons. If you would prefer not to have your information used as outlined in this notice, if you wish to review your information for accuracy, or for more information on our privacy practices, please call us at (1) 800-852-1641 or write us at: privacy@standardandpoors.com. For more information about The McGraw-Hill Companies Privacy Policy please visit www.mcgraw-hill.com/privacy.html.

Analytic services provided by Standard & Poor's Ratings Services ("Ratings Services") are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. Credit ratings issued by Ratings Services are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of credit ratings issued by Ratings Services should not rely on any such ratings or other opinion issued by Ratings Services in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or by the underwriters participating in the distribution thereof. The fees generally vary from US\$2,000 to over US\$1,500,000. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications.

Permissions: To reprint, translate, or quote Standard & Poor's publications, contact: Client Services, 55 Water Street, New York, NY 10041; (1) 212-438-7280; or by e-mail to: research_request@standardandpoors.com.

The McGraw-Hill Companies