FitchRatings

Banks
Retail & Consumer Banks
New Zealand

Nelson Building Society

Key Rating Drivers

Asset Quality Underpins Ratings: Nelson Building Society's (NBS) Issuer Default Ratings (IDRs) are driven by its Viability Rating (VR). The assigned VR is one notch below its implied VR due to a negative adjustment to reflect a capital ratio lower than its peers. The VR is supported by NBS's leading position in profitability and sound asset quality, which benefit from a larger franchise relative to its New Zealand Non-Bank Deposit Taker (NBDT) peers. Nevertheless, its market share in residential mortgages remains small relative to the overall banking system.

Stable Operating Environment: Fitch Ratings expects the operating environment for New Zealand non-bank deposit takers (NBDTs) to remain stable and consistent with the 'a-' factor score. High household leverage remains a key risk for the banking system, and drives the negative adjustment from the 'aa(cat)' implied operating environment score. We also adjust the score to reflect less stringent regulatory oversight of NBDTs relative to registered banks in the operating environment assessment, resulting in a score one notch below the registered banks.

Asset Quality Remains Sound: Fitch believes the Covid-19 pandemic will have a limited impact on NBS's asset quality, and the society's stage 3 loan ratio will remain stable over the next two years. NBS's assigned factor score of 'bbb' is lower than the implied 'aa' category score due to its higher product and geographic concentration

Profitability Above Peers: We expect NBS's profitability to remain sound and stronger than that of its NBDT peers over the next two years. NBS's net interest margins may narrow modestly in the short term due to intense competition in residential mortgages.

Steady Capital Improvement: We expect a steady improvement in NBS's capital ratios over the medium term. There will be limited pressure on capitalisation from credit growth due to the society's strong profitability and ability to issue capital instruments. The high influence of NBS's capitalisation factor score reflects the negative adjustment on its implied VR.

Fully Deposit Funded: Fitch expects NBS's funding profile to remain reasonably stable over the next two years. The four-year average of its loan/deposit ratio should remain below 90% over the period, which implies an 'a' category score. We have applied a negative adjustment on NBS's funding score of 'bbb-' to reflect the society's lack of access to the Reserve Bank of New Zealand's (RBNZ) liquidity facilities.

Rating Sensitivities

Increased Risk Profile: NBS's Long-Term IDRs and Viability Rating may be downgraded if there is an increase in risk profile – aimed potentially at boosting market share and profitability – that leads to greater volatility in the financial profile through the cycle.

It may be reflected in a combination of: stage 3 loans/gross loans rising above 8% for a sustained period, operating profit/risk-weighted assets falling below 0.5% for a sustained period, the regulatory total capital ratio declining below 9.5% without a credible plan to replenish regulatory capital buffers, and the loans/customer deposits ratio rising to above 100% on a sustained basis.

Limited Upgrade Potential: NBS's ratings may be upgraded – although this appears unlikely in the short term – if the society's credit growth is consistent with its capital generation, resulting in a continued improvement in the regulatory capital ratio to above 15% for a sustained period. At the same time, NBS's core financial metric for asset quality, earnings and profitability, funding and liquidity should remain broadly stable. An improvement in risk controls to be more in line with that of the New Zealand registered banks would also be positive for the ratings.

Ratings

Foreign Currency	
Long-Term IDR	BB+
Short-Term IDR	B
Local Currency	
Long-Term IDR	BB+
Short-Term IDR	B
Viability Rating	bb+
Government Support Rating	ns
Sovereign Risk	
Long-Term Foreign-Currency IDR	AA
Long-Term Local-Currency IDR	AA+
Country Ceiling	AAA

Outlooks

Long-Term Foreign-Currency IDR	Stable
Long-Term Local-Currency IDR	Stable
Sovereign Long-Term Foreign-Currency IDR	Positive
Sovereign Long-Term Local-Currency IDR	Stable

Applicable Criteria

Bank Rating Criteria (November 2021)

Related Research

Fitch Affirms Nelson Building Society at 'BB+'; Outlook Stable (February 2022)

Fitch Ratings 2022 Outlook: Asia-Pacific Developed Market Banks (December 2021)

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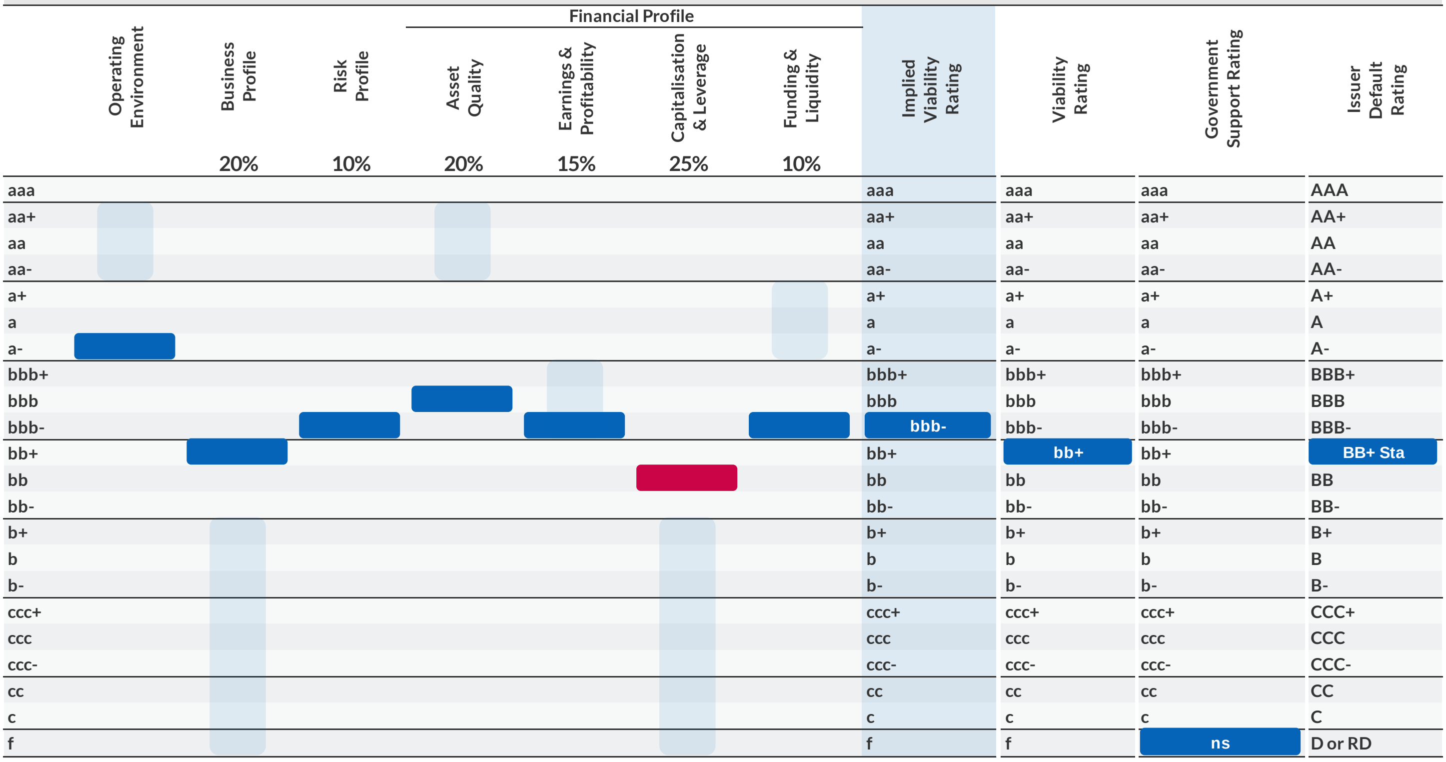
Ratings Navigator

Nelson Building Society

ESG Relevance:

Banks
Ratings Navigator



The Key Rating Driver (KRD) weightings used to determine the implied VR are shown as percentages at the top. In cases where the implied VR is adjusted upwards or downwards to arrive at the VR, the KRD associated with the adjustment reason is highlighted in red. The shaded areas indicate the benchmark-implied scores for each KRD.

Brief Company Summary

Solid Outlook for Operating Environment

Our economic forecast for New Zealand has improved significantly since the onset of the pandemic. This has been driven largely by the authorities' success in dealing with the health crisis, allowing the domestic economy to reopen quickly. Fitch expects real GDP to have expanded by 5.0% in 2021, and forecasts a further increase of 3.5% in 2022, although there may be some pressure in the near term as an outbreak of the omicron Covid-19 variant gathers pace.

The unemployment rate has fallen to an all-time low of 3.4%, which should provide some support to bank asset quality as the effect of the unwinding of pandemic-related support measures works its way through the economy. Inflation has accelerated, prompting an increase in the cash rate of 50bp in 2H21 by the RBNZ, and we expect a further 75bp of increases in 2022.

House-price growth accelerated significantly through late-2020 and 2021, and could pose a risk to financial stability in the medium term. As a result, the RBNZ reimplemented macroprudential limits that are tighter than those in place prior to the pandemic, and the government enacted policies aimed at moderating price growth. The RBNZ has also flagged additional measures, including debt/income limits, that could be enforced in 2022. New Zealand's high household leverage relative to that of other countries is factored into our operating environment assessment for non-bank deposit takers. Household debt/disposable income was 169% at end-June 2021, a record high for this measure.

We also adjusted the score to reflect less stringent regulatory oversight of non-bank deposit takers relative to banks in our assessment of the operating environment, although the implementation of the Deposit Takers Act from 2023 should result in regulatory oversight transitioning towards levels required for banks. Greater clarity on the implementation timetable is likely in 2022.

Small Franchise with Strong Local Community Links

NBS was established in 1862 in Nelson, New Zealand, to provide housing and personal finance to members of the local communities in the Nelson and Tasman regions. Its lending market share (less than 0.2%) is insignificant in the national context, which is reflected in its Business Profile score of 'bb'. NBS's implied score is in the 'b' category; we have applied a positive adjustment to reflect its consistent business model which focuses on simple products including mortgages.

The majority of NBS's lending is provided to the consumer segment, with residential mortgages making up around two-thirds of the net loan book. We believe NBS will maintain the current loan mix and continue to focus on residential mortgages in its home market.

NBS's management depth and experience is adequate for its size. As a mutual building society, NBS's focus on absolute returns is less intense than publicly listed institutions. The society has no specific quantitative targets, reflecting its key priority to serve its members and community. Nonetheless, profitability has been an important consideration as it enables the society to accumulate capital to continue to support balance-sheet growth.

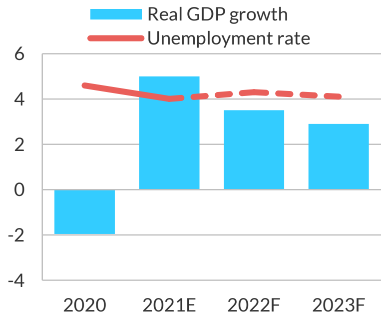
Underwriting Standards Consistent with Industry

NBS's underwriting standards and serviceability assessment are generally in line with industry practice. All loans are assessed on an amortising basis using an interest rate that is higher than the current advertised rate. Residential mortgages remain the largest segment, accounting for 49% of total assets at end-September 2021. The society's commercial exposures are moderate, and consist mainly of property investment and agriculture lending.

NBS's risk-control and management tools are reasonable for its size. Lending authority is delegated by position and experience. Its operational risk-management approach – including cyber security – appears adequate, and there were no major incidents during 2021.

NBS has no trading activities or foreign-exchange exposure. The society's market risk arises primarily from its fixed-rate lending and borrowings. Loans are managed to relatively short fixed-rate periods, which limits the interest-rate mismatch. Market risk is monitored on a quarterly basis through the treasury committee.

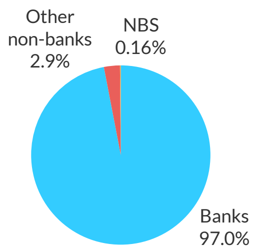
Economic Outlook



Source: Fitch Ratings, Fitch Solutions

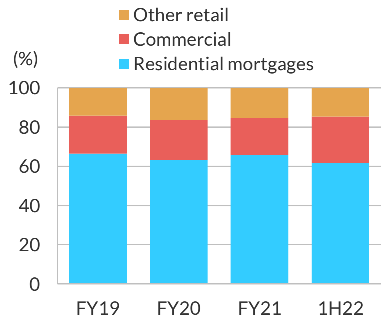
Market Share

Sep 21



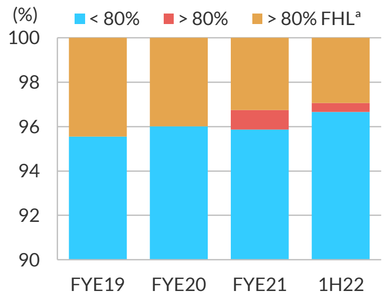
Source: Fitch Ratings, Reserve Bank of New Zealand, NBS

Loan Book



Source: Fitch Ratings,NBS

Mortgage Loan/Value Ratios



[a] Government guaranteed
Source: Fitch Ratings, NBS

Summary Financials and Key Ratios

	31 Mar 21		31 Mar 20	31 Mar 19	31 Mar 18
	Year end	Year end	Year end	Year end	Year end
	(USDm)	(NZD 000)	(NZD 000)	(NZD 000)	(NZD 000)
	Audited - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified	Audited - unqualified
Summary income statement					
Net interest and dividend income	17	24,228.8	21,546.4	18,093.7	15,167.2
Net fees and commissions	1	1,054.4	1,328.1	941.1	866.0
Other operating income	0	419.3	425.2	357.0	359.6
Total operating income	18	25,702.5	23,299.7	19,391.8	16,392.8
Operating costs	8	12,147.0	11,266.8	10,712.6	9,975.2
Pre-impairment operating profit	9	13,555.5	12,032.9	8,679.2	6,417.6
Loan and other impairment charges	1	1,353.7	3,422.9	782.5	878.6
Operating profit	9	12,201.8	8,610.0	7,896.7	5,539.0
Other non-operating items (net)	n.a.	n.a.	n.a.	n.a.	n.a.
Tax	2	3,275.6	2,439.6	2,247.3	1,566.4
Net income	6	8,926.2	6,170.4	5,649.4	3,972.6
Other comprehensive income	n.a.	n.a.	n.a.	n.a.	146.5
Fitch comprehensive income	6	8,926.2	6,170.4	5,649.4	4,119.1
Summary balance sheet					
Assets					
Gross loans	503	719,623.9	680,021.8	641,832.7	558,355.6
- of which impaired	1	1,060.3	874.4	1,150.9	1,589.8
Loan loss allowances	4	5,166.4	4,209.6	1,330.9	1,331.2
Net loans	499	714,457.5	675,812.2	640,501.8	557,024.4
Interbank	156	223,371.5	181,335.9	182,265.0	159,659.1
Derivatives	n.a.	n.a.	n.a.	n.a.	n.a.
Other securities and earning assets	n.a.	n.a.	n.a.	n.a.	n.a.
Total earning assets	655	937,829.0	857,148.1	822,766.8	716,683.5
Cash and due from banks	2	2,464.8	2,464.8	2,142.5	2,677.1
Other assets	5	7,861.7	5,914.9	3,907.6	3,667.8
Total assets	663	948,155.5	865,527.8	828,816.9	723,028.4
Liabilities					
Customer deposits	595	851,227.7	789,081.1	767,946.2	671,721.5
Interbank and other short-term funding	n.a.	n.a.	n.a.	n.a.	n.a.
Other long-term funding	n.a.	n.a.	612.8	n.a.	n.a.
Trading liabilities and derivatives	n.a.	n.a.	n.a.	n.a.	n.a.
Total funding and derivatives	595	851,227.7	789,693.9	767,946.2	671,721.5
Other liabilities	3	4,465.1	2,448.2	2,404.3	2,234.7
Preference shares and hybrid capital	35	50,638.5	39,048.5	29,068.5	24,278.5
Total equity	29	41,824.2	34,337.2	29,397.9	24,793.7
Total liabilities and equity	663	948,155.5	865,527.8	828,816.9	723,028.4
Exchange rate		USD1 = NZD1.43082	USD1 = NZD1.6675	USD1 = ZD1.473839	USD1 = NZD1.38831

Source: Fitch Ratings, Fitch Solutions, NBS

Summary Financials and Key Ratios

	31 Mar 21	31 Mar 20	31 Mar 19	31 Mar 18
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	1.9	1.4	1.4	1.2
Net interest income/average earning assets	2.8	2.6	2.4	2.4
Non-interest expense/gross revenue	47.3	48.4	55.2	60.9
Net income/average equity	15.3	19.4	20.9	17.1
Asset quality				
Impaired loans ratio	0.2	0.1	0.2	0.3
Growth in gross loans	5.8	6.0	15.0	14.1
Loan loss allowances/impaired loans	487.3	481.4	115.6	83.7
Loan impairment charges/average gross loans	0.2	0.5	0.1	0.2
Capitalisation				
Fitch Core Capital ratio	6.1	5.4	5.2	5.1
Tangible common equity/tangible assets	4.2	3.8	3.5	3.4
Net impaired loans/Fitch Core Capital	-10.3	-10.1	-0.6	1.1
Funding and liquidity				
Gross loans/customer deposits	84.5	86.2	83.6	83.1
Customer deposits/total non-equity funding	94.4	95.2	96.4	96.5

Source: Fitch Ratings, Fitch Solutions, NBS

Key Financial Metrics – Latest Developments

Asset Quality to Remain Sound

Material weakening appears unlikely, reflecting the stable operating environment in New Zealand. Rising interest rates may pressure borrowers with higher leverage, especially the ones with higher debt-to-income ratios. However, we believe there are sufficient buffers built into NBS's assessment of borrowers' serviceability at origination of the loans to withstand this. NBS's loan-loss provision coverage ratio appears conservative (487% at FYE21), and we expect it to decline moderately in the next two years.

NBS's limited franchise and regional focus leaves its asset quality more susceptible to losses should there be a regional downturn. The concentration risk is reflected in NBS's assigned factor score of 'bbb' which is lower than the implied 'aa' category score.

Leading Peers in Profitability

We expect NBS's profitability to remain the strongest amongst the NBDTs over the next two years, supported by its larger scale and strong credit growth and resulting in a factor score of 'bbb-'. The potential short-term narrowing in the NIM should be counter-balanced by rising interest rates.

Non-interest income accounts for a small portion of NBS's total revenue (approximately 6% during FY21), and is likely to remain flat in the near term, reflecting stable transaction volumes. Higher personnel expenses and investment in systems and compliance should lead to a continued increase in operating expenses in the next two years. Nonetheless, we believe NBS is better positioned to manage a rising cost base, reflecting its larger size among the peer group.

Steady Improvement in Capitalisation

NBS's credit growth is likely to remain strong in the next two years, driven by improved recovery in business activities. We believe there will be limited pressure on capitalisation from credit growth due to the society's strong profitability and ability to issue capital instruments. We expect steady improvement in capital ratios over the medium term, reflecting management's focus on boosting capital buffers.

NBS's capitalisation and leverage score of 'bb' is supported by the society's substantial issuance of perpetual preference shares, which are non-redeemable and non-cumulative capital instruments that can make up 100% of NBS's regulatory capital base. When assessing capitalisation of New Zealand NBDTs like NBS, Fitch uses the Fitch Core Capital (FCC) ratio as the starting point and makes adjustments based on capital buffers available to the institution.

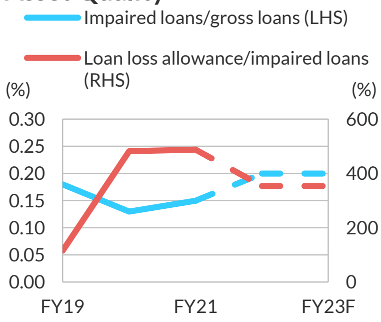
NBS's regulatory minimum capital ratio is 8%, and the society reported a capital ratio of 12.3% at end-September 2021. The regulatory capital ratio is an important measure as it is the only regulatory requirement applied to the NBDTs. The assigned factor score incorporates a positive adjustment to reflect NBS's satisfactory capital buffer above the regulatory minimum.

Stable Funding Profile, Fully Deposit Funded

NBS's funding profile should remain reasonably stable in the next two years. The society is funded entirely by member deposits, which we believe will continue. Deposit growth should remain relatively strong, reflecting ample liquidity in the banking system. However, rising interest rates and reduced monetary stimulus should lead to slower deposit growth over the medium term.

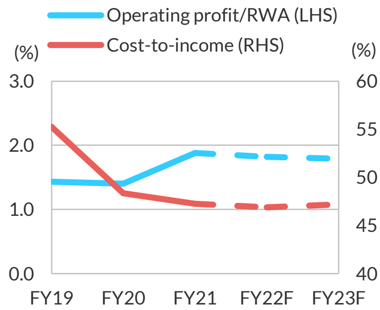
There is a moderate level of individual concentration on NBS's deposit base, although geographic concentration remains high, reflecting its business model. We expect the four-year average of NBS's loan/deposit ratio to remain below 90% over the next two years, which implies a score in the 'a' category. However, we have applied a negative adjustment to NBS's funding score of 'bbb-' to reflect lack of access to the RBNZ's lender-of-last-resort liquidity facilities.

Asset Quality



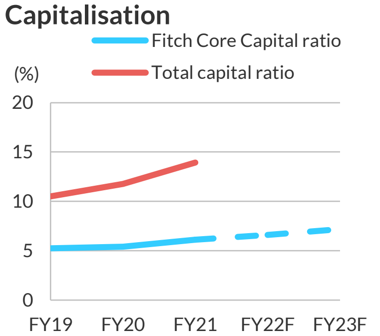
Source: Fitch Ratings, Fitch Solutions, NBS

Profitability



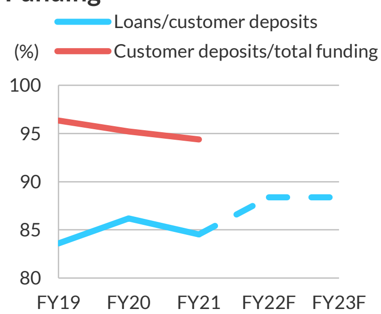
Source: Fitch Ratings, Fitch Solutions, NBS

Capitalisation



Source: Fitch Ratings, Fitch Solutions, NBS

Funding



Source: Fitch Ratings, Fitch Solutions, NBS

Government/Shareholder Support

Commercial Banks: Government Support Rating KRDs	
Typical D-SIB GSR for sovereign's rating level (assuming high propensity)	A or A-
Actual jurisdiction D-SIB GSR	N/A
Government Support Rating	**ns**
Government ability to support D-SIBs	
Sovereign Rating	AA/ Positive
Size of banking system	Negative
Structure of banking system	Neutral
Sovereign financial flexibility (for rating level)	Neutral
Government propensity to support D-SIBs	
Resolution legislation	Negative
Support stance	Negative
Government propensity to support bank	
Systemic importance	Negative
Liability structure	Positive
Ownership	Neutral

The colours indicate the weighting of each KRD in the assessment.
Higher influence Moderate influence Lower influence

The GSR of 'ns' assigned to NBS reflects our expectation that there is no reasonable assumption of support being forthcoming because of New Zealand's open bank resolution scheme (OBR). NBS is not part of the OBR, which allows for the imposition of losses on depositors and senior debt holders to recapitalise failed institutions. However, Fitch believes that the existence of the scheme, in conjunction with NBS's low systemic importance, makes sovereign support doubtful.

Environmental, Social and Governance Considerations

FitchRatings **Nelson Building Society**

Banks
Ratings Navigator

Credit-Relevant ESG Derivation

Nelson Building Society has 5 ESG potential rating drivers

- Nelson Building Society has exposure to compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security) but this has very low impact on the rating.
- Governance is minimally relevant to the rating and is not currently a driver.

			Overall ESG Scale
key driver	0	issues	5
driver	0	issues	4
potential driver	5	issues	3
not a rating driver	4	issues	2
	5	issues	1

Environmental (E)

General Issues	E Score	Sector-Specific Issues	Reference	E Scale
GHG Emissions & Air Quality	1	n.a.	n.a.	5
Energy Management	1	n.a.	n.a.	4
Water & Wastewater Management	1	n.a.	n.a.	3
Waste & Hazardous Materials Management; Ecological Impacts	1	n.a.	n.a.	2
Exposure to Environmental Impacts	2	Impact of extreme weather events on assets and/or operations and corresponding risk appetite & management; catastrophe risk; credit concentrations	Business Profile (incl. Management & governance); Risk Profile; Asset Quality	1

Social (S)

General Issues	S Score	Sector-Specific Issues	Reference	S Scale
Human Rights, Community Relations, Access & Affordability	2	Services for underbanked and underserved communities: SME and community development programs; financial literacy programs	Business Profile (incl. Management & governance); Risk Profile	5
Customer Welfare - Fair Messaging, Privacy & Data Security	3	Compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security)	Operating Environment; Business Profile (incl. Management & governance); Risk Profile	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Business Profile (incl. Management & governance)	3
Employee Wellbeing	1	n.a.	n.a.	2
Exposure to Social Impacts	2	Shift in social or consumer preferences as a result of an institution's social positions, or social and/or political disapproval of core banking practices	Business Profile (incl. Management & governance); Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Business Profile (incl. Management & governance)	5
Governance Structure	3	Board independence and effectiveness; ownership concentration; protection of creditor/stakeholder rights; legal /compliance risks; business continuity; key person risk; related party transactions	Business Profile (incl. Management & governance); Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Business Profile (incl. Management & governance)	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Business Profile (incl. Management & governance)	2
				1

How to Read This Page
ESG scores range from 1 to 5 based on a 15-level color gradation. Red (5) is most relevant and green (1) is least relevant.

The Environmental (E), Social (S) and Governance (G) tables break out the individual components of the scale. The right-hand box shows the aggregate E, S, or G score. General Issues are relevant across all markets with Sector-Specific Issues unique to a particular industry group. Scores are assigned to each sector-specific issue. These scores signify the credit-relevance of the sector-specific issues to the issuing entity's overall credit rating. The Reference box highlights the factor(s) within which the corresponding ESG issues are captured in Fitch's credit analysis.

The Credit-Relevant ESG Derivation table shows the overall ESG score. This score signifies the credit relevance of combined E, S and G issues to the entity's credit rating. The three columns to the left of the overall ESG score summarize the issuing entity's sub-component ESG scores. The box on the far left identifies some of the main ESG issues that are drivers or potential drivers of the issuing entity's credit rating (corresponding with scores of 3, 4 or 5) and provides a brief explanation for the score.

Classification of ESG issues has been developed from Fitch's sector ratings criteria. The General Issues and Sector-Specific Issues draw on the classification standards published by the United Nations Principles for Responsible Investing (PRI) and the Sustainability Accounting Standards Board (SASB).

Sector references in the scale definitions below refer to Sector as displayed in the Sector Details box on page 1 of the navigator.

CREDIT-RELEVANT ESG SCALE

How relevant are E, S and G issues to the overall credit rating?

5	Highly relevant, a key rating driver that has a significant impact on the rating on an individual basis. Equivalent to "higher" relative importance within Navigator.
4	Relevant to rating, not a key rating driver but has an impact on the rating in combination with other factors. Equivalent to "moderate" relative importance within Navigator.
3	Minimally relevant to rating, either very low impact or actively managed in a way that results in no impact on the entity rating. Equivalent to "lower" relative importance within Navigator.
2	Irrelevant to the entity rating but relevant to the sector.
1	Irrelevant to the entity rating and irrelevant to the sector.

Unless otherwise disclosed in this section, the highest level of environmental, social and governance (ESG) credit relevance is a score of 3 - 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.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.