MOODY'S
INVESTORS SERVICE

CREDIT OPINION
19 February 2021

Update

Rate this Research

RATINGS

BankVic

Domicile	Australia
Long Term CRR	A3
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	(P)Baa1
Type	Senior Unsecured MTN - Fgn Curr
Outlook	Not Assigned
Long Term Deposit	Baa1
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.

Contacts

Tanya Tang +61.2.9270.8123
Analyst
tanya.tang@moodys.com

Patrick Winsbury +61.2.9270.8183
Associate Managing Director
patrick.winsbury@moodys.com

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Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

BankVic

Update to credit analysis

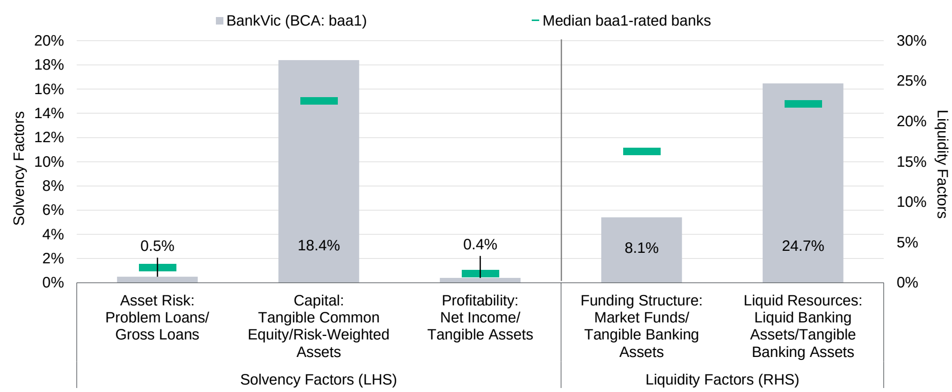
Summary

BankVic's long-term issuer rating of Baa1 reflects its strong asset quality, underpinned by its focus on both conservatively underwritten residential mortgages for members of the police, health, emergency and public service sectors in Victoria. These sectors generally have good employment and income stability.

BankVic's profitability and internal capital generation ability will remain under pressure as a result of the low interest rate environment and strong competition. Important mitigants include the bank's current strong capitalization and its mutual ownership structure, which allows full profit retention and flexibility to slow growth and conserve capital in times of stress.

Retail deposits will remain the bank's primary funding source, complemented by wholesale funding sources, which we expect to be well covered by its liquid assets.

Exhibit 1
Rating Scorecard - Key financial ratios



Source: Moody's Financial Metrics

Credit strengths

- Strong asset quality, underpinned by a low-risk business model
- Strong capitalization, supported by its mutual bank status
- Conservative funding profile, dominated by retail deposits

Credit challenges

- Ongoing profitability pressure from the low interest rate environment and strong competition

Outlook

The outlook on the ratings is stable, reflecting our expectation that the bank will maintain its conservative underwriting standards and strong balance sheet settings over the next 12-18 months

Factors that could lead to an upgrade

An upgrade of the bank's ratings is unlikely during the current economic downturn.

Factors that could lead to a downgrade

- Significant deterioration in asset quality, with problem loans/gross loans rising above 1%
- Tangible common equity/risk-weighted assets (RWA) declining below 15%
- Insufficient liquid assets to cover unsecured wholesale debt maturities

Key indicators

Exhibit 2
BankVic (Unconsolidated Financials) [1]

	06-20[2]	06-19[2]	06-18[2]	06-17[2]	06-16[2]	CAGR/Avg.[3]
Total Assets (AUD Million)	2,308.0	2,062.8	1,830.3	1,632.9	1,502.9	11.3[4]
Total Assets (USD Million)	1,589.1	1,447.6	1,352.3	1,252.5	1,119.0	9.2[4]
Tangible Common Equity (AUD Million)	195.0	185.1	177.2	164.5	153.6	6.2[4]
Tangible Common Equity (USD Million)	134.3	129.9	130.9	126.2	114.3	4.1[4]
Problem Loans / Gross Loans (%)	0.5	0.5	0.2	0.3	0.4	0.4[5]
Tangible Common Equity / Risk Weighted Assets (%)	18.4	18.8	20.1	20.7	21.0	19.8[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	4.7	4.1	2.0	2.4	2.9	3.2[5]
Net Interest Margin (%)	2.1	2.3	2.4	2.5	2.5	2.4[5]
PPI / Average RWA (%)	1.6	1.7	2.2	2.1	2.1	1.9[6]
Net Income / Tangible Assets (%)	0.4	0.5	0.7	0.7	0.7	0.6[5]
Cost / Income Ratio (%)	70.5	71.1	65.3	66.5	67.5	68.2[5]
Market Funds / Tangible Banking Assets (%)	8.1	7.2	5.7	2.5	1.7	5.0[5]
Liquid Banking Assets / Tangible Banking Assets (%)	24.7	18.9	20.7	19.5	19.5	20.7[5]
Gross Loans / Due to Customers (%)	90.5	97.3	93.9	92.3	91.6	93.1[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 because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. [5] Simple average of periods for the latest accounting regime. [6] Simple average of Basel III periods.
Sources: Moody's Investors Service and company filings

Profile

BankVic is a mutually owned authorized Australian deposit-taking institution (ADI). As of 31 December 2020, it reported total assets of AUD2.5 billion, and residential mortgages accounted for 97% of its loans.

Of BankVic's total loans, 95% were originated from the state of Victoria, and 40% were to employees in the state's police, health, emergency and public service sectors — which are mostly considered essential services — as of 30 June 2020.

The bank only uses direct channels to originate loans, in contrast to many of its peers that have been increasingly reliant on broker channels for business growth.

Detailed credit considerations

Strong asset quality, supported by a low-risk business model

The economic fallout from the coronavirus pandemic has affected the repayment ability of borrowers, creating a risk to asset quality. However, to date, the impact on the bank's asset quality has been low.

The bank's problem loans made up just 0.5% of gross loans as of the fiscal year that ended 30 June 2020 (fiscal 2020), despite the pandemic-induced economic slowdown. More significantly, mortgage loans that benefited from a temporary loan repayment deferral arrangement were less than 1% of gross loans as of 31 December 2020, in contrast to 2.4% across the country's banking system.

This strong performance reflects BankVic's focus on lending to employees in the above-mentioned essential services sectors, which typically have stable employment prospects. The bank's performance also reflects its conservative underwriting. For example, its shares of investor loans and interest-only loans remained low at 18% and 10%, respectively, as of 30 June 2020, compared with 34% and 16% for the country's banking system.

Despite BankVic's strong loan performance to date, Australia's high levels of household leverage and house prices will continue to create borrower sensitivity to tail risks, even after the effects of the pandemic subside. Additionally, the bank retains a high geographic concentration in Victoria, a state that has experienced higher house price volatility, especially in Melbourne, over recent years.
That said, these risks are partly offset by BankVic's wide presence across the state and the state's diversified economic base. These considerations underpin our downward adjustment to the Asset Risk and Business Diversification sections of our scorecard.

Ongoing profitability pressure from the low interest rate environment and strong competition

BankVic's net income/tangible assets (ROA) declined by 11 basis points to 0.44% over fiscal 2020 because of 10x increase in loan-loss provision charges, in response to the pandemic-induced economic slowdown, and a 20-basis-point lower net interest margin (NIM).

We expect the low interest rate environment and strong competition for home loans to continue to pressure BankVic's net interest income, which constituted about 83% of the bank's total revenue in fiscal 2020. That said, some profit drags from 2020 are unlikely to persist. For example, the significant loan-loss provision charges and elevated levels of liquidity, in response to the pandemic, should ease in 2021.

Non-interest income growth is likely to be constrained as Australian banks have been reducing or removing customer fees and commissions for banking services.

Other profitability constraints arise from the bank's structurally high cost base compared with that of larger banks that have more significant economies of scale, which help offset ongoing regulatory and compliance costs and IT investment.

Despite these challenges, BankVic's profitability metrics remain healthy, as reflected by a ROA and NIM of 0.44% and 2.1%, respectively, as of 30 June 2020, compared to 0.28% and 1.9% for other rated mutual ADIs.

Strong capitalization, supported by its mutual bank status

Whilst a potential improvement in loan growth, as the economy continues to recover, and modest profitability could weigh on the bank's capitalization, any weakening will be off a strong base. The bank's Common Equity Tier 1 (CET1) capital ratio was 17.18% as of 30 September 2020 which was at the higher end of the 13%-20.2% range for its peers. Consistently high capital levels demonstrate the bank's preference for capital conservation over loan growth.

Nevertheless, as a mutual this also means that the bank's ability to raise core capital is somewhat limited, which we reflect as a downward adjustment to the Capital sub-score. The newly legislated, mutual capital instrument could enhance capital management flexibility, although investor appetite remains somewhat uncertain.

Conservative funding profile and ample liquidity

As of 30 June 2020, retail deposits as a proportion of total funding remained high at 91.5%. Retail deposit growth has been supported by reduced consumption, government wage subsidies and unemployment benefits during the economic downturn. For BankVic, most of the growth has been in at-call accounts, increasing the share of these deposits to 80% from 76%.

Middle-market and wholesale deposits accounted for 6% of total funding whilst a drawdown from the Reserve Bank of Australia's Term Funding Facility (TFF) accounted for 2.5% as of June 2020. This facility was established in response to the pandemic to provide banks with three-year funding at a low cost. BankVic has an additional undrawn allowance of AUD35 million from this facility, which expires on 30 June 2021. This allowance, if drawn, would be equivalent to 1.5% of total funding as of 30 June 2020.

We view the bank's current funding mix a credit positive. That is, the bank is dominated by retail deposits - a relatively stable funding source - and its small exposure to wholesale funding adds duration and funding diversity. However, BankVic is expected to access more wholesale funding going forward and we have made downward adjustment to the Funding Structure score in our scorecard accordingly.

Whilst the bank's holdings of liquid assets increased in response to the economic slowdown, we expect liquidity to ease back to its long-term average as the economy continues to recover. As of June 2020, the bank's on-balance-sheet liquid assets increased to 25% of total assets from 19% a year earlier and its holdings of internal residential mortgage-backed securities (RMBS) also doubled to 25% of total liabilities. These securities are repo-eligible with the Reserve Bank of Australia (RBA) and allow the bank to quickly monetize its large, high-quality mortgage book if liquidity needs arise.

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

Australia's Strong+ Macro Profile reflects a very high degree of economic resilience, institutional and government financial strength, and low susceptibility to event risk. Australia has had 28 years of uninterrupted economic growth and unemployment remains low. However, our baseline scenario for real GDP growth was downgraded to negative 4% in 2020 because of an expected slowdown in global economic activity because of the pandemic. While we expect a recovery in 2021, with a GDP growth of 3.5%, risks remain.

The government has announced a substantial economic support package that will provide financial assistance to companies and individuals, which will likely mitigate the negative impact of reduced activity caused by the pandemic. Fiscal measures and partial government guarantees provide credit to small and medium-sized enterprises (SMEs), while wage subsidies and debt rescheduling efforts by banks will relieve immediate pressure on borrowers and help minimize a potential wave of bankruptcies. The magnitude of the deterioration in the economy will ultimately depend on the length of the disruptions.

While Australian banks' current asset quality is very strong, it will deteriorate significantly if the disruption persists for a prolonged period and pushes up the unemployment rate, leading to more impairments of residential mortgages, which constitute about two-thirds of banking system loans. Relatively low average loan-to-value ratios provide a buffer against house price declines, but household debt is high, with household debt/annualized disposable income at 180% as of September 2020.

Australian banks' very strong pricing power has historically been supported by the high level of concentration in the banking sector. However, we expect banks to face profitability pressure because of the constraints caused by the pandemic. Loan-loss charges will increase and revenue will decline as net interest margins narrow in the low interest rate environment. Loan volumes will decrease as economic conditions deteriorate, offering little room for revenue growth. While banks may save costs by pausing projects, this is unlikely to fully offset the challenges posed by the decrease in revenue.

Australia's structural reliance on external financing remains a key vulnerability. However, Australian banks have been extending the term structure of their wholesale market funding for a number of years and they pre-fund upcoming maturities well in advance. Further, slower credit growth, combined with weaker spending, will reduce banks' wholesale funding needs. The RBA's committed liquidity facility, combined with its bond purchases and term-repo operations, will underpin system-level liquidity. A temporary reciprocal swap line arrangement between the RBA and the US Federal Reserve will facilitate access to US dollar liquidity.

ESG considerations

In line with our general view for the banking sector, BankVic has low exposure to environmental risks, particularly because it is primarily focused on home loans. Please refer to our environmental risks heat map for more details.

We regard the pandemic as a social risk under our environmental, social and governance (ESG) framework, given the substantial implications for public health and safety. The rapid and widening spread of the pandemic and the deteriorating global economic outlook are creating a severe and extensive credit shock across many sectors, regions and markets, also affecting debt purchasers' business and performance.

The most relevant social risks for banks also arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy, which are mitigated by sizable technology investments and banks' long track record of handling sensitive client data. Fines and reputational damage because of product mis-selling or other types of misconduct are a further social risk. Societal trends are also relevant in a number of areas, such as shifting customer preferences toward digital banking services increasing information technology costs, aging population concerns in several countries affecting demand for financial services or socially driven policy agendas that may translate into regulation that affects banks' revenue base.

Overall, we believe banks face moderate social risks, although we see mutual ADIs' focus on delivering value to their members as a point of differentiation to the listed financial sector. Please refer to our social risks heat map for more details.

Governance is a key area of focus for banks that requires ongoing monitoring. In this regard, we note the bank's track record of low loan losses and maintaining balance-sheet strength.

Support and structural considerations

There is currently no statutory bail-in system in Australia. As a result, we do not consider Australia to have an operational resolution regime (as defined in our Banks rating methodology). We apply a Basic Loss Given Failure approach in rating Australian banks' junior securities.

To determine whether or not Australia has an operational resolution regime, we take both the current resolution framework and Australian policymakers' public stance into account. Although Australia is a member of the Financial Stability Board, which has highlighted the lack of a statutory bail-in system as a gap compared with international standards, the authorities have so far adopted a more nuanced public stance on this issue.

In contrast to loss-absorbing capacity requirements in many other jurisdictions, the Australian Prudential Regulation Authority (APRA) has not proposed a new form of loss-absorbing instrument or a statutory bail-in framework. There are also no proposed legislative changes to impose explicit burden-sharing on bank creditors. However, APRA has indicated that in 2020, it will work on a new prudential standard on resolution and recovery planning.

In 2019, APRA required Australia's four largest banks to lift total capital by three percentage points of RWA by 1 January 2024 by means of Tier 2 issuance, with a long-term target of an additional four to five percentage points of loss-absorbing capacity to support their orderly resolution. Banks will be able to meet this requirement with existing capital instruments, including CET1, Additional Tier 1 and Tier 2 capital instruments. However, APRA eased the pressure on the four banks to maintain CET1 ratios of at least 10.5% to facilitate lending during the pandemic.

APRA's stance thus far does not alter our view that there remains a role for public funds in resolving a failing bank. We do not factor into the ratings any government support for smaller banks with lower systemic importance, such as BankVic. However, we view the current economic support packages, including fiscal stimulus, enhanced financial market liquidity and term funding to support credit intermediation, as measures that are temporarily increasing the level of indirect government support for the entire banking system.

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 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 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 a bank's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquidity facilities.

BankVic's CR Assessment is positioned at A3(cr)/P-2(cr)

The CR Assessment, before government support, is positioned one notch above the Adjusted BCA and, therefore, above the Preliminary Rating Assessment of senior unsecured debt obligations. This positioning 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 senior obligations represented by the CR Assessment will be more likely preserved to limit contagion, minimize losses and avoid the disruption of critical functions.

For BankVic, the CR Assessment does not benefit from any government support, in line with our support assumptions on senior unsecured debt. This 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.

Counterparty Risk Ratings (CRRs)

CRRs are opinions of the ability of entities to honor the uncollateralized portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honored. CRR liabilities typically relate to transactions with unrelated parties. Examples of CRR liabilities include the uncollateralized portion of payables arising from derivatives transactions and the uncollateralized portion of liabilities under sale and repurchase agreements. CRRs are not applicable to funding commitments or other obligations associated with covered bonds, letters of credit, guarantees, servicer and trustee obligations, and other similar obligations that arise from a bank performing its essential operating functions.

BankVic's CRRs are positioned at A3/P-2

The long-term CRR is positioned one notch above BankVic's Adjusted BCA and does not benefit from any government support, in line with our support assumptions on senior unsecured debt.

Methodology and scorecard

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

BankVic

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

Factor	**Historic Ratio**	**Initial Score**	**Expected Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	0.5%	aa2	↔	a2	Quality of assets	Geographical concentration
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	18.4%	aa2	↔	aa3	Expected trend	Access to capital
Profitability						
Net Income / Tangible Assets	0.4%	ba1	↔	ba1	Expected trend	
Combined Solvency Score		a1		a2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	8.1%	a1	↔	a2	Expected trend	Deposit quality
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	24.7%	baa1	↔	baa1	Expected trend	Additional liquidity resources
Combined Liquidity Score		a2		a3		
Financial Profile				a2		
Qualitative Adjustments				Adjustment		
Business Diversification				-2		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				-2		
Sovereign or Affiliate constraint				Aaa		
BCA Scorecard-indicated Outcome - Range				a3 - baa2		
Assigned BCA				baa1		
Affiliate Support notching				0		
Adjusted BCA				baa1		

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency Rating**	**Foreign Currency Rating**
Counterparty Risk Rating	1	0	a3	0	A3	A3
Counterparty Risk Assessment	1	0	a3 (cr)	0	A3(cr)	
Deposits	0	0	baa1	0	Baa1	Baa1
Senior unsecured bank debt	0	0	baa1	0	Baa1	Baa1

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
BANKVIC	
Outlook	Stable
Counterparty Risk Rating	A3/P-2
Bank Deposits	Baa1/P-2
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Counterparty Risk Assessment	A3(cr)/P-2(cr)
Issuer Rating	Baa1
Senior Unsecured MTN	(P)Baa1
ST Issuer Rating	P-2
Other Short Term	(P)P-2

Source: Moody's Investors Service

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