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CREDIT OPINION

22 March 2018

Update

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RATINGS

Auswide Bank Ltd

Domicile	Australia
Long Term Debt	Not Assigned
Long Term Deposit	Baa2
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

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.

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Auswide Bank Ltd

Update to credit analysis - H1 2018

Summary

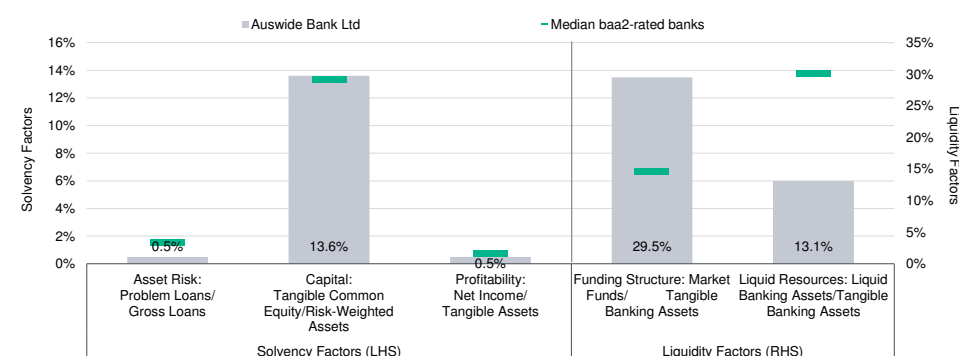
The Baa2 long-term rating of [Auswide Bank Ltd](#) (Auswide) reflects its healthy asset quality and capitalization, but also the tail risks inherent to its loan book. Auswide's lending focus on mortgages supports its asset quality. However, relative to its peer group of smaller, domestic mortgage-focused banks it has greater exposure to higher risk loans, such as interest-only loans and investment loans, increasing the bank's exposure to interest-rate hikes and housing market corrections.

Additionally, the bank's geographic concentration in Queensland exposes it to weather-related event risk (for example, the flooding in North Queensland in March 2018), although loan losses from such events have been low. Auswide is also diversifying to Southeast Queensland, which has stronger growth and employment conditions.

Auswide's healthy capital level provides an important buffer against asset risks. The bank is primarily deposit funded, but has more wholesale funding than its peers. Nevertheless, Auswide has ample liquidity to cover wholesale funding maturities.

Exhibit 1

Rating Scorecard - Key financial ratios



Source: Moody's Financial Metrics

Credit strengths

- » Healthy asset quality, supported by its focus on mortgage lending
- » Healthy capitalization
- » Sufficient liquidity to cover unsecured wholesale funding maturities

Credit challenges

- » Geographic concentration and higher than peer group exposure to investment and interest-only loans
- » Continued pressure on profitability
- » Sizable wholesale funding

Rating outlook

The stable rating outlook reflects our expectation that Auswide's credit metrics will be within the tolerance levels set for the rating. The outlook could change in the event that the bank's tangible common equity ratio (TCE ratio) drops below 13%.

Factors that could lead to an upgrade

- » A reduction in the bank's proportion of interest-only loans and investor loans to the level of that of its peers
- » Achievement of its growth targets without eroding profitability and capitalization

Factors that could lead to a downgrade

- » A deterioration in the credit conditions in [Australia](#) (Aaa stable), in particular, further material increases in the country's credit/GDP and household debt/income
- » A loosening of loan underwriting standards amid competitive pressures
- » A weakening in the bank's liquid asset coverage of unsecured wholesale debt maturities

Key indicators

Exhibit 2

Auswide Bank Ltd (Consolidated Financials) [1]

	12-17 ²	6-17 ²	6-16 ²	6-15 ²	6-14 ²	CAGR/Avg. ³
Total Assets (AUD million)	3,245	3,290	3,072	2,717	2,634	6.1 ⁴
Total Assets (USD million)	2,538	2,524	2,288	2,088	2,486	0.6 ⁴
Tangible Common Equity (AUD million)	178	162	165	153	145	6.2 ⁴
Tangible Common Equity (USD million)	140	125	123	118	136	0.7 ⁴
Problem Loans / Gross Loans (%)	0.4	0.4	0.6	0.5	0.9	0.6 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	13.6	12.7	13.1	14.8	13.6	13.6 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	6.3	6.5	9.1	7.7	13.7	8.7 ⁵
Net Interest Margin (%)	1.9	1.9	1.9	2.0	1.9	1.9 ⁵
PPI / Average RWA (%)	2.0	1.8	1.5	1.8	2.0	1.8 ⁶
Net Income / Tangible Assets (%)	0.5	0.5	0.4	0.5	0.5	0.5 ⁵
Cost / Income Ratio (%)	63.4	60.6	68.8	62.5	59.3	62.9 ⁵
Market Funds / Tangible Banking Assets (%)	19.6	29.5	29.9	29.6	29.8	27.7 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	4.3	13.1	9.9	11.2	12.0	10.1 ⁵
Gross Loans / Due to Customers (%)	120.3	135.0	141.1	140.2	138.7	135.1 ⁵

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] May include rounding differences due to scale of reported amounts [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [5] Simple average of periods presented for the latest accounting regime. [6] Simple average of Basel III periods presented

Source: Moody's Financial Metrics

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.

Profile

With AUD3.2 billion in total assets as of December 2017, Auswide accounted for only 0.1% of total Australian banking system assets. The bank is predominantly a residential mortgage lender and is primarily deposit funded. 83% of the bank's loans are in Queensland, although the loans are diversified within the state. The bank has been increasing its lending to Southeast Queensland, which now accounts for 37% of its total loans, overtaking Central Queensland (traditionally its core market, with 34% of total loans).

Since 2013, changes to the bank's business strategy and risk appetite have resulted in a simpler business model and more conservative underwriting. In particular, the bank has wound up its captive insurance business, Mortgage Risk Management Pty Ltd (MRM), and turned to external mortgage insurers for risk mitigation. The bank has also actively reduced its mortgages with higher risk profiles, for example, mortgages for investment purposes, mortgages with interest-only features and mortgages with high loan-to-valuation ratios.

Detailed credit considerations

Healthy asset quality, but tail risks remain

Asset quality is a key rating consideration for Auswide because, as a small bank, it has limited geographic diversification, and limited resources and flexibility to absorb unexpected shocks.

Auswide's asset quality is better than the broader system average owing to its focus on residential mortgages, an asset class that has historically reported low credit losses in Australia. Specifically, residential mortgages comprised 93% of the bank's loans compared with a system average of 62% as of December 2017. The bank also reported a nonperforming loan (NPL) ratio of 0.4%, compared with 0.8% for the system as of the same date. NPLs refer to impaired loans and greater than 90 days past due loans.

Auswide's NPL ratio is now comparable with that of other domestic mortgage-focused banks, after a steady improvement over the last five years. During this period, the bank's NPL ratio dropped to 0.4% from 1.5%, largely attributable to tighter underwriting and better collection performance under its refreshed business strategy.

Auswide retains greater exposure to investment loans and interest-only loans than its peers, a fact that constrains the bank's rating. However, it has scaled back significantly, driven by the bank's own business strategy but is also driven by regulatory caps.¹ For example, investment loans were 33% of Auswide's total loans as of December 2017 compared with 20%-25% for its peers. This situation constrains the bank's rating.

Another rating constraint is Auswide's concentration risk, with 83% of its total loans concentrated in Queensland. This risk is not fully mitigated by the following factors: (1) the bank's diversification within the state — its expansion into Southeast Queensland, which fares better than Central Queensland in terms of economic growth and employment, is credit positive but is unlikely to completely immunize the bank to the impact of natural disasters or economic shocks in the state; (2) its relatively lower exposure to the inner Sydney and Melbourne markets, which have seen the highest levels of house price appreciation since 2013. This situation serves to moderate the bank's sensitivity to a housing market correction.

We also see increased credit risk from Auswide's expansion into personal lending and business lending, although we expect mortgages will continue to dominate the bank's loan portfolio. These asset classes support returns and diversity, but have a higher risk profile than mortgage loans.

The above considerations underpin our downward adjustment to the business diversification and asset risk sections of the scorecard.

Healthy capitalization

Auswide has maintained healthy capitalization to mitigate the aforementioned asset risks. Its Common Equity Tier 1 (CET1) ratio is higher than the broader banking system average, while Auswide's arrears are lower than average. As of December 2017, Auswide's CET1 ratio was 12.2% compared with 10.6% for the system.

The bank was able to strengthen its CET1 ratio by 106 basis points over the last three years, benefiting from its dividend reinvestment plans and loan growth, which has lagged the broader system, and driven by its focus on tighter underwriting. However, we expect further improvement in Auswide's capitalization to moderate, given that the recent recovery in loan growth is expected to be maintained.

Continued pressure on profitability

Auswide's profitability has been comparable with that of its peers since the bank wound up MRM, and removed the earnings and costs associated with this business. As of December 2017, the bank's net income as a percentage of tangible assets was 0.47% versus 0.45% for the mutual sector average.

We expect continued pressure on the bank's profitability, driven by strong competition for both mortgages and deposits, and the low interest rate environment (which is generally negative for margins). The bank's continuous investment in newer technologies such as online and mobile banking, to meet member expectations, is also a drag on its profitability. The bank also needs to invest in risk systems to meet regulatory and compliance requirements. These costs can be significant for a small bank like Auswide. Furthermore, Auswide's focus on growing outside of Central Queensland and use of broker channels, while supportive of loan growth, could expose the bank to greater price competition because of weaker brand recognition outside of its home region.

However, stronger balance-sheet growth and greater efficiency from the bank's ongoing improvements in IT and processes should somewhat mitigate these profitability pressures.

Sizable wholesale funding, mitigated by sufficient liquidity

Auswide's primary funding source is retail deposits, which constituted 68% of total funding as of June 2017. That said, the bank's wholesale funding (32% of total funding) remains high compared with that of its peers, despite declining from 46% in 2008.

Rollover risk is mitigated by the diversification in Auswide's wholesale funding profile and its ample liquid assets. The bank has shifted away from solely relying on securitization to issuing other wholesale debt (in forms of negotiable certificates of deposits and floating-rate notes), which made up 32% of its total wholesale funding as of 30 June 2017.

The bank holds enough liquid assets on its balance sheet to fully cover unsecured wholesale maturities. There are additional liquid assets that are not reflected on Auswide's balance sheet but can be created through self-originated residential mortgage-backed securities (self-originated RMBS).² As of June 2017, the bank had around AUD245 million Class A notes in its self-originated RMBS that are repo-eligible with the Reserve Bank of Australia, if liquidity is needed. These additional liquid assets underpins our upward adjustment to the liquid resources section of the scorecard.

Auswide's rating is supported by Australia's Strong+ Macro Profile

Australian banks, including Auswide, benefit from operating in an economy with a very high degree of economic resilience, institutional and governmental financial strength, and low susceptibility to event risk. Australia is in its 26th year of uninterrupted economic growth, although the economy is facing reduced investment in the resources sector and below-trend nominal income growth. Our baseline scenario assumes GDP growth of up to 2.7% in 2018 and 2.8% in 2019. Australia's economy has undergone a transition from growth led by investment in the resources sector to other sources of growth. This adjustment has led to below-trend nominal GDP and wage growth and, consequently, a more difficult operating environment for banks.

While there may be pockets of weakness from lower private-sector investment and fiscal spending, low interest rates support overall private-sector demand. Rising house prices over 2013-17 were accompanied by an elevated proportion of lending to residential property investors, raising concerns regarding financial stability. Australia also has very high levels of household debt, with household debt/annualized disposable income reaching 199.7% in September 2017. To address the rising risks in the housing market, the Australian Prudential Regulation Authority has undertaken a number of initiatives to preserve prudent lending standards and strengthen the resilience of the banking system.

These actions have led to a slowdown in higher-risk lending activity and a reduction in overall credit growth compared with the national income. However, the resilience of household balance sheets and, consequently, bank portfolios, to a serious economic downturn has not been tested at these levels of private-sector debt. Our view of the operating environment also reflects banks' strong pricing power as a result of the high concentration in the banking sector. Australia's structural reliance on external financing remains the sector's primary vulnerability. On a net basis, the country's foreign debt funding has traditionally been sourced primarily through the banking system, exposing Australian banks to the risk of sudden shifts in foreign investor sentiment.

Notching considerations

There is currently no statutory bail-in in Australia. As a result, we do not consider Australia to have an operational resolution regime (as defined in Moody's Banks Rating Methodology). We apply a basic Loss Given Failure (LGF) approach in rating Australian banks' junior securities. In determining whether Australia has an operational resolution regime, we take into account both the current resolution framework and Australian policymakers' public stance. Although Australia is a member of the Financial Stability Board, and the board has highlighted the lack of statutory bail-in as a gap, compared with international standards, the Australian authorities have so far adopted a more cautious and nuanced public stance on this issue. The Treasury has said that further consideration is warranted, but has noted concerns about the workability of bail-in for large institutions.

At the same time, while supporting the objective to minimize the burden of bank resolution costs on taxpayers, the Reserve Bank of Australia has said that the policy toolkit should retain the ability to take an institution under public ownership, before selling it again when the risk appetite of the private sector has returned to more normal levels. In its final report, Australia's Financial System Inquiry has recommended that Australia adopt a loss-absorbing capacity and resolution framework. The inquiry expressed a preference for introducing securities with contractual bail-in features, rather than creating a statutory bail-in regime. The exact resolution mechanisms that Australia will ultimately adopt remain to be determined. Accordingly, the resolution mechanisms' impact on bank ratings would depend on the degree to which the positive effect of higher loss-absorption capacity offsets the possible reduction in our assumption of systemic support for the banks' senior obligations.

Counterparty Risk (CR) Assessment

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails, and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default, and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to an ADI's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquidity facilities.

Auswide's long-term CR Assessment is positioned at Baa1(cr)

The CR Assessment is positioned one notch above the credit union's Adjusted Baseline Credit Assessment (a reflection of its standalone credit profile, including intragroup support) and, therefore, above the Preliminary Rating Assessment of senior unsecured debt obligations. The assessment reflects our view that the probability of default of obligations represented by the CR Assessment is lower than that of senior unsecured debt. We believe that, in the event of resolution, the specific senior obligations of the credit union, represented by the CR Assessment, will be more likely to be preserved in order to limit contagion, minimize losses and avoid disruption of critical functions.

The CR Assessment of Auswide does not benefit from any government support, in line with our support assumptions on senior unsecured debt. This assessment reflects our view that operating activities and obligations reflected by the CR Assessment are unlikely to benefit from any support provisions from resolution authorities to senior unsecured debt.

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 3

Auswide Bank Ltd

Macro Factors

Weighted Macro Profile **Strong +** **100%**

Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	0.5%	aa1	← →	a2	Quality of assets	Geographical concentration
Capital						
TCE / RWA	13.6%	a2	← →	a2	Access to capital	Risk-weighted capitalisation
Profitability						
Net Income / Tangible Assets	0.5%	ba1	← →	ba1	Expected trend	
Combined Solvency Score		a2		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	29.5%	baa2	← →	baa2	Expected trend	Extent of market funding reliance
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	13.1%	ba1	← →	baa2	Additional liquidity resources	
Combined Liquidity Score		baa3		baa2		
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				0		
Adjusted BCA				baa2		
Instrument class	Loss Given Failure notching	Additional Notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Counterparty Risk Assessment	1	0	baa1 (cr)	0	Baa1 (cr)	--
Deposits	0	0	baa2	0	Baa2	Baa2
Senior unsecured bank debt	0	0	baa2	0	Baa2	Baa2

Source: Moody's Financial Metrics

Ratings

Exhibit 4

Category	Moody's Rating
AUSWIDE BANK LTD	
Outlook	Stable
Bank Deposits	Baa2/P-2
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	Baa1(cr)/P-2(cr)
Issuer Rating	Baa2
ST Issuer Rating	P-2

Source: Moody's Investors Service

Endnotes

- 1 Since December 2014, the entire banking system has been subject to the Australian Prudential Regulation Authority's (APRA) speed limits on these two types of loans. Specifically, APRA caps the annual growth rate of investment loans to 10%, and the proportion of interest-only loans at 30% of total new originations.
- 2 The Reserve Bank of Australia allows Australian banks this facility to address the country's low level of sovereign debt and the modest scale of its bond market, which limit the availability of traditional liquid assets, such as government bonds, for banks' liquidity management needs.

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