FitchRatings

Fitch Affirms Heartland Bank at 'BBB'; Outlook Stable

Fitch Ratings-Sydney-10 October 2016: Fitch Ratings has affirmed New Zealand-based Heartland Bank Limited's (HBL) Long-Term Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook, its Short-Term IDR at 'F2' and its Viability Rating at 'bbb'. The bank's Support Rating has also been affirmed at '5' and its Support Rating Floor at 'No Floor'.

The affirmation of HBL's IDRs and Viability Rating reflects the continued improvement in its underwriting standards and risk-controls, especially in light of its higher risk appetite relative to peers. The bank focuses on niche markets, where it has achieved a leading franchise and benefits from price-setting powers. This has resulted in a strong net interest margin relative to peers, offsetting the higher risk associated with some of its lending products. The Stable Outlook reflects our view that HBL is likely to continue its solid performance over the next year or two, based on the company's primarily organic growth. A significant acquisition is likely to trigger a review of the ratings.

Fitch expects New Zealand's operating environment to remain stable in the absence of a significant external shock. However, macroeconomic risks are rising due to mounting household debt and weak dairy prices.

KEY RATING DRIVERS
IDRS AND VIABILITY RATING
HBL's Long- and Short-Term IDRs and Viability Rating reflect its continuing strengthened risk-management practices, which should support asset-quality through the cycle. However, HBL's risk appetite remains higher relative to peers - especially given the bank's growth aspiration and customer target groups - this is a constraint on HBL's rating. HBL continued to reduce its non-core property finance portfolio and any losses from this portfolio will be immaterial.

HBL has a simple and transparent business model. It operates in New Zealand and Australia, focusing on niche markets, such as vehicle-finance for households and businesses, home-equity release (HER) mortgages as well as equipment, livestock and invoice finance for businesses. The bank's organisational structure changed at end-2015 following the amalgamation of HBL with its previous shareholder, Heartland New Zealand Limited (HNZ), and HBL became the sole shareholder of all subsidiaries previously owned by HNZ. The restructure removed group inefficiencies and increased the bank's earning streams as well as geographical and business diversification. The effect on HBL's capitalisation and market risk has been modest. Overall, Fitch views the group restructure neutral to HBL's ratings.

HBL's funding and liquidity profile is satisfactory for its rating level. The bank benefits from a more balanced asset-liability-maturity profile relative to domestic peers, as its lending products typically have shorter maturities, although HBL's HER mortgages have lengthened its asset maturity by reducing the portion of assets maturing within 12 months. HBL's on-balance sheet liquidity is adequate, consisting of cash and securities only. The bank has no internal securitisation capabilities for residential mortgage-backed securities due to its limited standard residential mortgages exposure.

Fitch sees HBL's capitalisation as adequate, considering its risk appetite and the agency's expectation of the bank's asset-quality and earnings performance through a full credit cycle. The bank benefits from sound levels of retained earnings, although asset-growth has consistently outpaced internal capital generation for the past three years. HBL can adjust its dividend payout by increasing share discount for its dividend re-investment plan, which improves capital flexibility. The group restructure has resulted in a manageable increase in risk-weighted assets affecting regulatory capital ratios, which Fitch expects to be offset through retained earnings. However, HBL's growth aspirations and new capital rules on HER mortgages may add some modest pressure to its capital ratios. HBL has access to equity markets and successfully raised fresh common equity in 2014, in contrast to its domestic peers.

SUPPORT RATING AND SUPPORT RATING FLOOR
HBL's Support Rating and Support Rating Floor reflect Fitch's view that while support from the New Zealand sovereign (AA/Stable) is possible, it cannot be relied on. We believe the Open Bank Resolution (OBR) scheme reduces the propensity of the sovereign to support its banks. The OBR scheme allows for the

imposition of losses on depositors and senior debt holders to make up capital shortfalls if a deposit-taking institution fails.

RATING SENSITIVITIES
IDRS AND VIABILITY RATING
HBL's IDRs and Viability Rating are sensitive to changes in the bank's risk appetite and funding and liquidity positions, especially if HBL expands its franchise into new and existing market segments by compromising its improved risk-management practices. Sustaining a more aggressive growth strategy over a long period could weaken HBL's financial profile and pressure its Viability Rating and IDRs. Positive rating action is not probable in the short- to medium-term.

SUPPORT RATING AND SUPPORT RATING FLOOR
HBL's Support Rating and Support Rating Floor are sensitive to change in assumptions around the propensity or ability of the New Zealand sovereign to provide timely support to HBL.

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Applicable Criteria
Global Bank Rating Criteria (pub. 15 Jul 2016) (https://www.fitchratings.com/site/re/884135)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
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