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Ratings

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Auswide Bank Ltd.

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Auswide Bank Ltd.

SACP	bbb-

Anchor	bbb+	
Business Position	Weak	-2
Capital and Earnings	Strong	+1
Risk Position	Adequate	0
Funding	Below Average	-1
Liquidity	Adequate	

\+

Support	0

ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating

BBB-/Positive/A-3

Major Rating Factors

Strengths:	Weaknesses:
• Strong capitalization • Growth in line with industry's, with a focus on residential mortgages	• Small scale and high geographic and product concentration, which make it susceptible to heightened competition from larger banks • Higher use of wholesale funding and lower levels of liquid assets to cover short-term wholesale funds, compared with similar size peers

Outlook: Positive

The positive outlook reflects a one-in-three chance that we will raise the long-term issuer credit rating on Auswide Bank Ltd. to 'BBB' during the next two years, driven by the potential improvement in Auswide's risk-adjusted capital (RAC) ratio above 15% with its future capital initiatives. We expect no material change to other aspects of Auswide's credit profile, including good asset quality, its stable long-term business franchise and funding, and liquidity profile that is commensurate with that of peers.

Upside scenario

We expect an upgrade scenario to emerge if Auswide executes on capital initiatives to restore its RAC ratio above 15% within the next 18 months. These capital initiatives could include a significant capital injection as well as the underwriting of the bank's dividend reinvestment plan (DRP).

Downside scenario

We expect to revise the outlook to stable if we believe significant impediments were to occur, hampering Auswide's execution of its capital management initiatives. Other factors that may also weigh on the bank's credit profile include: Auswide failing to benefit from its transformation projects and/or significant merger and acquisition activities that could increase the bank's overall operational risk profile.

In addition, loan growth below system level or a continued deterioration in operating performance relative to peers' over a prolonged period could also reflect weakness in the bank's product and service offering and the inability to implement strategic initiatives. This would signal a potential weakness in its long-term business franchise and pressure the ratings.

Rationale

The ratings on Auswide reflect its very strong capitalization and good credit-loss experience, benefiting from a focus on residential mortgages. Operating risks stemming from technology transformation and acquisitions have abated. Offsetting these factors is the bank's small scale and high geographic and product concentration, which makes it susceptible to heightened competition from larger banks.

The ratings on Auswide don't benefit from additional extraordinary support or additional factors, given it is not part of a wider group, a government-related enterprise, systemically important, or an outlier in its industry.

Anchor: Resilient economy, conservative regulations, and risk appetite offset funding weaknesses in the operating environment

Table 1

Auswide Bank Ltd. Key Figures

		--Year-ended June 30--			
(Mil. A$)	**2017***	**2016**	**2015**	**2014**	**2013**
Adjusted assets	3,052.8	3,023.7	2,675.0	2,592.1	2,630.3
Customer loans (gross)	2,670.9	2,671.5	2,331.8	2,226.4	2,231.3
Adjusted common equity	165.8	161.8	152.9	148.3	143.2
Operating revenues	32.9	63.0	61.0	59.9	62.5
Noninterest expenses	21.9	37.0	41.2	39.0	48.7

Table 1

Auswide Bank Ltd. Key Figures (cont.)					
		--Year-ended June 30--			
(Mil. A$)	**2017***	**2016**	**2015**	**2014**	**2013**
Core earnings	7.3	11.9	13.6	14.4	8.9

*Data as of Dec. 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

The starting point for our ratings on Auswide--similar to our ratings on all other banks operating in Australia--reflects our assessment of Australia's macro-environment. We view Australia as a wealthy, open, and resilient economy that has performed relatively well during and following negative cycles and external shocks, including the global recession in 2009.

We forecast that solid economic growth will continue over the short-to-medium term, even if slightly below trend given a muted recovery in nonmining business investment. However, Australian banks are exposed to heightened imbalances after years of strong growth in property prices and private-sector debt, and in light of Australia's persistent current account deficits and high level of external debt.

We consider that such imbalances increase banks' sensitivity to any correction in property prices. Nevertheless, in our base case we believe a sharp correction in property prices is unlikely and loan losses from a large correction would likely remain very low by international standards.

We regard the institutional and competitive environment for banks in Australia as low risk. We believe the structure of the banking industry is supportive of industry stability, with a small number of strong retail and commercial banks dominating the industry. In our view, conservative and proactive regulatory and governance frameworks engender very low risk appetites and underpin banking system stability.

Offsetting these positive elements, however, are the Australian banking system's relatively low levels of customer deposits. It is this factor which underpins Australia's sizable dependence on net external borrowings, despite some improvement in banks' funding profiles in recent years.

Business position: Small scale and high geographic and product concentration make it susceptible to heightened competition from larger banks

Table 2

Auswide Bank Ltd. Business Position					
		--Year-ended June 30--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Total revenues from business line (currency in millions)	32.9	63.0	61.0	59.9	62.5
Retail banking/total revenues from business line	100.0	97.7	97.5	96.6	95.3
Commercial & retail banking/total revenues from business line	100.0	97.7	97.5	96.6	95.3
Return on equity	6.7	5.6	6.7	7.3	1.3

*Data as of Dec. 31.

We view Auswide's business position to be consistent with that of similar size listed peers such as Mystate Ltd. In addition, it is in line with mutual bank peers such as mecu Ltd, Qudos Mutual Ltd, Community CPS Australia Ltd, and larger mutual peers such as IMB Ltd and Credit Union Australia Ltd that rely on broker networks to generate new business. In our opinion, the bank's size, nature, and complexity mean that its business position is comparable with its mutual peers rather than the significantly larger regional and major banks.

We expect Auswide to remain heavily concentrated in residential mortgages (about 85% of the bank's total credit exposures) in its home state of Queensland (about 80% of loans). Similar to the industry and most peers, the bank leverages broker distribution channels to source loans beyond its branch footprint and generally outside of its home state.

As expected in our previous review, the use of brokers has helped the bank reduce its loan concentration to Queensland from 84% in 2014. While the loan portfolio shifted slightly to other states, the relative shift within Queensland is more interesting given aggregate loan growth of A$183 million in south-east Queensland since 2015 has exceeded the growth of the rest of the portfolio combined--in part helped by the merger of Your Credit Union (YCU). The bank's 37% exposure to south-east Queensland is, in our view, likely to only increase as its mobile lenders leverage the newly acquired YCU branch as a base of operations.

Business banking accounts for a modest 4% of Auswide's total loan book.

Auswide's technology transformation strategy is supportive of the current business position assessment. The transformation of Auswide's technology platforms will improve the bank's ability to respond to customers' needs faster, as well as simplify and enhance existing products. In this regard, we note that:

- The Lendfast origination platform improves the origination time for the bank to originate loans through branches, contact centers, and the broker network. In addition, the system allows for automated valuation ordering and electronic document storage, contributing to further efficiencies. An overall increase in the throughput of loan origination is likely.
- The refreshed online banking interface will allow customers to access more self-service features such as password resets, card activation and locking, and My Tax and interest information.
- Enhanced access to customer data allows the bank to improve the monitoring of new business volumes, progress measurement, and focus on areas where improvement is needed.

The evolution to offer existing customers online origination of transactions, consumer, and home loan products would launch in 2018. We also note that Auswide would be introducing a credit card offering during the latter part of 2017.

The acquisition of YCU has been successful and resulted in a material one-off increase to Auswide's loan portfolio. Post-acquisition, Auswide has consolidated all of YCU's customer data and services with its Ultracs core banking platform. The experience and knowledge provide a blueprint for potential future acquisitions, albeit we consider that over the short to medium term, acquisitions would be unlikely. Post the merger, customer retention was close to 100% and synergies extracted helped Auswide in absorbing some of the acquisition and capital expenditure costs.

In February 2017, Auswide acquired a controlling interest in Moneyplace, a peer-to-peer lender focusing on consumer finance. Auswide will manage Moneyplace as a stand-alone entity. The main risks Moneyplace introduces is of a contagion or reputational nature. Moneyplace will also increase Auswide's consumer lending and further diversify

Auswide's revenue streams.

Although Auswide's size and product offering is similar to mutual banks', in our opinion, its public listing on the Australian Stock Exchange results in greater management focus on the market performance targets--maximizing net profit after tax, return on equity, and dividends--of larger listed banks. In our view, competing against larger banks is extremely difficult for Auswide given its relative lack of size and scale, without management being more aggressive in reducing operating costs and being opportunistic in growing its balance sheet.

While the bank's long-term point of differentiation is limited to price, in our opinion, its ongoing drive for enhanced digital product and service offerings is likely to keep its business flexibility ahead of similar size peers. The focus on price is reflected in its net interest margin of 1.92%, relative to our peer average of 2.15% (which includes mutual banks), while the bank's work with MoneyPlace and broader financial technology firms reflect its flexibility in the digital age.

In our view, the experienced executive management team has supported Auswide's execution of its transformation strategy over the past year. This demonstrates that the required skillset is in place at the bank. However, we also note, consistent with the group's status as a listed entity, Auswide has a more fluid position with respect to its business strategy than many of its similar size peers. This is both with respect to its response to market pressures and potential merger and acquisition opportunities.

Capital and earnings: Strong capital ratio, with a one-in-three chance that the RAC ratio may trend in the very strong range

Table 3

Auswide Bank Ltd. Capital And Earnings					
		--Year-ended June 30--			
(%)	2017*	2016	2015	2014	2013
Tier 1 capital ratio	12.2	11.9	12.6	11.7	11.2
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	85.9	85.6	83.9	82.9	81.5
Fee income/operating revenues	N/A	12.5	13.4	13.0	13.1
Market-sensitive income/operating revenues	N/A	0.0	0.2	0.7	0.5
Noninterest expenses/operating revenues	66.6	58.8	67.5	65.1	77.9
Preprovision operating income/average assets	0.7	0.9	0.7	0.8	0.5
Core earnings/average managed assets	0.5	0.7	0.5	0.5	0.3

*Data as of Dec. 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 4

Auswide Bank Ltd. RACF [Risk-Adjusted Capital Framework] Data					
(Mil. A$)	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)
Credit risk					
Government and central banks	0	0	0	0	0
Institutions	316	83	26	54	17

Table 4

Auswide Bank Ltd. RACF [Risk-Adjusted Capital Framework] Data (cont.)					
Corporate	0	0	0	0	0
Retail	2,465	980	40	772	31
Of which mortgage	2,392	907	38	718	30
Securitization§	28	31	108	6	20
Other assets	38	38	100	43	113
Total credit risk	2,848	1,132	40	875	31
Market risk					
Equity in the banking book†	13	0	0	97	760
Trading book market risk	--	0	--	0	--
Total market risk	--	0	--	97	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	146	--	95	--
(Mil. A$)		**Basel II RWA**		**Standard & Poor's RWA**	**% of Standard & Poor's RWA**
Diversification adjustments					
RWA before diversification		1,278		1,066	100
Total Diversification/Concentration Adjustments		--		266	25
RWA after diversification		1,278		1,332	125
(Mil. A$)		**Tier 1 capital**	**Tier 1 ratio (%)**	**Total adjusted capital**	**Standard & Poor's RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		156	12.2	165	15.5
Capital ratio after adjustments‡		156	12.2	165	12.4

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2016, S&P Global Ratings.

In our base case, we expect Auswide's RAC ratio to trend in the strong range following the revision of the economic risk score on Australia's banking system to '4' from '3' in May 2017. Nevertheless, there is at least a one-in-three probability that Auswide's RAC ratio will trend back to the very strong range over the next 12 to 18 months, after falling below 15% following the economic risk score revision.

This expectation reflects our view that Auswide's board and senior management are committed to maintaining a RAC ratio above 15%. Capital management initiatives to restore its RAC ratio above 15% (very strong range) could include a potential significant capital injection in August 2018 and the underwriting of the dividend reinvestment plan (DRP) in 2017 and 2018.

In addition to the aforementioned factors, our forecasts also include the following adjustments and assumptions (among others):

- Our expectation that Auswide's net interest margin will remain at about 1.9% by the year ending June 30, 2017, and remain at about that level into fiscal 2018;
- Loan growth to trend at system levels over the forecast period;
- Credit-loan loss provisions to remain low; and
- Continued focus on cost curtailment, although higher amortization costs (intangibles) will affect this.

Risk position: Operating risk stemming from technology transformation and acquisitions have abated

Table 5

Auswide Bank Ltd. Risk Position

		--Year-ended June 30--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	(0.0)	14.6	4.7	(0.2)	0.0
Total managed assets/adjusted common equity (x)	18.7	19.0	17.8	17.8	18.7
New loan loss provisions/average customer loans	0.0	(0.0)	0.0	0.0	0.1
Net charge-offs/average customer loans	N.M.	(0.2)	0.1	0.0	0.0
Gross nonperforming assets/customer loans + other real estate owned	0.4	0.6	0.5	0.9	1.5
Loan loss reserves/gross nonperforming assets	N/A	32.7	14.4	12.0	6.4

*Data as of Dec. 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

In our view, Auswide's operating risk will materially improve with the bank's significant progress in implementing key technology transformation initiatives, as well as integration of YCU. These technology transformation initiatives will also enhance the bank's sales and risk management capabilities, which we view as necessary for its long-term business franchise.

More specifically, Auswide has made progress on the following initiatives:

- Completed the update of its core banking system, Ultracs;
- Significantly implemented the transformation strategy: Lendfast origination system, online banking interface, and branch technology infrastructure; and
- Integrated YCU, supported by YCU being on the same core banking platform as Auswide.

We consider Auswide will benefit from these enhancements, including using data analytics to provide deeper insights into customers and loan origination with the update of the core banking system. In addition, operational efficiencies, such as the implementation of the Lendfast system and new online banking interface, will remove manual processes and improve the bank's origination performance.

We don't consider the bank's acquisition of a majority stake in Moneyplace will introduce significant risk. We understand the bank will manage Moneyplace as a stand-alone entity, effectively capping the bank's financial risk at its equity investment in Moneyplace. Furthermore, Auswide actively oversees the risk management of Moneyplace through independent periodic reviews and reports of the findings and remedial actions to the bank's executive team and board risk committee.

We expect that targeted loan growth will be measured and at around system levels over the next two years (at around 6% per annum). Broker distribution channels and self-origination channels will remain the main sources of loan growth for Auswide (each responsible for about 50% of loan originations).

In our view, Auswide has proactively managed investor lending, which is well within Australian Prudential Regulation Authority (APRA)'s 10% growth cap pricing initiatives, as well as reducing the maximum investor loan-to-value ratio (LVR) down to 90% (previously 95%), has helped in cutting the exposures. Interest-only loans have also reduced and the bank is confident that monthly approvals will be well within the APRA benchmark of 30% by the end of December 2017.

We expect Auswide's asset quality to remain stable over the forecast horizon, supported by the current low interest rate environment. Gross nonperforming loans represent about 0.39%, which is slightly better than the peer average of 0.47%. Auswide is undertaking initiatives to de-risk the loan portfolio, including decreasing high LVR products, controlling investor loan growth by reviewing the credit policy, and the introduction of pricing mechanisms. In our view, Auswide's projected losses will be in line with that of peers' over the next 12 to 18 months.

Funding and liquidity: Balance-sheet structure is susceptible to competitive funding dynamics

Table 5

Auswide Bank Ltd. Funding And Liquidity

		--Year-ended June 30--			
(%)	**2017***	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	77.6	67.0	67.0	66.7	66.5
Customer loans (net)/customer deposits	120.5	140.8	140.1	138.5	137.6
Long term funding ratio	93.4	90.3	69.0	68.7	68.3
Stable funding ratio	103.3	97.6	75.0	75.1	74.4
Short-term wholesale funding/funding base	7.0	10.3	33.0	33.3	33.5
Broad liquid assets/short-term wholesale funding (x)	1.6	0.9	0.3	0.3	0.3
Net broad liquid assets/short-term customer deposits	5.6	(1.5)	(35.8)	(35.0)	(35.1)
Short-term wholesale funding/total wholesale funding	31.1	31.1	100.0	100.0	100.0

*Data as of Dec. 31.

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

We forecast Auswide's funding and liquidity profile to remain weaker and less stable than similar size peers and industry for the next 12 to 18 months. Under a stressed scenario, the bank's small size and market presence would be a disadvantage. Similar to peers, Auswide's size would significantly constrain its ability to access funding relative to the Australian major banks.

This stressed scenario could occur, for example, if a material dislocation were to happen to the offshore wholesale funding markets, on which the Australian major banks are heavily reliant. A material dislocation to these markets could lead these major banks to compete more aggressively for domestic funding sources, putting significant pressure on all other financial institutions in Australia.

In our opinion, Auswide is more reliant on wholesale funding markets compared with its mutual peers. Its use of short-term negotiable certificates of deposits and residential mortgage-backed securities (RMBS) for funding purposes increases the bank's sensitivity to stress if wholesale markets were to close for six months.

Auswide's higher risk funding profile is reflected in core deposits accounting for around 78% (peer average 86%), although its long-term RMBS issuances result in a comparable long-term funding ratio of 93% (peer average 84%). We classify warehouse facilities with less than 12 months maturity as short-term, given there is a material risk that these would not be renewed in a stress scenario.

In our opinion, Auswide's size, public listing, and pricing based point of differentiation somewhat force it to source the cheapest funding for growth. However, this is usually short-term wholesale, which can be the first market to close in a stress scenario. An increase in the proportion of wholesale funding at Auswide would increase its exposure to stress and, as such, could put negative pressure on the rating.

Our view is that Auswide is likely to meet liquidity challenges under stressful conditions for six months without requiring support from the Reserve Bank of Australia for 50% or more of its funding needs. Our assessment factors in a potential drawdown of the bank's unutilized RMBS warehouse facilities. Over the past year, the bank's holding of liquid assets and securities has dropped as a proportion of the balance sheet. The bank's liquid assets to short-term wholesale funding of 1.6x is weaker than similar size peers', which average 2.6x. Auswide's heavy use of RMBS funding also restricts, in our opinion, its flexibility, given that around 20% of assets are encumbered (peer average 5%).

Our current liquidity assessment relies on stability of the bank's deposit base under a stress scenario. If there was indication that the bank could not manage deposit retention or the structure of its funding profile deteriorates, requiring additional reliance on central bank funding beyond our current expectation, our liquidity assessment would come under pressure.

Support:

As of April 30, 2017, Auswide's market share was 0.1% of system gross loans and advances, and 0.1% of total deposits. Given this small market share, we consider it unlikely that Auswide would receive extraordinary support from the Australian government. Accordingly, we rate Auswide at its SACP of 'bbb'.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

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Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	**4**	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	**bbb+**	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of June 28, 2017)

Auswide Bank Ltd.	
Counterparty Credit Rating	BBB-/Positive/A-3
Senior Unsecured	A-3
Senior Unsecured	BBB-
Subordinated	BB+
Counterparty Credit Ratings History	
20-Jun-2017	BBB-/Positive/A-3
21-May-2017	BBB-/Watch Neg/A-3
30-Oct-2016	BBB/Negative/A-2
03-Jun-2015	BBB/Stable/A-2
18-Jun-2013	BBB/Negative/A-2
Sovereign Rating	
Australia (Commonwealth of)	AAA/Negative/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.