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Research Update:

Ratings On Kiwibank Ltd. Affirmed At 'A+/A-1', Outlook Remains Negative

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Overview

- We have affirmed our issuer credit rating on Kiwibank Ltd. at A+/Negative/A-1.
- These ratings remain equalized with those on the bank's parent, New Zealand Post, which unconditionally guarantees all of the bank's senior obligations.
- We believe that an improvement in Kiwibank's business profile has neutralized the impact of increased risks within New Zealand's financial system on the bank's stand-alone credit profile, which therefore remains unchanged.
- Nevertheless, the rating outlook on Kiwibank remains negative, mirroring that on its parent New Zealand Post. This reflects our view that downside ratings pressure remains on the broader New Zealand Post group, due primarily to ongoing structural pressures in the core postal operations and execution risks associated with the group's restructuring programs.

Rating Action

On Aug. 14, 2015, Standard & Poor's Ratings Services affirmed its issuer credit ratings on Kiwibank at 'A+/A-1'. The outlook on Kiwibank Ltd. remains negative. The ratings on Kiwibank remain equalized with those on its parent, New Zealand Post Ltd. (NZ Post, A+/Negative/A-1), reflecting the benefit of an unconditional guarantee from the parent for all of the bank's senior obligations.

Rationale

The rating affirmation is based on our view that an improvement in Kiwibank's business profile has neutralized the impact of increased risks within New Zealand's financial system.

Kiwibank forms a significant part of the NZ Post group's earnings and assets. Consequently, any changes in its stand-alone credit profile (SACP; that is, excluding the benefits of parent support) could affect the credit profile and rating on the NZ Post group, which would then be reflected in a change in the Kiwibank rating (see related research on New Zealand Post Ltd.). We believe that the risks facing all the financial institutions in New Zealand have increased due to the prolonged period of strong residential property price inflation, particularly in Auckland. Nevertheless, we consider the impact of

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these increased risks on Kiwibank's credit-profile—and consequently on the NZ Post group's credit profile and rating--have been neutralized by an improvement in the bank's business profile.

We have been highlighting our view of increasing risks in the New Zealand financial system in several commentaries since 2013 (see Related Research), during which we placed the ratings on Kiwibank, as well as a number of other New Zealand financial institutions, on negative outlook.

We believe the higher risk within New Zealand's financial system stems from increased imbalances in the economy arising from the strong growth in residential property prices, particularly in Auckland, over the past three years. This has occurred against a broader backdrop of structural economic weaknesses, including a material reliance on external borrowings. Our base-case expectation remains that economic imbalances will unwind in an orderly manner. Nevertheless, we believe there is an increased risk of a sharp correction in property prices, which would likely be accompanied by a material weakening in general economic conditions, and would lead to higher credit losses for most financial institutions operating in New Zealand.

We consider that Kiwibank has further strengthened its competitive advantages in the past two years over the smaller financial institutions in New Zealand that target the same customer base, and narrowed the gap between itself and the major banks. Kiwibank's stronger business profile is reflected in a defendable and increasingly significant market share in New Zealand. We estimate that Kiwibank had an 8% share of residential mortgages and 5% share of customer deposits in New Zealand at March 31, 2015. Demonstrating the bank's franchise strength is its above banking-system growth in residential mortgages, and maintenance of its net interest margin and the credit quality of its residential mortgage loan portfolio.

We believe that Kiwibank's restructuring of its distribution network and progress in completing the first phase to replace its core banking system in the quarter ending Sept. 30, 2015, will better enable it to cater to the evolving needs of its customer base and sustain its business growth.

Furthermore, in our view, Kiwibank has leveraged off and consolidated its competitive advantage over the four major banks as well as the smaller financial institutions, by positioning itself as a domestically-owned full-service bank with a nationwide presence. We believe that this appeals to a significant section of the customer base, given that the New Zealand banking system is dominated by the four Australian-owned major banks, which account for about 90% of the market share.

Despite this strengthening in Kiwibank's business profile, we consider that it remains disadvantaged relative to the New Zealand major banks in its primary business of deposit-taking and residential-mortgage lending, which is becoming increasingly commoditized and price-sensitive. We consider that Kiwibank's larger competitors generally enjoy greater pricing power and operating efficiency due to greater economies of scale as well as business diversity.

We forecast that Kiwibank will maintain a strong risk-adjusted capital ratio at 11% to 12% in the next 18 months, despite the increase in our risk weights stemming from higher economic risks facing New Zealand banks. We believe that Kiwibank and its parent are committed to, and capable of, maintaining the bank's capital at this level. Our forecast also factors in our expectation of continued above banking-system asset growth for the next two years.

We consider that other credit factors specific to Kiwibank remain largely unchanged.

Outlook

The outlook reflects that on Kiwibank's parent, NZ Post. We expect the ratings on Kiwibank to remain equalized with those on NZ Post unless there is a significant dilution or withdrawal of the guarantee provided by the parent.

We expect to lower the ratings on Kiwibank by one notch if the same rating action occurs for its parent NZ Post. The most likely triggers for a downgrade of NZ Post's rating are if:

- The letter-delivery business experiences material losses;
- There is a significant deterioration in the competitive position or operating performance of any of the group's key businesses; or
- Funds from operations (FFO)-to-debt (excluding any contribution from the banking operations) is sustained at less than 25%, due to persisting weak operating performance, debt-funded acquisitions, or debt-funded distributions.

Although less likely, downward ratings pressure could also arise if: 1) we considered there to be a reduced likelihood that the New Zealand government would provide timely and sufficient extraordinary support to the NZ Post group or 2) we lowered our SACP on Kiwibank. The most likely scenario for Kiwibank contributing to rating pressure on NZ Post would be a weakening in bank's business profile. We believe the bank's business would be under pressure if there were a prolonged period of slower organic growth and reducing net interest margins relative to the New Zealand major banks and system average, which could be indicative of--among other things--a structural decline in Kiwibank's business franchise.

Although a one-notch downgrade of the NZ Post rating will be mirrored in the Kiwibank rating, the latter is insulated from any further downgrade in the parent rating, all other things remaining equal for Kiwibank. This is because we consider that Kiwibank has a "high" likelihood of receiving extraordinary support from the New Zealand government, reflecting the bank's "very strong" link and "important" role to the government.

Therefore, the rating on Kiwibank can factor in external support from either its parent or extraordinary support from the government, whichever is higher.

While the rating on the bank currently benefits from parent support (because this offers the highest rating uplift benefit), external support from the two sources would provide equal rating uplift if the rating on NZ Post is lowered by one notch. If there is any further deterioration in the parent rating, the uplift in the bank rating due to extraordinary government support would exceed that from the parent support, and thus sufficient to maintain the long-term issuer credit rating on the bank at 'A', all other things remaining equal.

We expect to revise the outlook to stable if:
- NZ Post maintains and improves the profitability of its letter-delivery business, underpinned by effective execution of its cost reduction strategies under the revised Deed of Understanding; and
- NZ Post maintains its FFO-to-debt (excluding the banking operations) of more than 25%.

We see limited prospects for upward rating movement in the next two years for Kiwibank.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	A+/Negative/A-1	A+/Negative/A-1
SACP Anchor	bbb	bbb+
Business Position	Adequate (0)	Moderate (-1)
Capital and Earnings	Strong (+1)	Strong (+1)
Risk Position	Moderate (-1)	Moderate (-1)
Funding	Average (0)	Average (0)
Liquidity	Adequate	Adequate
SACP	bbb	bbb
Support	4	4
GRE Support	0	0
Group Support	4	4
Sovereign Support	0	0
Additional Factors	0	0

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Group Rating Methodology, Nov. 19, 2013
- Quantitative Metrics For Rating Banks Globally: Methodology And

Assumptions, July 17, 2013
- Legal Criteria: Guarantee Criteria-Structured Finance, May 7, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Credit FAQ: Explaining Standard & Poor's Rating Actions On Several New Zealand Financial Institutions Due To Rising House Prices, Aug. 14, 2015
- Various Rating Actions Taken On New Zealand Financial Institutions Reflecting Rising Economic Imbalances, Aug. 14, 2015

Ratings List

Ratings Affirmed

Kiwibank Ltd.	
Issuer Credit Rating	A+/Negative/A-1
Certificate Of Deposit	
Local Currency	A-1
Kiwibank Ltd.	
Senior Unsecured	A+
Subordinated	BB+
Certificate Of Deposit	A-1
Commercial Paper	A-1
Kiwi Capital Funding Ltd.	
Subordinated	BB+
Junior Subordinated	BB-
Kiwi Capital Securities Ltd.	
Preference Stock	BB

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