FitchRatings

Banks
Retail & Consumer Banks
New Zealand

Nelson Building Society

Key Rating Drivers

Asset Quality Underpins Ratings: The ratings on Nelson Building Society (NBS) are underpinned by sound profitability and asset quality, which benefit from the building society's larger franchise relative to New Zealand non-bank deposit taker (NBDT) peers. Fitch Ratings expects the coronavirus pandemic to start affecting some of NBS's financial metrics in 2021. However, its credit profile is likely to remain stable.

Impaired Loans to Increase: Fitch expects the society's impaired loan ratio to start rising in 2021 due to the impact from the pandemic. However, significant deterioration is unlikely. We have revised the factor outlook to stable, as our base-case deterioration would be insufficient to warrant a lower asset quality score, currently at 'bbb-', and downside uncertainty has fallen.

Profitability Headwinds: NBS's profitability is likely to weaken moderately in the next 12 to 18 months due to our anticipated deterioration in asset quality and pressure from low interest rates. Nevertheless, we believe there is adequate buffer at NBS's current score for earnings and profitability to weather a deterioration that is more severe than our base-case expectations. Therefore, we have revised the factor outlook to stable.

Improving Capitalisation: Fitch expects capitalisation to continue improving, reflecting the society's sound profitability and management's focus on building capital buffers. NBS's credit growth is likely to remain moderate and generally in line with system growth in the next 12 months. The factor outlook on NBS's capitalisation and leverage score is stable.

Fully Deposit Funded: Fitch expects NBS's funding and liquidity profile to remain sound in the next two years. The society is funded entirely by member deposits, which we expect to continue. We maintain a stable factor outlook on the funding and liquidity score.

Reduced Downside Risks: Fitch has revised the factor outlook on the 'a-' operating environment score assigned to New Zealand NBDTs to stable, from negative. This reflects plans by New Zealand authorities to bring the NBDTs under the same regulatory framework as banks. It also considers the country's success in combatting the coronavirus pandemic, although downside risks remain. We will consider equalising the NBDT operating environment score with the bank score closer to the implementation of the new framework.

Rating Sensitivities

Increased Risk Appetite: The Long-Term Issuer Default Ratings (IDR) and Viability Rating may be downgraded if there is an increase in risk appetite, potentially aimed at expanding market share and profitability, that leads to greater volatility in the financial profile through the cycle.

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

Limited Upgrade Potential: The ratings may be upgraded 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 without affecting the core financial metrics for asset quality, earnings and funding. This appears unlikely in the short term. An improvement in risk controls to be more in line with that of New Zealand's 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+
Support Rating	5
Support Rating Floor	NF
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 (February 2020)

Related Research

Fitch Affirms Nelson Building Society at BB+; Outlook Stable (March 2021)

Fitch Ratings 2021 Outlook: Asia-Pacific Developed Market Banks (December 2020)

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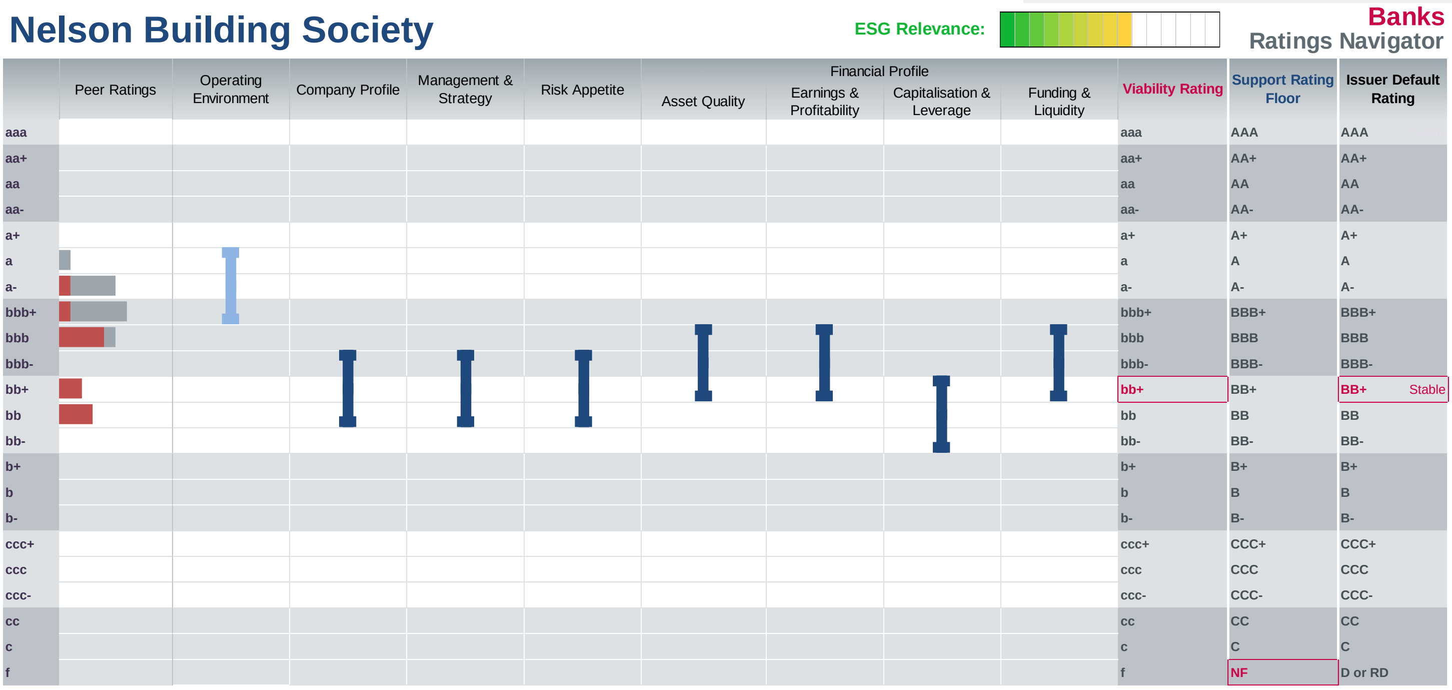
Sovereign/Institutional Support Assessment

Support Rating Floor			Value
Typical D-SIB SRF for sovereign's rating level (assuming high propensity)			A or A-
Actual country D-SIB SRF			N/A
Support Rating Floor:			**NF**
Support Factors	**Positive**	**Neutral**	**Negative**
Sovereign ability to support system			
Size of banking system relative to economy			✓
Size of potential problem		✓	
Structure of banking system			✓
Liability structure of banking system		✓	
Sovereign financial flexibility (for rating level)		✓	
Sovereign propensity to support system			
Resolution legislation with senior debt bail-in			✓
Track record of banking sector support		✓	
Government statements of support			✓
Sovereign propensity to support bank			
Systemic importance			✓
Liability structure of bank	✓		
Ownership		✓	
Specifics of bank failure		✓	
Policy banks			
Policy role			
Funding guarantees and legal status			
Government ownership			

The Support Rating and Support Rating Floor of NBS reflect our assessment that while support from the New Zealand government is possible, it cannot be relied on. The institution is 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 NBS's low systemic importance, will make sovereign support unlikely.

Ratings Navigator



Significant Changes

Operating Environment Factor Revised to Stable

Fitch has revised the factor outlook on the 'a-' operating environment score assigned to New Zealand NBDTs to stable, from negative. This reflects plans by local authorities to bring the NBDTs under the same regulatory framework as banks; the less stringent framework applied to NBDTs is the key reason for the once-notch difference between the operating environment score of the NBDTs and the banks (a/negative). The revision also considers the country's success in combatting the coronavirus pandemic, although downside risks remain. We will consider equalising the NBDT operating environment score with the bank score closer to implementation of the new framework.

Asset Quality Factor Revised to Stable

Fitch revised NBS's asset quality factor outlook to stable, from negative, reflecting a sufficient buffer at its current rating and limited downside risk in the short term.

Earnings and Profitability Factor Revised to Stable

Fitch revised the factor outlook on NBS's earnings and profitability to stable, from negative, as we believe there is adequate buffer at the society's current score to weather a deterioration that is more severe that our base-case expectations.

Bar Chart Legend

Vertical bars – VR range of Rating Factor

Bar Colors – Influence on final VR

- Higher influence
- Moderate influence
- Lower influence

Bar Arrows – Rating Factor Outlook

- ⇧ Positive
- ⇩ Negative
- ⇳ Evolving
- ▫ Stable

Brief Company Summary

Limited Downside Risk to Operating Environment

The outlook for the operating environment has improved since early 2020, largely due to New Zealand's success in handling the health crisis. Fitch expects real GDP to rise by 4.6% in 2021, following a contraction of 2.6% in 2020. However, risks to the outlook remain, with widespread vaccination unlikely to occur until late 2021, meaning international borders are likely to remain largely closed until the end of the year. Outbreaks of the virus in the community may also prompt localised or national lockdowns, while support measures will be gradually unwound during the year as well.

Strong house-price growth that is fuelled by credit growth poses risk in the medium-term if it leads to a significant increase in household leverage. This would leave households even more susceptible to any sudden increase in interest rates. We already consider New Zealand's high level of household debt when assigning the operating environment score.

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 community. NBS operates a small franchise consisting of eight branches that span across the country's upper South Island. The society operates in a competitive market against major banks and smaller institutions. Its lending market share, at less than 0.2%, is insignificant in the national context, meaning it has limited pricing power and is a price taker. Despite this, the society has expanded its balance sheet at rates in line with or faster than the system.

NBS offers full transaction banking services in addition to traditional loan and savings products to retail customers and small and medium businesses. It does not operate an insurance business, but has received commissions and fee income for referrals from third-party providers.

Adequate Management and Satisfactory Execution

NBS's management depth and experience is adequate for its size. The executive team consists of five members, including the CEO and four general managers who are responsible for a number of key functions, including banking operations, commercial and marketing, finance, risk and compliance. The society is overseen by trustees; while it files returns to the Reserve Bank of New Zealand, the regime is less stringent than the requirements for registered banks. NBS's corporate culture and identity has remained consistent through the cycle, focusing on typical mutual institutional values, such as service, benefit and community.

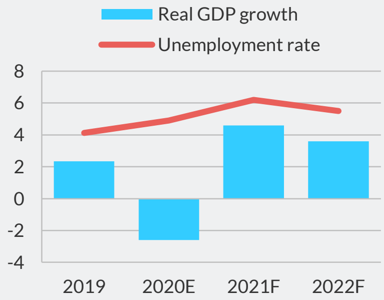
Underwriting Standards Generally In Line with Peers

NBS demonstrates a prudent approach to risk management. The society'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 materially higher than the advertised rate. NBS's exposure to commercial lending is moderate and mainly consists of loans to the property investment and agriculture sectors.

NBS's risk management framework and management tools are acceptable. Credit risk is managed by the general manager of risk and compliance, who regularly reports to the board through the CEO. Lending authorities are delegated based on position and experience, with any exceptions to policy approved by senior credit staff. NBS's operational risk-management approach appears adequate. Disaster recovery sites are tested annually to ensure smooth transition and switchover during a crisis. There was no major issue with employees working remotely during the coronavirus pandemic in 2020.

We expect NBS's credit growth to remain moderate in the short-term as management continues to focus on strengthening capitalisation. NBS does not have trading activity or foreign-exchange exposure. Its market risk primarily arises from fixed-rate lending and borrowings. Similarly to most other NBDTs, NBS uses a natural hedging strategy and manages this risk through the re-pricing of assets and liabilities. Loans are managed to relatively short fixed-rate periods, which limits interest rate mismatch. Market risk is monitored quarterly through the treasury committee.

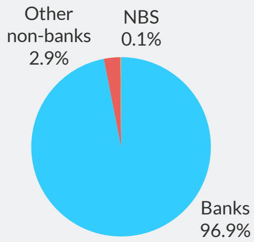
Economic Outlook



Source: Fitch Ratings, Fitch Solutions

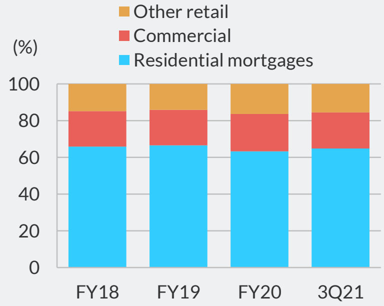
Market Share

Sep 20



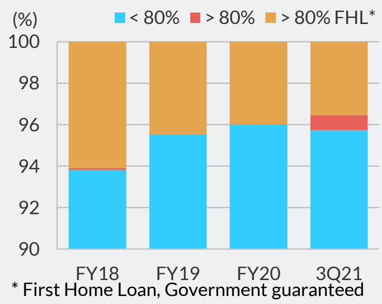
Source: Fitch Ratings, Reserve Bank of New Zealand, NBS

Loan Book



Source: Fitch Ratings,NBS

Mortgage Loan/Value Ratios



* First Home Loan, Government guaranteed
Source: NBS, Fitch Ratings

Summary Financials and Key Ratios

	31 Mar 20		31 Mar 19	31 Mar 18	31 Mar 17
	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	13	21,546.4	18,093.7	15,167.2	13,360.7
Net fees and commissions	1	1,328.1	941.1	866.0	801.6
Other operating income	0	425.2	357.0	359.6	321.9
Total operating income	14	23,299.7	19,391.8	16,392.8	14,484.2
Operating costs	7	11,266.8	10,712.6	9,975.2	9,180.6
Pre-impairment operating profit	7	12,032.9	8,679.2	6,417.6	5,303.6
Loan and other impairment charges	2	3,422.9	782.5	878.6	269.0
Operating profit	5	8,610.0	7,896.7	5,539.0	5,034.6
Other non-operating items (net)	n.a.	n.a.	n.a.	n.a.	n.a.
Tax	1	2,439.6	2,247.3	1,566.4	1,425.0
Net income	4	6,170.4	5,649.4	3,972.6	3,609.6
Other comprehensive income	n.a.	n.a.	n.a.	146.5	101.2
Fitch comprehensive income	4	6,170.4	5,649.4	4,119.1	3,710.8
Summary balance sheet					
Assets					
Gross loans	408	680,021.8	641,832.7	558,355.6	489,511.6
- Of which impaired	1	874.4	1,150.9	1,589.8	0.0
Loan loss allowances	3	4,209.6	1,330.9	1,331.2	711.6
Net loans	405	675,812.2	640,501.8	557,024.4	488,800.0
Interbank	109	181,335.9	182,265.0	159,659.1	143,409.8
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	514	857,148.1	822,766.8	716,683.5	632,209.8
Cash and due from banks	1	2,464.8	2,142.5	2,677.1	2,345.9
Other assets	4	5,914.9	3,907.6	3,667.8	3,925.9
Total assets	519	865,527.8	828,816.9	723,028.4	638,481.6
Liabilities					
Customer deposits	473	789,081.1	767,946.2	671,721.5	594,998.7
Interbank and other short-term funding	n.a.	n.a.	n.a.	n.a.	n.a.
Other long-term funding	0	612.8	n.a.	n.a.	n.a.
Trading liabilities and derivatives	n.a.	n.a.	n.a.	n.a.	n.a.
Total funding	474	789,693.9	767,946.2	671,721.5	594,998.7
Other liabilities	1	2,448.2	2,404.3	2,234.7	1,652.5
Preference shares and hybrid capital	23	39,048.5	29,068.5	24,278.5	20,280.5
Total equity	21	34,337.2	29,397.9	24,793.7	21,549.9
Total liabilities and equity	519	865,527.8	828,816.9	723,028.4	638,481.6
Exchange rate		USD1 = NZD1.6675	USD1 = NZD1.473839	USD1 = NZD1.38831	USD1 = NZD1.4304

Source: Fitch Ratings, Fitch Solutions

Summary Financials and Key Ratios

	31 Mar 20	31 Mar 19	31 Mar 18	31 Mar 17
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	1.4	1.4	1.2	1.1
Net interest income/average earning assets	2.6	2.4	2.4	2.5
Non-interest expense/gross revenue	48.4	55.2	60.9	63.4
Net income/average equity	19.4	20.9	17.1	18.0
Asset quality				
Impaired loans ratio	0.1	0.2	0.3	0.0
Growth in gross loans	6.0	15.0	14.1	21.3
Loan loss allowances/impaired loans	481.4	115.6	83.7	n.a.
Loan impairment charges/average gross loans	0.5	0.1	0.2	0.1
Capitalisation				
Common equity Tier 1 ratio	n.a.	n.a.	n.a.	n.a.
Fully loaded common equity Tier 1 ratio	n.a.	n.a.	n.a.	n.a.
Fitch Core Capital ratio	5.4	5.2	5.1	4.7
Tangible common equity/tangible assets	3.8	3.5	3.4	3.3
Basel leverage ratio	n.a.	n.a.	n.a.	n.a.
Net impaired loans/common equity Tier 1	n.a.	n.a.	n.a.	n.a.
Net impaired loans/Fitch Core Capital	-10.1	-0.6	1.1	-3.4
Funding and liquidity				
Loans/customer deposits	86.2	83.6	83.1	82.3
Liquidity coverage ratio	n.a.	n.a.	n.a.	n.a.
Customer deposits/funding	95.2	96.4	96.5	96.7
Net stable funding ratio	n.a.	n.a.	n.a.	n.a.

Source: Fitch Ratings, Fitch Solutions

Key Financial Metrics – Latest Developments

Impaired Loans to Rise, Material Weakening Unlikely

Fitch expects NBS's impaired loan ratio to start rising in 2021 due to the impact from pandemic. However, significant deterioration is unlikely due to sound underwriting standards. Low interest rates should also continue to support banking-sector asset quality in the next few years. NBS's loan impairments and credit losses have historically been low through the cycle.

NBS's limited franchise and regional focus leaves its asset quality susceptible to product and geographic concentration, although we believe this risk is mitigated by strong collateral coverage. NBS's high geographic concentration reflects its business model, but compares favourably with some smaller peers. Exposure to the Nelson and Tasman regions accounted for 69% of the society's total loan book in FY20.

Profitability Stronger than Peers; Headwinds Remain

NBS's profitability is likely to weaken moderately in the next 12 to 18 months due to our anticipated deterioration in asset quality and pressure from low interest rates. Its margin improved during FY20, reflecting strong brand recognition in its home markets, which provided some flexibility to reprice its loan book and customer deposits. However, we believe NBS's credit growth will remain subdued in the near term and for its holding of liquid assets to remain elevated. This could further pressure its interest margin and net interest income.

Non-interest income accounts for a small portion of NBS's total revenue, at approximately 7% in FY20, and is likely to remain flat in the near-term due to stable transaction volumes. Operating expenses may continue to rise moderately on ongoing investment in systems and compliance. Higher regulatory and compliance costs could have a larger impact on smaller entities, like NBDTs. Nonetheless, we believe NBS is better positioned to manage a rising cost base relative to peers, reflecting its larger size within the peer group.

Steady Improvement in Capitalisation and Leverage

Fitch expects NBS's capitalisation to continue improving over the next two years, reflecting its profitability and management's focus on increasing capital buffers. Credit growth should stay moderate and generally in line with system growth in the next 12 months, which will ease pressure on capitalisation. The regulatory capital ratio rose to 13.9% at December 2020, despite the impact from the pandemic, from 11.9% in March 2020, driven by higher retained earnings and new perpetual preference shares issued during the year.

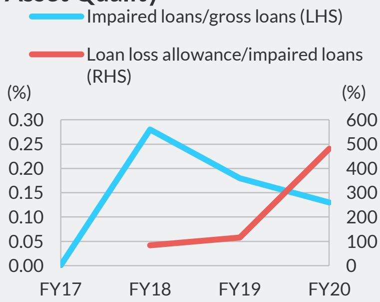
NBS's capitalisation and leverage score of 'bb' is supported by its large preference share issuance; we use the Fitch Core Capital ratio as the starting point to assess the capitalisation of New Zealand NBDTs and make adjustments based on available regulatory capital buffers. The regulatory total capital ratio is an important measure, as it is the only regulatory requirement applied to these entities.

Fully Deposit Funded, Liquidity Ratios to Remain Elevated

Fitch expects NBS's funding and liquidity profile to remain sound in the next two years. The society is funded entirely by member deposits, which we believe will continue. Deposit growth is likely to remain strong in the next 12 months, reflecting significant government stimulus and the substantial amount of liquidity injected by the Reserve Bank of New Zealand through its quantitative easing programme. Deposit reinvestment rates have been stable, but the geographic concentration of NBS's deposits remains high, reflecting its business model. There is a modest level of individual concentration.

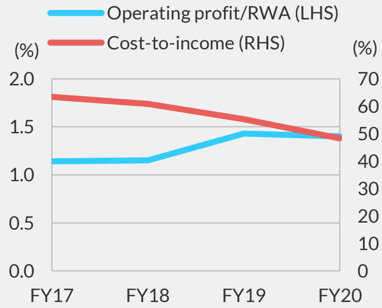
NBS's liquidity is appropriately managed and its holding of liquid assets increased during 2020, driven by deposit growth. We believe the society's liquidity position will remain elevated in the near term. Liquid assets comprised of interbank deposits and cash reserves, typically on-call deposits and short-dated term deposits with up to 12 months maturity.

Asset Quality



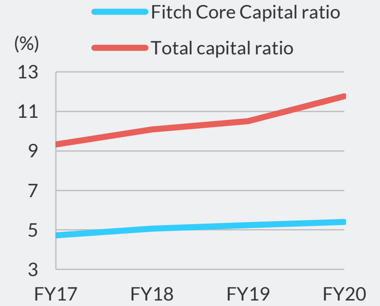
Source: Fitch Ratings, Fitch Solutions, NBS

Profitability



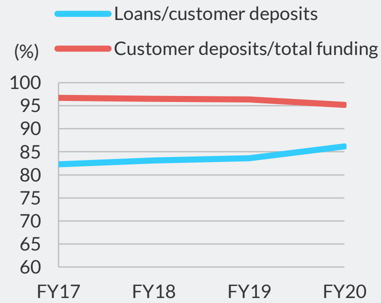
Source: Fitch Ratings, Fitch Solutions, NBS

Capitalisation



Source: Fitch Ratings, Fitch Solutions, NBS

Funding



Source: Fitch Ratings, Fitch Solutions, NBS

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	Company Profile; Management & Strategy; Risk Appetite; 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	Company Profile; Management & Strategy; Risk Appetite	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; Company Profile; Management & Strategy; Risk Appetite	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Company Profile; Management & Strategy	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	Company Profile; Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Management & Strategy	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	Management & Strategy; Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Company Profile	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Management & Strategy	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.