FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Outlook on Southland Building Society to Positive; Affirms at 'BBB'

Wed 09 Jul, 2025 - 10:24 pm ET

Fitch Ratings - Sydney - 09 Jul 2025: Fitch Ratings has revised the Outlook on New Zealand-based Southland Building Society's (SBS) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to Positive from Stable and affirmed the Long-Term IDRs at 'BBB'. Fitch has also affirmed SBS's Short-Term IDRs at 'F3', Viability Rating (VR) at 'bbb' and Government Support Rating (GSR) at 'ns' (no support).

The Outlook revision is driven by our expectation that SBS's capital ratios will improve over the next two years, ultimately supporting a higher VR.

KEY RATING DRIVERS

Solid Financial Profile: SBS's Long-Term IDRs are driven by its VR, which is underpinned by a solid financial profile and modest risk appetite. The VR is below the implied VR of 'bbb+' as capitalisation remains below levels reported by domestic peers, and access to fresh ordinary equity is limited due to SBS's mutual ownership.

Capitalisation to Improve: We expect SBS's common equity Tier 1 (CET1) ratio to rise to around 14% by the financial year ending March 2026 (FYE26) as loan growth slows, underpinning our revision of the outlook on the 'bbb' capitalisation and leverage score to positive from stable. SBS's CET1 ratio is towards the lower end of ratios reported by New Zealand regional bank peers that have limited access to fresh capital.

Improving Operating Environment: Fitch expects New Zealand's economic environment to improve in 2025, limiting further pressure on bank asset quality. Our revision of the operating environment score to 'a+'/stable from 'a'/stable follows similar action on New Zealand's largest banks and reflects a sustained reduction in risks from households over the last decade through strengthened regulation. However, we maintain the score below the implied 'aa' category as household debt remains high relative to many other jurisdictions.

Model Supports Business Profile: SBS's simple business model of providing lower-risk mortgages, as well as consumer loans that are funded primarily through deposits, offsets its small national market share of about 1% of mortgages and deposits, and supports the business profile score of 'bbb', which is above the 'bb' category implied score.

Framework Commensurate with Risk: SBS's risk-management and control framework appears well suited to manage the risks associated with the society's largely consumer-focused lending activity. Residential mortgages focus on loan/value ratios (LVR) of below 80% and Kainga Ora First Home Loans, a product that benefits from insurance from a government agency, limiting the risk of loss. SBS's consumer finance business is riskier than the mortgage book, although the risk is managed well.

Asset Quality to Improve: We expect SBS's core asset-quality metric, stage 3 loans/gross loans, to improve in FY26, from 0.5% at FYE25, as interest rates cuts and a stabilisation in unemployment reduce pressure on consumers. Our asset-quality score of 'a-' also considers the higher charge-off rate relative to domestic peers, driven by SBS's consumer loan portfolio, which leads to higher impairment charges and provision coverage.

Earnings Pressure Possible: We expect SBS to report a broadly stable operating profit/risk-weighted asset (RWA) ratio in FY26. That said, there are downside risks to our forecasts, particularly around costs that may continue to grow faster than inflation for smaller New Zealand banks as they increase investment. This drives the negative outlook on the 'bbb' earnings and profitability score.

Loan Growth to Exceed Deposits: We expect deposit growth to be slower than loan growth in FY26, resulting in a modest weakening in the loan/customer deposit ratio. Our funding and liquidity factor score of 'bbb' is lower than that of most domestic peers to reflect SBS's higher reliance on wholesale funding. Liquidity is well managed, and we expect regulatory metrics to remain well above required minimums.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

Long-Term IDRs and VR

We may revise the Outlook on the Long-Term IDRs to Stable if it appears that SBS's CET1 ratio will not reach and be maintained at around 14.0%, or if other aspects of the credit profile weaken in conjunction with the strengthening in capital.

A downgrade of the Long-Term IDRs and VR appears unlikely but may occur if there is a weakening in the business and risk profiles, potentially reflected in ongoing above-system net interest margin attrition due to the need to price more sharply to compete or a prolonged deterioration in the loan/customer deposit ratio.

Rising regulatory and investment burdens in an increasingly digitalised market may also reduce SBS's competitive standing and pressure the business profile assessment. This may, in turn, prompt SBS to increase its appetite for riskier exposures, resulting in greater earnings volatility and pressure on capitalisation through the cycle.

The above scenario may be reflected in all of the following occurring:

- The four-year average of stage 3 loans/gross loans rising above 4.0% (FY22-FY25 average: 0.3%).

- The four-year average of the operating profit/RWA ratio falling below 1.0% (FY22-FY25 average: 1.5%).

- The CET1 ratio declining below 11.0% without a clear path to return above this level (FYE25: 13.5%).

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

Long-Term IDRs and VR

The Long-Term IDRs and VR may be upgraded if the bank sustains a CET1 ratio around 14.0% while maintaining or improving most other aspects of its credit profile.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

Short-Term IDRs

The Short-Term IDRs are assigned at the lower of the two options available at a Long-Term IDR of 'BBB', as the funding and liquidity score of 'bbb' is not sufficiently high to support the higher rating.

Senior Unsecured Debt

SBS's customer deposits, medium-term notes (MTNs) and commercial paper (CP) programme are rated one notch above its IDRs, at 'BBB+' for customer deposits and MTNs and 'F2' for CP. This is because New Zealand has an effective resolution framework and there are significant buffers of junior ranking instruments in the funding structure. Redeemable shares and subordinated debt combined accounted for over 120% of RWAs at FYE25 and both classes of liabilities rank junior to customer deposits, MTNs and the CP programme.

Subordinated Debt

SBS's subordinated Tier 2 debt is rated two notches below its anchor rating, the VR, consistent with the baseline approach for subordinated debt with no coupon flexibility in Fitch's *Bank Rating Criteria*. This captures two notches for loss severity and zero notches for non-performance risk, with the latter already adequately reflected in the VR.

The Reserve Bank of New Zealand's capital framework does not permit contractual loss absorption triggers in capital instruments, meaning Tier 2 debt instruments are effectively long-dated subordinated bonds. Coupons can only be paid if the bank is solvent but there are no other coupon deferral mechanisms. None of the reasons for alternative notching as described in the criteria is present.

GSR

The GSR reflects our view that there is no reasonable assumption of support from the New Zealand sovereign (AA+/Stable) being forthcoming if required. We believe the existence of an open bank resolution scheme lowers the propensity of the sovereign to support its banks. The scheme allows for the imposition of losses on depositors and senior debt holders to recapitalise a failed institution.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

Short-Term IDRs

The Short-Term IDRs would only be downgraded if the Long-Term IDRs were downgraded by at least two notches.

Senior Unsecured Debt

The long-term ratings on customer deposits and MTNs will be downgraded if the Long-Term IDRs are downgraded. The short-term rating on the CP programme would be downgraded if the long-term rating assigned to the customer deposits and MTNs is downgraded.

The senior unsecured debt ratings may be downgraded upon a substantial reduction in the level of redeemable shares and subordinated debt such that, combined, they account for less than 10% of RWAs. However, this is unlikely to occur.

Subordinated Debt

The subordinated debt ratings would be downgraded if SBS's VR is downgraded.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

Short-Term IDRs

The Short-Term IDRs would be upgraded to 'F2' if we upgrade the Long-Term IDRs or revise our funding factor mid-point to 'bbb+', from 'bbb'. The latter would require SBS to consistently maintain a loan/deposit ratio of less than 110%.

Senior Unsecured Debt

The long-term ratings on customer deposits and MTNs will be upgraded if the Long-Term IDRs are upgraded. The short-term rating on the CP programme would be upgraded if:

- the long-term rating on customer deposits and MTNs is upgraded by at least two notches to 'A'; or

- the funding and liquidity factor score is raised by at least three notches to 'a' in conjunction with an upgrade of at least one notch on the Long-Term IDRs.

Subordinated Debt

The subordinated debt ratings would be upgraded if SBS's VR is upgraded.

GSR

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

The GSR is already at the lowest level on Fitch's rating scale and cannot be downgraded.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

The GSR would be upgraded if the state's propensity to support is increased, but this appears unlikely given the resolution framework in place.

VR ADJUSTMENTS

The operating environment score has been assigned below the implied score due to the following adjustment reason: level or growth of credit (negative).

The business profile score has been assigned above the implied score due to the following adjustment reason: business model (positive).

Sources of Information

The principal sources of information used in the analysis are described in the applicable criteria.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Southland Building Society	LT IDR	BBB	Affirmed	BBB
	ST IDR	F3	Affirmed	F3
	LC LT IDR	BBB	Affirmed	BBB
	LC ST IDR	F3	Affirmed	F3
	Viability	bbb	Affirmed	bbb
	Government Support	ns	Affirmed	ns
senior unsecured	LT	BBB+	Affirmed	BBB+
subordinated	LT	BB+	Affirmed	BB+
senior unsecured	ST	F2	Affirmed	F2

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VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 22 Mar 2025) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Southland Building Society	EU Endorsed, UK Endorsed

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