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Credit FAQ:

Rating Australia's Midsize Regional Banks Under Standard & Poor's Revised Bank Criteria

Primary Credit Analysts:
Nico De Lange, Sydney (61) 2-9255-9887; nico_delange@standardandpoors.com
Peter Sikora, Melbourne (61) 3-9631-2094; peter_sikora@standardandpoors.com
Gavin Gunning, Melbourne (61) 3-9631-2092; gavin_gunning@standardandpoors.com

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Standard & Poor's Ratings Services rates the three midsize regional banks in Australia: Bank of Queensland Ltd. (BOQ, BBB/Stable/A-2), Bendigo and Adelaide Bank Ltd. (BEN, A-/Stable/A-2), and Suncorp-Metway Ltd. (Suncorp, A+/Stable/A-1). On Dec. 6, 2011, following our review of the ratings on these three banks under Standard & Poor's revised criteria for bank ratings, we affirmed our long-term 'A+' rating on Suncorp, lowered our long-term rating on BOQ to 'BBB' from 'BBB+', and raised our long-term rating on BEN to 'A-' from 'BBB+'. This FAQ provides further insight into our ratings on the above-mentioned three midsize regional banks in Australia.

Frequently Asked Questions

Why have there been three different actions on the issuer credit rating (ICR) on the three midsize regional banks? ICR on one bank was raised, the second affirmed, and the third lowered.

The methodology for assessing the ICR is set out in the new criteria document, Banks: Rating Methodology And Assumptions, published to the Global Credit Portal on Nov. 9, 2011. The criteria represent a significant change to the way we conduct our analysis. In particular, the new criteria provide greater transparency and enhance the global comparability of our bank ratings. To that end, the ICR now comprises two parts: 1) assessment of a bank's stand-alone credit profile (SACP), and 2) assessment of its external support (from the government or the group).

For the ICR changes on BOQ and BEN, note that although the ICRs were the same under the Bank Rating Analysis Methodology Profile that was published on March 18, 2004, the new criteria provide greater clarity around the assessment of the SACP factors on each bank, and resulted in the raising of the ICR on BEN and the lowering of the ICR on BOQ. The reasons for the differences in the SACP factors for the three regional banks are discussed in the next question.

The ICR for Suncorp was affirmed after our review, which makes it four-notches higher than that on BOQ, even though the SACP factors for Suncorp and BOQ are identical. This is because the rating on Suncorp also factors in our assessment of likelihood of external support from its parent. The rating affirmation on Suncorp reflects our view that the bank remains a "core" subsidiary of Suncorp Group Ltd. group of companies, and therefore its ratings remain equalised with those on other core operating subsidiaries of the group, in accordance with our Group Rating Methodology And Assumptions, published Nov. 9, 2011.

What are the main reasons for the difference between the SACPs of the three midsize regional banks?

While, in our assessment, the SACP factors for BOQ and Suncorp are identical, BEN's SACP is assessed at two-notches higher on the relative strength of its business position and capital and earnings (see table 1).

Table 1

Rating Factors On Australian Midsize Regional Banks

	Bank of Queensland Ltd.	Suncorp-Metway Ltd.	Bendigo and Adelaide Bank Ltd.
Stand-alone credit profile (SACP) factors			
Anchor	a-	a-	a-
Business position	Moderate (-1)	Moderate (-1)	Adequate (0)

Table 1

Rating Factors On Australian Midsize Regional Banks (cont.)			
Capital & Earnings	Adequate (0)	Adequate (0)	Strong (+1)
Risk position	Adequate (0)	Adequate (0)	Adequate (0)
Funding and liquidity	Below average (-1)	Below average (-1)	Below average (-1)
SACP	bbb	bbb	a-
Systemic importance	Low	Low	Low
Final issuer credit rating	BBB/Stable/A-2	A+/Stable/A-1	A-/Stable/A-2
Previous rating	BBB+/Negative/A-2	A+/Stable/A-1	BBB+/Positive/A-2

Difference in "business position" assessment. Compared to BOQ and Suncorp (business position for both assessed as "moderate"), we have assessed BEN's business position as "adequate", reflecting our favourable view of the bank's business franchise and stability. In our view, BEN's business stability benefits from an increased national focus, and its unique "Community Bank" network, which helps it garner customer support. In our previously published reports, we had highlighted our view that BOQ had a slightly weaker business profile than BEN; we also consider that BOQ's franchise strength and stability outside its home state is weaker than BEN's outside its home state. Furthermore, we consider that BOQ and Suncorp are exposed to higher competition in their home state of Queensland, where all regional and major banks actively compete and there are a large number of nonbank financial institutions (building societies and credit unions) competing for the business that is targeted by BOQ.

Difference in "capital and earnings" assessment. We assess each of Suncorp's and BOQ's capitalisation and earnings positions as "adequate", even though we expect Suncorp's projected risk-adjusted capital (RAC) ratio to be slightly above 10% and BOQ's slightly below 10%. This assessment is in line with our new criteria (see ¶80 and table 7 of the new criteria), under which we may assign the capital and earnings score in any of the two categories if the projected RAC ratio is borderline within 25 basis points of the RAC ratio limit. In our view, a high contribution of hybrid capital in Suncorp's total capital slightly weakens the overall strength of capital and earnings, as does the bank's recently weaker asset-quality experience compared with many peers, which has resulted in lower profitability and internal capital generating capacity. Nonetheless, a revision of our capital and earnings score on Suncorp to "strong" from "adequate" remains a possibility over the medium-to-long term. In BOQ's case, we do not consider that the bank has a sufficiently progressed capital-management plan that would support a projected RAC ratio comfortably in the 10%-15% range (which is generally consistent with a "strong" capital and earnings assessment) in the next one-to-two years. We assess BEN's capital earnings as "strong". This is because we believe that BEN's announced capital-management plans are well progressed and likely to support the bank achieving a RAC ratio of above 10% in the next 12 months.

Why don't the ratings on these three banks benefit from any government support?

Actually, they do incorporate a degree of government support through our Banking Industry Country Risk Assessment (BICRA) on Australia. The important rating linkages between the Australian government and the three regional banks can be classified into three broad categories (see Analytical Linkages Between Sovereign And Bank Ratings, published Dec. 6, 2011): Direct links, indirect links, and other influences.

1) Direct links. The likelihood of extraordinary government support has been assessed as "low" for all the three banks, which results in no rating uplift from the SACP (see our Government Support Framework detailed in ¶162-¶212 of the new criteria). This assessment is based on our view that the three regional banks are of "low" systemic importance, although we consider that the Australian government has a "highly supportive" tendency when it comes to private sector banks (see ¶192 and table 20, and the next two questions for further details).

2) Indirect links, and other influences. The "anchor SACP" (the starting point) for ratings on all the three banks is 'a-', benefitting from Australia's BICRA scores. The BICRA factors in the economic, political, monetary, and fiscal scores on the government under our sovereign criteria. Additionally, system-wide funding is part of our industry risk assessment within the BICRA analysis. A government and its agents often play an important role in the way banks access funding and liquidity, and we form a view on whether this role is a positive, neutral, or negative factor. In addition, a sovereign in distress can weigh down our assessment of system-wide funding, because we see that a rapid deterioration in sovereign creditworthiness often leads to negative wholesale and interbank funding conditions for banks based in that country (see ¶112 and ¶113 of the Banking Industry Country Risk Assessment Methodology And Assumptions, published Nov. 9, 2011). In our report, Banking Industry Country Risk Assessment: Australia, published Dec. 12, 2011, we have noted our view that the Australian government has an effective track record of providing guarantees for wholesale and retail funding throughout the global financial crisis.

Additionally, the BICRA also considers the influence of government in our assessments of the institutional framework and competitive dynamics of a banking industry. We have assessed these two factors within the Australian banking industry to be of "very low risk".

Why does Standard & Poor's consider the Australian government as "highly supportive"?

We have assessed the Australian government's tendency to support private sector banks as "highly supportive" in line with ¶191 of the new criteria. This reflects our expectation of the Australian government's timely financial support to ensure the stability of the financial system, if needed. The assessment also factors in our view that a well-developed administrative and institutional framework should facilitate a timely and coordinated response, and that there has been a track record of proactive and prompt support for the banking system through measures such as guarantees for retail and wholesale funding during the global financial crisis. We also believe that the government's existing legislation, policy, and relationships with supranational agencies do not hinder it from assisting the banking system.

Why does Standard & Poor's consider the three regional banks to be of "low" systemic importance?

Under ¶189 of our new criteria, a bank is assessed as being of "low" systemic importance when it does not fit the criteria for "high" or "moderate" systemic importance. This paragraph also states that the majority of the banks (by number) in a banking industry are likely to be in the "low" systemic importance category. This view supports the notion that a government is likely to make the "high" or "moderate" systemic importance entities a priority for support if they experience stress that could lead to a default. We are of the opinion that none of Australia's midsize regional banks display the characteristics we expect from a bank classified under our new criteria as of "high" systemic importance. For example, we expect that banks classified as being of "high" systemic importance maintain a substantial market share of typically more than 10% in retail banking, and have a leading position in brand recognition in the country. We have classified the four major banks in Australia as being of "high" systemic importance, as we consider that these are the only banks in the country that show the above characteristics: Australia and New Zealand Banking Group Ltd. (AA-/Stable/A-1+), Commonwealth Bank of Australia (AA-/Stable/A-1+), National Australia Bank Ltd. (AA-/Stable/A-1+), and Westpac Banking Corp. (AA-/Stable/A-1+). These banks collectively account for about 80% of the Australian financial systems assets. We believe that the failure of any of these four banks is likely to have a high adverse impact on Australia's financial system and the real economy. We consider that, in particular, a default by any of these banks on its senior unsecured obligations is likely to weaken Australia's financial system, limit the availability of credit for the private sector, and trigger a significant financial stress at several other financial institutions.

Furthermore, we consider that none of the three midsize regional banks in Australia show the characteristics we expect to see in a bank of "moderate" systemic importance (see ¶188 of the new criteria). For example, in our view, none of these banks maintain a significant market share of retail banking at a national level or are leading providers of banking services to a particular region or sector that plays a significant role in the economy. We also do not consider that any of the midsize regional banks are leading providers of politically-sensitive products such as residential mortgages. This view is supported by the fact that Australia's regional banks individually maintained market shares of less than 3% in both mortgage lending and deposit-taking activities (APRA Monthly Banking Statistics, dated November 2011). Additionally, the three midsize regional banks are not leading providers of banking services in their respective core geographic regions of operation, when considering that they individually operate less than 10% of the branches in the state of Queensland and less than 15% in the state of Victoria (APRA ADI Point of Presence data, dated June 2011). In our view, these market-share factors are important considerations in terms of the position of other financial product-and-services providers such as the market-dominant Australian major banks. Furthermore, we consider that the regional banks offer a set of relatively homogenised financial products and services that are widely provided by other financial service providers. It is, therefore, our view that the failure of any of the regional banks is not likely to have a material adverse impact on the financial system or real economy. We also do not consider that it is likely to lead to a considerable disruption in the provision of financial services to a specific region or sector of the economy.

We have classified only two financial institutions in Australia as being of "moderate" systemic importance namely Cuscal Ltd. (Cuscal, A+/Stable/A-1), and Macquarie Bank Ltd. (MBL, A/Stable/A-1). This is in line with our criteria where the failure of any one of these two institutions, in our opinion, could lead to a disruption in the provision of financial services to a specific sector of the economy. For Cuscal we believe a failure of Cuscal could lead to a disruption in the provision of financial services by a large number of authorised deposit-taking institutions to their respective customers. For MBL, the licensed banking entity within Macquarie Group Ltd. (BBB/Stable/A-2), we believe that MBL is an important financial services provider to certain significant sectors in the Australian economy. We believe, however, that other businesses of Macquarie group (outside the licensed banking entity) are of "low" systemic importance.

Our classification of the Australian regional banks as being of "low" systemic importance contributes to our assessment of likelihood of extraordinary government support for these banks relative to that for the other banks within the country. This assessment does not completely discount the prospect that the Australian government may decide to support regional banks in the event of a crisis (see ¶184 of the new criteria). Indeed, the recent global financial crisis saw the Australian government implement a range of stabilising and supporting measures, including the retail deposit and wholesale funding guarantees. But, we consider that these measures were universally implemented for entire banking system, and hence, not sufficient to regard the three banks in question as being of "moderate" or "high" systemic importance.

But why then has Standard & Poor's classified midsize regional banks in some other countries as "moderately" systemically important?

We assess systemic importance in terms of the degree to which a bank's failure impacts all or part of a financial system and the real economy of the country in which the bank operates (see ¶184 of the new criteria).

There are indeed some instances outside of Australia in which Standard & Poor's has classified financial institutions as being of "moderate" systemic importance despite them having a market share below 10%. These instances include Yorkshire Building Society (YBS) in the U.K. and some regional banks in Japan. Our rationale for these classifications is as follows:

- We consider YBS to be a leading provider of politically-sensitive products, such as residential mortgages. This assessment reflects YBS' position as one of the ten largest lenders in the U.K. both in terms of stock of outstanding mortgage loans and gross lending volume. Furthermore, YBS is a significant provider of mortgages and savings in the north of England, and is therefore a leading provider of banking services to a particular region or sector that plays a significant role in the economy.
- In our view, the Japanese regional banks have important roles in their key operating prefectures given Japan's unique industry structure in which prefecture based banks are the mainstay of banking services in their respective prefectures. Hence their failure could cause serious financial system damage to the prefecture absent governmental support.