



## Fitch Affirms Heartland Bank Limited at 'BBB'; Outlook Stable

Fitch Ratings-Sydney-03 October 2017: Fitch Ratings has affirmed New Zealand-based Heartland Bank Limited's (HBL) Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook, its Short-Term Foreign-Currency 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'. At the same time Fitch has assigned the bank Local-Currency IDRs. A full list of rating actions is at the end of this rating action commentary.

The affirmation of the IDRs, Viability Rating and instrument ratings, and the Stable Outlook reflect our view that the bank is likely to continue to perform solidly over the next year or two, absent a significant acquisition. However, we expect HBL to be more acquisitive than its peers. HBL continues to improve its underwriting standards and risk controls, which Fitch views as important given its higher risk appetite relative to peers. The bank focuses on niche markets where it has achieved a leading franchise and some price-setting power. This has resulted in a strong net interest margin that partly offsets the higher risks associated with its lending book.

Macro-economic risks continue to increase due to high household leverage driven by house-price appreciation over a sustained period. The employment market, however, remains relatively strong in New Zealand, with unemployment rates at their lowest levels since 2008. After three seasons of depressed dairy prices, we have observed a sustainable recovery this season, which should help ease the pressure on the farmers and subsequently the bank's asset quality.

### KEY RATING DRIVERS

#### IDRS AND VIABILITY RATING

The bank's IDRs and Viability Rating reflect its higher risk appetite compared with its peers, capitalisation, and funding and liquidity structure. HBL's risk appetite is influenced by its focus on products where the bank has a competitive advantage and does not need to compete with the major banks. Its products are higher risk, which is partly reflected in weaker collateral compared with the residential mortgage books of other New Zealand banks. However, this is mitigated by the strong margin generation and acceptable capital position to date.

The bank continues to grow strongly, with gross loans increasing at double-digit rates in financial year ended 30 June 2017 (FY17). HBL raised additional capital during FY17 to support growth. A more aggressive risk appetite reflected in strong growth could lead to weaker funding and capital positions, and negatively impact asset quality and profitability.

HBL's capital levels sit in line with its peers, which we consider to be on the low side given HBL's higher risk appetite but still acceptable overall. Given its unique position as the only listed bank in New Zealand, we expect HBL to continue to be able to access the equity market if fresh equity is required. In addition, it has the ability to retain capital via a dividend reinvestment plan. HBL raised additional capital during FY17 via a NZD 20 million share placement and a NZD20 million sale of new shares to New Zealand-resident shareholders.

HBL sources 75% of its funding from customer deposits, mainly stable retail deposits. However the bank continues to be reliant on wholesale funding markets and we do not foresee any significant change in funding model in the near term given HBL's growth aspirations. Liquidity remains acceptable with liquid assets about equal to short-term wholesale funding. HBL benefits from a sizeable portfolio of motor-vehicle and business loans, which have a shorter duration than residential mortgages, and means HBL generally has a lower duration mismatch than domestic peers. A weakening in the funding and liquidity position could result in negative rating action, especially if combined with aggressive organic or acquisitive growth.

### SUPPORT RATING AND SUPPORT RATING FLOOR

The bank'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) framework reduces the propensity of the sovereign to support its banks. The OBR framework allows for the imposition of losses on depositors and senior debt holders to make up capital shortfalls if a deposit-taking institution fails.

### DEBT RATINGS

The bank's senior unsecured notes and commercial paper programme are rated at the same level as its Long-Term and Short-Term Foreign-Currency IDRs, respectively, in accordance with Fitch's criteria.

The bank's subordinated notes are rated one notch below HBL's Viability Rating of 'bbb' to reflect their below-average recovery prospects compared with senior unsecured notes.

### RATING SENSITIVITIES

## IDRS AND VIABILITY RATING

The bank's IDRs and Viability Rating are sensitive to a change in Fitch's assumptions around the bank's risk appetite and funding and liquidity positions, especially if the bank expands its franchise into new and existing market segments by compromising its improving risk management practices. Sustaining a more aggressive growth strategy over a long period could weaken the bank'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

The Support Rating and Support Rating Floor are sensitive to any change in assumptions around the propensity of the New Zealand sovereign to provide timely support to the bank.

## DEBT RATINGS

The ratings on the bank's senior unsecured notes, commercial paper programme and subordinated notes are sensitive to the same factors as the IDRs and Viability Rating.

The rating actions are as follows:

Long-Term Foreign-Currency IDR affirmed at 'BBB'; Outlook Stable

Short-Term Foreign-Currency IDR affirmed at 'F2'

Long-Term Local-Currency IDR assigned at 'BBB'; Outlook Stable

Short-Term Local-Currency IDR assigned at 'F2'

Viability Rating affirmed at 'bbb'

Support Rating affirmed at '5'

Support Rating Floor affirmed at 'No Floor'

Commercial paper programme affirmed at 'F2'

Subordinated debt affirmed at 'BBB-'

Senior unsecured medium-term fixed-rate notes affirmed at 'BBB'

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### **Applicable Criteria**

Global Bank Rating Criteria (pub. 25 Nov 2016) (<https://www.fitchratings.com/site/re/891051>)

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