

CREDIT OPINION

14 April 2016

Update

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RATINGS

Kiwibank Limited

Domicile	New Zealand
Long Term Rating	Aa3 , Possible Downgrade
Type	LT Bank Deposits - Fgn Curr
Outlook	Rating(s) Under Review

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Kiwibank Limited

Update after rating action

Summary Rating Rationale

On 7 April 2016, Moody's placed the ratings of Kiwibank Limited on review for downgrade. The rating action is a result of Kiwibank's announcement that its parent, New Zealand Post, intends to remove its guarantee on Kiwibank's payment obligations. Should the guarantee be removed, the change would only apply to future obligations. Hence the bank's Aa3 Backed Senior Unsecured and (P)Aa3 Backed Senior Unsecured MTN Program ratings, which represent Kiwibank's existing senior unsecured obligations, are not impacted by this announcement.

The announcement also states that New Zealand Post has received an indicative offer from two government-owned entities, New Zealand Superannuation Fund (NZ Super Fund) and the Accident Compensation Corporation (ACC) to purchase stakes of 25% and 20%, respectively, of Kiwi Group Holdings Limited.

Moody's will complete the review when the bank announces a decision on the parent guarantee, which is expected by 30 June 2016, after the sale to NZ Super Fund and ACC is completed.

The rating review will focus on (1) Moody's assessment of ongoing government support for Kiwibank; (2) the financial profiles of NZ Super Fund and the ACC and the final terms of the sale; (3) any changes made to the terms of the uncalled capital facility.

Kiwibank Limited's long-term issuer rating of Aa3 incorporates the very high potential for support from its parent, New Zealand Post Limited, which lifts the rating five notches above its baseline credit assessment of baa2. The payment obligations of Kiwibank benefit from a deed poll guarantee provided by New Zealand Post, which is a State-Owned Enterprise.

The rating uplift provided by the guarantee reflects the strength of New Zealand Post, which in turn benefits from a high potential for support from the New Zealand government (Aaa stable) - given the government's ownership of New Zealand Post and its importance to the New Zealand economy - and its commitment to supporting Kiwibank.

Credit Strengths

- » Guarantee from New Zealand Post
- » Strong distribution network and brand recognition support franchise
- » Strong funding profile that is centered on deposits
- » New Zealand's Strong+ macro profile

Credit Challenges

- » Capital generation has improved but profitability challenges are rising
- » Residential mortgages underpin strong asset quality although house prices remain high

Rating Outlook

Kiwibank's ratings are currently on review for downgrade

Factors that Could Lead to an Upgrade

Given that Kiwibank's ratings are on review for downgrade there is very little upward potential for Kiwibank's rating.

Factors that Could Lead to a Downgrade

- » Removal of the guarantee from New Zealand Post
- » Downgrade of the New Zealand Government rating
- » Deterioration of the financial profile of New Zealand Post
- » Changes to Government policy or ownership that impact the potential for support of New Zealand Post and/or Kiwibank

Key Indicators

Exhibit 1

Kiwibank Limited (Consolidated Financials) [1]

	12-15 ²	6-15 ²	6-14 ²	6-13 ²	6-12 ³	Avg.
Total Assets (NZD million)	18,459	17,754	16,676	15,209	14,745	5.8 ⁴
Total Assets (USD million)	12,637	12,007.1	14,600.7	11,745.9	11,851.3	1.6 ⁴
Tangible Common Equity (NZD million)	835	816	750	641	568	10.1 ⁴
Tangible Common Equity (USD million)	571.6	551.9	656.7	495	456.5	5.8 ⁴
Problem Loans / Gross Loans (%)	0.1	0.2	0.4	0.5	1	0.4 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	9	9.3	9.2	8.6	8.2	9 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	2.7	3.7	6.8	10	18.2	8.3 ⁵
Net Interest Margin (%)	2	2	1.8	1.8	1.7	1.9 ⁵
PPI / Average RWA (%)	2.1	2.1	1.6	1.8	2	1.9 ⁶
Net Income / Tangible Assets (%)	0.7	0.7	0.5	0.6	0.5	0.6 ⁵
Cost / Income Ratio (%)	61.1	61.2	67.7	69.5	66.5	65.2 ⁵
Market Funds / Tangible Banking Assets (%)	13.8	14.1	15	12.2	15.7	14.2 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	9.9	10.6	10.4	11.2	13.5	11.1 ⁵
Gross loans / Due to customers (%)	113.7	113.9	115.2	109.5	108.4	112.1 ⁵

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Source: Moody's Financial Metrics

Detailed Rating Considerations

GUARANTEE FROM NEW ZEALAND POST

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

The payment obligations of Kiwibank benefit from a deed poll guarantee provided by its parent, New Zealand Post Limited, a State-Owned Enterprise. The benefits of this guarantee are a key ratings driver for Kiwibank and hence the rating is sensitive to removal of the guarantee or any perceived changes by the government in its attitude towards the support of either Kiwibank or New Zealand Post.

The rating uplift provided by the guarantee reflects the credit strength of New Zealand Post, which itself incorporates the high potential for support from the New Zealand government (Aaa Stable) - given the government's ownership of New Zealand Post and its importance to the New Zealand economy.

The Government has provided an NZ\$300m "uncalled capital facility" to New Zealand Post for the express purpose of supporting Kiwibank in case of need. The facility cannot be used to fund the growth of the bank and New Zealand Post can only call upon it in certain circumstances - such as a stress event where its additional capital needs exceed the resources of both Kiwibank and New Zealand Post. Nevertheless, we view this facility to be an important driver of the rating, given the size of the facility relative to Kiwibank's capital base.

STRONG DISTRIBUTION NETWORK AND BRAND RECOGNITION SUPPORT FRANCHISE

Formed in November 2001, Kiwibank was established by the New Zealand government to promote competition in the banking sector, which is dominated by the New Zealand subsidiaries of Australia's four major banks. Kiwibank is a wholly owned subsidiary of New Zealand Post, which itself is wholly owned by the New Zealand government.

Through its strong brand recognition as a government-owned entity and by leveraging off its parent's network of 269 PostShops (of which 113 are now under bank control), Kiwibank maintains a stronger market position than its 4% total loan market share would suggest. The bank's current programme to refurbish some of these PostShops (to focus more on banking) will support the visibility of the bank's franchise.

With access to a nationwide branch network, competitive pricing and successful marketing, Kiwibank has grown well in excess of the system, to become New Zealand's fifth largest bank by assets, and the largest domestically-owned bank. Currently, the bank has market share of approximately 5% for total deposits and 4% for total loans.

Primarily a retail bank, Kiwibank has historically focused on residential mortgages and deposit gathering, which make up the largest part of the bank's income. However, the bank is now focused on improving its revenue generation by targeting higher-margin SME lending as well as becoming the main relationship bank for its customers.

CAPITAL GENERATION HAS IMPROVED BUT PROFITABILITY CHALLENGES ARE RISING

Historically, Kiwibank's standalone profile has reflected the bank's reliance on capital support from New Zealand Post. Its parent has made regular capital injections since the bank was established in 2002. This capital support has in turn enabled the bank's strong and frequently price-led growth, to meet its mandate to provide a domestically-owned alternative to the subsidiaries of Australia's four major banks.

However, as a result of its high rate of growth and below-peer margins, Kiwibank has not generated sufficient retained earnings to meet its growing capital needs, which has historically constrained its baseline credit assessment.

Over the past few years, the bank has moderated its loan growth to levels more in line with its ability to generate capital internally, which has also improved - during FY2015 the bank reported a 27% increase in net profits to NZD127million. As a result, the bank was able to pay, for the first time, dividends of NZD46m for the 2015 financial year.

While the outlook for profitability in the broader banking sector is challenging -- given margin pressure from competitive forces -- Moody's expects that the bank will manage its loan growth to minimize any need for any further injections of capital from its parent.

RESIDENTIAL MORTGAGES UNDERPIN STRONG ASSET QUALITY ALTHOUGH HOUSE PRICES REMAIN HIGH

Predominantly a mortgage lender, Kiwibank's strong asset quality is supported by its low-risk loan portfolio: residential mortgages have demonstrated low loss rates over time and continue to perform relatively well in the current economic environment.

Whilst the bank's asset quality metrics remain very strong, household leverage and house prices, particularly in Auckland, are high relative to historical levels. This exposes the New Zealand housing market to external shocks that could increase unemployment, which could lead to a rapid decline in house prices and place pressure on asset quality. This risk underpins our negative 'asset risk' adjustment in our scorecard.

Kiwibank's risk management framework is commensurate with its business model, which has been centred around relatively homogenous residential mortgage lending. However, the bank continues to invest in its systems and has commenced plans to modernise its core banking systems over the next three years. Given the bank's intention to diversify into different areas, such as increasing SME lending, we would view this as an important step in supporting future growth aspirations.

STRONG FUNDING PROFILE THAT IS CENTERED ON DEPOSITS

Kiwibank's funding is expected to continue to be centered on customer deposits, which make up approximately 83% of total funding. Whilst competition for stable deposits remains strong, the bank's deposit growth is supported by its extensive distribution network and competitive pricing.

Whilst competitively-priced products will always attract a portion of price-sensitive funding, we expect Kiwibank's customers to be more "sticky" than other smaller institutions that also adopt similar pricing strategies. This is due to Kiwibank's government ownership (via New Zealand Post), which is likely to provide some reassurance to customers during times of economic stress.

In addition to deposits, the bank supplements its funding through the issuance of long-term and short-term debt securities in both the domestic and offshore wholesale markets. Such instruments provide some diversification to the bank's funding profile and allows it to access funding that is cheaper than some customer deposit products. However, we note that the bank's standalone credit profile could face pressure should the bank significantly increase its (currently low) reliance on short-term debt.

Kiwibank's liquidity position is adequate and covers all of its short-term wholesale debt. The bank has a conservative liquidity policy and ensures that its liquid asset portfolio is comprised predominantly of highly-rated securities. In order to alleviate any short-term funding requirements, the bank has established NZ\$600m of internal RMBS, which it is able to repo with the Reserve Bank of New Zealand and hence provides an important contingent source of liquidity. To reflect this additional source of liquidity, we apply a positive adjustment to this section of our scorecard, assessing Liquid Resources in the 'baa' range.

KIWIBANK'S RATING IS SUPPORTED BY NEW ZEALAND'S STRONG+ MACRO PROFILE

New Zealand banks, including Kiwibank, benefit from operating in a country with high economic strength, very high institutional and government financial strength, and low susceptibility to event risk. However, our view of New Zealand's economic structure also incorporates the country's structural reliance on external financing: on a net basis, New Zealand's foreign debt funding has traditionally been sourced primarily through the banking system. Credit growth has also started to accelerate, increasing the potential for the country's high private sector debt, and in particular, housing sector debt, to amplify negative shocks.

Economic growth is weakening on the back of low dairy prices, which is New Zealand's largest export commodity. Whilst this weakness has been primarily evident in lower export incomes, it could have broader, second-order negative effects on the rest of the economy as milk prices are likely to remain subdued beyond the current 2015/2016 dairy season.

Notching Considerations

There is currently no statutory bail-in regime in place in New Zealand. As a result, we do not consider New Zealand to have an operational resolution regime (as defined in our methodology). Therefore we apply a basic loss-given-failure (LGF) approach in rating New Zealand banks' junior securities.

In determining whether New Zealand has an operational resolution regime we take into account both the current resolution framework and the New Zealand policymakers' public stance. Whilst the New Zealand authorities have developed a framework to impose losses on creditors outside of bankruptcy under their Open Bank Resolution (OBR) Policy, we view this framework to be a policy tool for responding to a bank failure, rather than a statutory bail-in regime. Furthermore, the RBNZ has acknowledged that the OBR is not intended to be the only option in the event of a bank failure and that there may be circumstances in which a private sector solution is available.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Methodology and Scorecard Factors

Exhibit 2

Kiwibank Limited

Macro Factors						
Weighted Macro Profile	Strong +	100%				
Financial Profile						
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	0.3%	aa1	↓	aa3	Expected trend	Quality of assets
Capital						
TCE / RWA	9.0%	ba1	← →	baa3	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	0.6%	baa2	↓	baa3	Expected trend	
Combined Solvency Score		a3		baa1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	14.1%	a2	← →	a2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	10.6%	ba1	← →	baa3	Additional liquidity resources	
Combined Liquidity Score		baa1		baa1		
Financial Profile				baa1		
Business Diversification				-1		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				-1		
Sovereign or Affiliate constraint:				Aaa		
Scorecard Calculated BCA range				baa1-baa3		
Assigned BCA				baa2		
Affiliate Support notching				--		
Adjusted BCA				aa3		

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Counterparty Risk Assessment	--	--	--	--	Aa2(cr) RUR Possible Downgrade	--
Deposits	--	--	--	--	Aa3 RUR Possible Downgrade	Aa3 RUR Possible Downgrade

Source: Moody's Financial Metrics

Ratings

Exhibit 3

Category	Moody's Rating
KIWIBANK LIMITED	
Outlook	Rating(s) Under Review
Bank Deposits	Aa3/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	aa3
Counterparty Risk Assessment	Aa2(cr)/P-1(cr)
Issuer Rating	Aa3
Bkd Senior Unsecured	Aa3
ST Issuer Rating	P-1

Source: Moody's Investors Service

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REPORT NUMBER 1022607