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Research Update:

New Zealand-Based Manchester Unity Credit Union Ratings Affirmed On Criteria Revision; Outlook Stable

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Overview

- Following a review of Manchester Unity Credit Union (MUCU) under Standard & Poor's revised bank criteria (published Nov. 9, 2011), we have affirmed our issuer credit ratings on MUCU at 'B+/B'. The outlook is stable.
- Our ratings on MUCU reflect the anchor stand-alone credit profile for a financial institution operating only in New Zealand, plus MUCU's very weak business position, very strong capital and earnings, weak risk position, below average funding and adequate liquidity.
- The stable outlook reflects our expectation that MUCU's asset-quality experience and depositor support will remain sound amid an expectation that the credit union will seek to resolve its moderating business position through an amalgamation with a larger credit union prior to any need to reassess its business-risk position.

Rating Action

As previously announced, on Dec. 13, 2011, Standard & Poor's Ratings Services affirmed its issuer credit ratings on Manchester Unity Credit Union (MUCU) at 'B+/B'. The outlook is stable.

Rationale

Our ratings on MUCU reflect the anchor stand-alone credit profile (SACP) for a financial institution operating only in New Zealand, plus MUCU's "very weak" business position, "very strong" capital and earnings, "weak" risk position, "below average" funding and "adequate" liquidity.

Our bank criteria use the BICRA economic risk and industry risk scores to determine a bank's anchor SACP, the starting point in assigning an ICR. The anchor SACP for a bank operating only in New Zealand is 'bbb+'. The BICRA score factors in our evaluation of economic risk, where we view that: New Zealand is an open, flexible, and well-developed economy; risk of economic imbalances have eased following some deleveraging in the private sector and an orderly wind down of real estate prices in the recent years; and, high private sector debt is mitigated by track record of low credit losses, conservative lending practices, and a creditor-supportive legal framework. Our assessment of industry risk in the New Zealand banking sector is underpinned by conservative regulation and the sector's restrained risk appetite, which are partly offset by limited funding support from customer deposits and a material dependence on net external borrowings.

The SACP for MUCU is 'b+'.

MUCU's business position is assessed as "very weak", highlighting its very concentrated residential mortgage loan portfolio and small and slowly-declining market position (gross loans have declined by 13.1% since March 31, 2008, to about NZ$33.3 million against a financial system asset base of about NZ$184 billion) as a retail-focused financial service provider in the Hawkes Bay region of New Zealand. Although the credit union has been well supported by its member base in the past, particularly its deposit customers--aided by government-wide system support from 2008 through 2010--MUCU's small size and limited operational efficiency (in an environment of rising compliance costs) have brought into question the credit union's longer-term business viability and supports the prospect that it might look to amalgamate with another credit union or financial institution. MUCU's business model is based around churning the credit union's balance sheet without materially increasing its size, which limits its ability to achieve operating efficiencies that can support its ability to compete with other, larger, more cost-efficient and better-resourced financial institutions. Furthermore, our assessment of MUCU's business position remains moderated by ongoing challenges a small mutual like MUCU faces in securing a board composition with a strong board governance-oversight capability, and business pressures stemming from the current subdued operating environment, which has seen a significant drop in new lending opportunities.

Our "very strong" assessment of capital and earnings is underpinned by our forecast risk-adjusted capital (RAC) ratio for MUCU of 18.0%-18.5% in fiscal 2012, offsetting to an extent MUCU's very small capital base and limited financial flexibility. Our forecasts factor in an expectation of a further softening in gross lending volumes, supported by a very modest earnings projection for 2012, which remain unencumbered by very low credit costs relative to peers. The increasing RAC outlook also compensates for the three-year average earnings buffer of around minus 15 bps in 2012--against normalised loss expectations of about 25 bps--which indicates forecast earnings would be unable to cover normalised losses in 2012.

MUCU's "weak" risk-position assessment is based on our view that the credit union's lending concentration, narrow management and governance structure, and rudimentary risk-management practices are not sufficiently captured in our "very strong" capital and earnings assessment. In particular, MUCU's capital base of NZ$3.7 million affords only minimal protection against a major negative event or operational risk problem. Further, we believe Standard & Poor's RAC calculation does not adequately capture MUCU's geographic concentration, nor does it adequately capture the single-name concentration (relative to capital) within its investment portfolio. That said, MUCU's credit-loss experience has been superior to that of both normalised loss expectations--actual credit losses were negligible in 2011--and relative to system, and we expect losses to remain very low in the medium term.

MUCU's funding is assessed as "below average" and liquidity is assessed as "adequate". Despite exhibiting strong funding metrics, with MUCU's loan-to-deposit ratio superior to system average at 72.3%, comprising retail deposits only, we believe MUCU's funding profile is sensitive to future disruptions in confidence in the New Zealand credit union sector, while competitive pressures from major banks that are reliant on offshore wholesale funding also pose a threat, should they compete more aggressively for domestic retail deposits. In our view, MUCU has adequate liquidity to meet its deposit obligations, underpinned by its balance-sheet liquid-asset holdings and cash flows generated from its lending activities. The ratio of net broad liquid assets to short-term customer deposits stood at a strong 33.1% in 2011, well above the domestic average--albeit in part reflecting limited lending opportunities--which moderates MUCU's limited access to additional sources of liquidity.

Outlook

The outlook reflects our expectation that MUCU's asset-quality experience and depositor support will remain sound amid an expectation that the credit union will seek to resolve its moderating business position through an amalgamation with a larger credit union prior to any need to reassess its business-risk position.

The rating could come under downward rating pressure from a number of fronts. These include:

- A reassessment of its capital and earnings assessment to "strong" if forecast earnings are less than anticipated, prompting a reduction in its forecast RAC ratio to below 15%
- A reassessment of its risk position to "very weak" if key credit quality indicators deteriorated sharply, or an unexpected loss that materially undermined our current view of the credit union's enterprise-wide risk-management capability.
- A sharp weakening in MUCU's deposit reinvestment or depositor support experience, which led to a reassessment of its funding and liquidity position.

We believe the most likely path to a rating upgrade for MUCU rests with an amalgamation with a larger, more-diversified group.

Rating Score Snapshot

Issuer credit rating	B+/Stable/B
SACP	b+
Anchor	bbb+
Business position	Very weak (-5)
Capital and earnings	Very strong (+2)
Risk position	Weak (-2)
Funding and liquidity	Below average and adequate (-1)

Support	0
GRE support	0
Group support	0
Sovereign support	0
Additional factors	0

Related Criteria And Research

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Group Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Ratings List

Ratings Affirmed

Manchester Unity Credit Union	
Issuer credit rating	B+/Stable/B

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.