Manchester Unity Friendly Society

Full Rating Report

Ratings

Insurer Financial Strength	BB-

Sovereign Risk

Long-Term Foreign-Currency IDR	AA
Long-Term Local-Currency IDR	AA+

Outlooks

Insurer Financial Strength	Stable
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Financial Data

Manchester Unity Friendly Society

	31 May 18
Gross written premiums (NZDm)	1.3
Total assets (NZDm)	83.1
Pre-tax operating return on assets (ROA) (including realised and unrealised gains) (%)	3
Risky assets ratio (%)	80
Regulatory capital ratio (%)	168
Liquid assets/ net technical reserves - excluding unit linked (total) (%)	149

Source: Fitch Ratings, Fitch Solutions, MUFS

Related Research

New Zealand (February 2019)

Analysts

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Key Rating Drivers

Moderately Weak Fundamentals: Manchester Unity Friendly Society's (MUFS) rating reflects the insurer's least favourable business profile, moderately weak financial performance and earnings as well as adequate capitalisation and leverage. The rating incorporates support from its loyal membership base, low-risk insurance exposure and conservative investment portfolio.

Least Favourable Business Profile: We assess MUFS's business profile as the least favourable compared with that of other New Zealand life insurance companies, due to its limited market franchise, niche focus and declining membership. Therefore, we score MUFS's business profile at 'b+' under our credit factor scoring guidelines.

MUFS is a small player in the domestic life insurance sector, with a market share of less than 1%. Most of its life products have been closed to new business since 2012. MUFS offers low-cost funeral and medical insurance to members; to become a policyholder, an individual must also be a member. It also provides holiday accommodation and fraternal services to members.

Declining Membership Base: MUFS's membership declined to 12,642 in the financial year ending May 2018 (FY18), from 13,180 in FY17, as member deaths outpaced new joiners. The society's strategies do not include business development or selling objectives to maximise its membership base, with word of mouth being the main source of new business.

Falling Premiums: Fitch sees MUFS's financial performance and earnings as moderately weak, in light of the trend of falling premiums (FY18: 4%, FY17: 5%) due to the decreasing membership and also because most of its insurance products are closed to new business. MUFS is not a profit-maximising entity due to its mutual ownership. Net profit after tax rose by NZD0.9 million to NZD2.4 million in FY18 on revaluation gains in the property portfolio.

Adequate Capitalisation: MUFS's coverage of the regulatory capital requirement was 168% at FYE18 (FYE17: 163%), well above the regulatory minimum of 100%. However, its small absolute capital base and limited access to new capital leaves it vulnerable to unexpected operational risk and changes in the external operating environment.

Asset-Liability Mismatch Mitigated: Strong liquidity and policyholder liabilities that, due to their design, discourage early redemption, and are mainly payable on death, mitigate asset-liability mismatch. The average duration of MUFS's policyholder liabilities is around 11 years, compared with two years for its cash and fixed-income investments. The society's liquid assets/policyholder liabilities ratio was a strong 149% at FYE18 (FYE17: 145%) and any duration mismatch will ultimately decline with the run-off of the closed insurance funds.

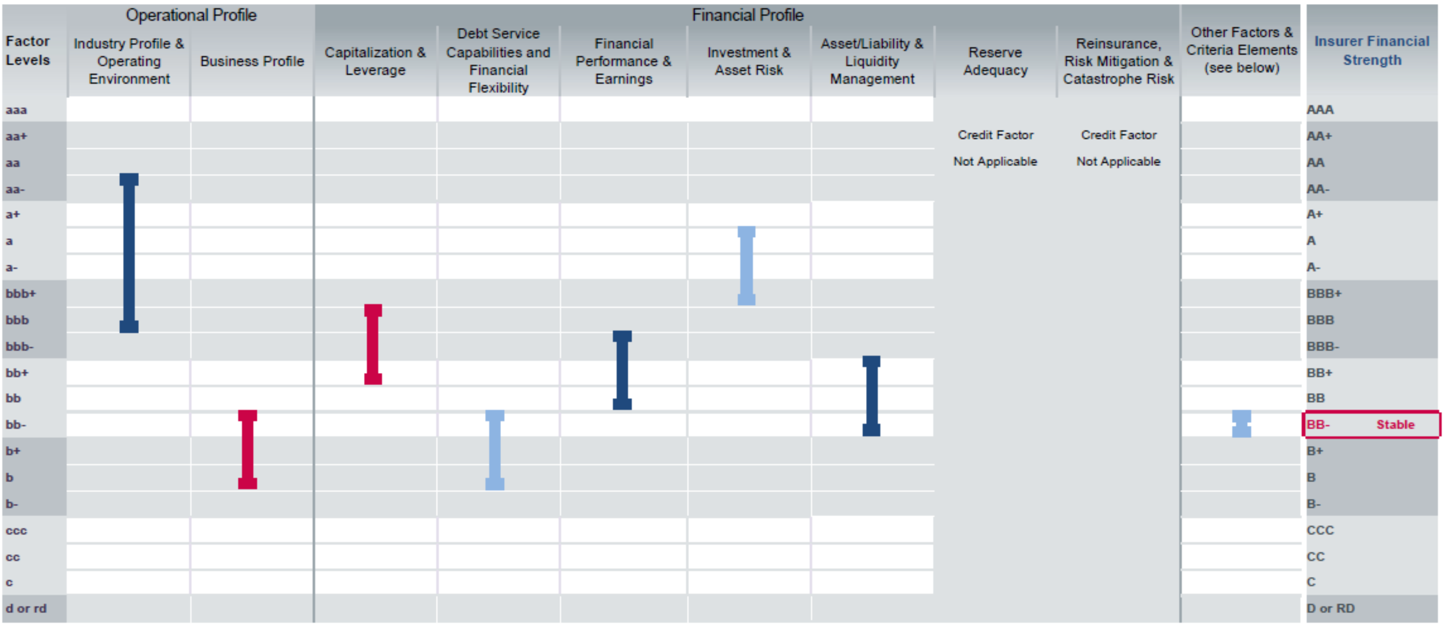
Rating Sensitivities

Business Profile and Capital: We will downgrade MUFS's rating if there's a continued deterioration in the weak business profile, including a decrease in the number of branches and significant reduction in the membership. A drop in coverage of MUFS's regulatory capital requirement below the management target of 150% for an extended period of time could also lead to a downgrade.

MUFS's ability to maintain coverage of the regulatory capital requirement above 170% on a sustained basis or a sustained improvement in the business profile could lead to an upgrade.

Manchester Unity Friendly Society

Insurance Ratings Navigator
APAC (Other Exc JP) Life



Other Factors & Criteria Elements				
Provisional Insurer Financial Strength				BB-
Non-Insurance Attributes	Positive	**Neutral**	Negative	+0
Corporate Governance & Management	**Effective**	Some Weakness	Ineffective	+0
Ownership	Positive	**Neutral**	Negative	+0
Transfer & Convertibility / Country Ceiling	Yes	**No**	AAA	+0
Insurer Financial Strength (IFS)			Final:	**BB-**
IFS Recovery Assumption	**Good**			-1
Issuer Default Rating (IDR)			Final:	**B+**

Bar Chart Legend:	
Vertical Bars = Range of Rating Factor	
Bar Colors = Relative Importance	
■	Higher Influence
■	Moderate Influence
■	Lower Influence
Bar Arrows = Rating Factor Outlook	
⇧	Positive
⇩	Negative
⇳	Evolving
□	Stable

Related Criteria

Insurance Rating Criteria (January 2019)

Business Profile

Least Favourable Business Profile

- Limited earnings generation
- Small market size; declining membership
- Most insurance products closed to new business
- Very limited diversification

Limited Earnings Generation

Fitch takes into consideration MUFS's business profile as least favourable compared with that of all other New Zealand life insurers, due to its limited market franchise, niche focus and declining membership. This in turn limits the insurer's earnings generation. Therefore, Fitch scores MUFS's business profile at 'b+' under its credit factor scoring guidelines.

MUFS's business is to provide financial products, holiday accommodation and fraternal services for the benefit of its members. Its core financial product is insurance.

Small Market Size; Declining Membership

MUFS's market share, measured by premium, is less than 1% of New Zealand's life insurance market. However, susceptibility to competition is significantly reduced due to the mutual design of its products. MUFS is the country's largest fraternal services provider, but it is not a profit-maximising entity and neither are its products, which subsequently tend to provide good comparative value against other market offerings.

Its membership has been falling in recent years, as member deaths outpaced the number of new members. MUFS's strategies did not include business development activities or selling objectives to expand its membership. Individuals must become members to hold a policy.

Most Insurance Products Closed to New Business

A number of MUFS's plans provide short- and long-term investments, financial protection and death cover, which are closed to new business, and include endowment, whole of life and term life policies. It can adjust bonus rates, appropriation rates and surrender values where payable.

The society underwrites three simple medical plans that provide low-cost cover to its members as well as simple funeral cover. Membership uptake of these products is still low.

Very Limited Diversification

MUFS's product and distribution channel diversification is very limited. The only insurance products open for new business are medical and funeral insurance plans, and the society has no intention of increasing the range of its insurance products. MUFS is mostly dependent on existing members bringing in new members to support volume growth.

MUFS has an arrangement with AON New Zealand for a number of non-life personal line products. However, MUFS does not receive any commission on the non-life products but instead has negotiated discounts for its members.

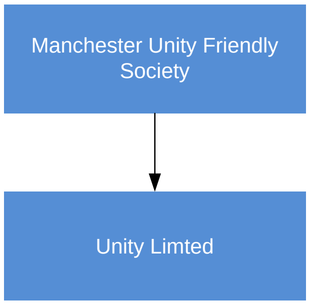
Ownership

MUFS is a member-owned association and is classified and registered as a friendly society under the Friendly Society and Credit Unions Act 1982. Its assets are vested to trustees for the use and benefit of the society and its members.

MUFS's members belong to a network of 32 branches and each member, upon joining a branch, has one vote on any decisions that require a vote. Each branch then sends a delegate to vote on its behalf at MUFS's annual general meeting.

MUFS has limited ability to raise capital as a mutual and therefore it requires retained earnings to support financial flexibility.

Simplified Group Structure Diagram



Source: Fitch Ratings, Fitch Solutions, MUFS

Capitalisation and Leverage

(%)	FY14	FY15	FY16	FY17	FY18	Fitch's expectation
Operating leverage	3	2	2	2	2	Capitalisation to remain adequate.
Net financial leverage	0	0	0	0	0	
Regulatory capital ratio	240	162	161	163	168	
Total equity (NZD 000)	19,105	20,006	22,264	23,737	25,600	

Source: Fitch Ratings, Fitch Solutions, MUFS

Capital is Adequate for Rating Category

- Good regulatory capital ratio; small absolute capital base
- Low operating leverage and no debt

Good Regulatory Capital Ratio; Small Absolute Capital Base

MUFS's coverage of the Reserve Bank of New Zealand's (RBNZ) risk-based minimum solvency of 168% at FYE18 (FYE17: 163%), was well above the regulatory minimum of 100%. Fitch sees MUFS's capitalisation, based on a technical assessment of its risk profile and coverage of the regulatory requirement, as 'Extremely Strong' for the rating. Nevertheless, the low absolute level of capital and limited access to new capital leaves MUFS susceptible to larger, more remote operational risks and changes in the external operating environment.

The board has set a minimum regulatory capital target of 150%, below which management actions occur to strengthen the ratio, such as lengthening the duration of the bond portfolio or reducing risk in the investment portfolio. This occurred in the past where a falling discount rate and MUFS's asset-liability mismatch resulted in a decline in the regulatory coverage ratio, which triggered a number of regulatory capital strengthening actions.

Low Operating Leverage and No Debt

MUFS's operating and asset leverage ratios remained unchanged at 2x in FY18. The society has very low leverage compared with Fitch's median criteria guidelines. The society has no debt and says it has no plans to raise any debt.

Debt Service Capabilities and Financial Flexibility

(%)	FY14	FY15	FY16	FY17	FY18	Fitch's expectation
Fixed-charge coverage ratio	0	0	0	0	0	Retained earnings to support financial flexibility in the medium term.

Source: Fitch Ratings, Fitch Solutions, MUFS

Mutual Ownership Limits Access to Capital; Balance Sheet Supports Financial Flexibility

MUFS's mutual structure limits its ability to raise capital and therefore it uses retained earnings to support financial flexibility. Fitch believes MUFS's financial flexibility is adequately supported by the absolute size of the investment portfolio and its ability to contribute to earnings. MUFS has a large equity and asset base compared with the volume of insurance underwritten, and targets investment earnings to support member benefits.

Financial Performance and Earnings

(%)	FY14	FY15	FY16	FY17	FY18	Fitch's expectation
Net income (NZD 000)	-971	901	2,262	1,475	2,424	Premiums continue to drop alongside falling membership.
Change in gross written premiums	-6	-8	-4	-5	-4	
Net income return on equity	-5	5	11	6	10	
Pre-tax operating ROA (excluding realised and unrealised gains)	1	0	3	1	1	
Pre-tax operating ROA (including realised and unrealised gains)	-1	1	3	2	3	

Source: Fitch Ratings, Fitch Solutions, MUFS

Declining Membership puts Pressure on Underlying Earnings

- Falling premium volumes
- Control over appropriations supports earnings

Falling Premium Volumes

We believe premium volumes are likely to continue declining if MUFS does not turnaround its membership numbers. The small, declining membership base and run-off of its insurance products have contributed to a decrease in premium volumes. MUFS's membership declined by 538 members in FY18, bringing the total down to 12,642. Premiums dropped 4% in FY18 compared with 5% in FY17.

Strategically, the society has not actively targeted new members, but more recently has shown a desire to boost membership by increasing member value and promoting the benefits available to existing members. New members typically join through word of mouth and around a decade ago, the membership requirement to hold an insurance policy was dropped.

Control Over Appropriations Supports Earnings

MUFS's large asset base and investment portfolio support earnings and the provision of member benefits. The board determines a share of net income to be distributed to members' benefit funds each year. Potential investment risks are mitigated as the participating nature of nearly all of the benefits and products means that investment losses/gains can be shared by way of adjusting the amount credited to members' benefit funds.

MUFS's investment earnings increased to NZD5.0 million in FY18 from NZD3.8 million in FY17 (FY16: NZD3.7 million). This was due mainly to revaluation gains of NZD1.8 million in FY18, stemming from MUFS's property portfolio, up from NZD0.5 million in FY17.

Investment and Asset Risk

(%)	FY14	FY15	FY16	FY17	FY18	Fitch's expectation
Risky-assets ratio	129	143	75	78	80	Investment strategy to remain conservative.
Sovereign investments to capital ratio[a]	n.a	n.a	n.a	52	50	
Cash and cash equivalents to total invested assets	20	25	13	29	25	
Fixed-income securities to total invested assets	49	45	67	48	50	
Real estate investments to total invested assets	25	24	20	22	25	

[a] Sovereign investments include government bonds and debt issued by local authorities and state-owned entities
Source: Fitch Ratings, Fitch Solutions, MUFS

Investment Risks Low

- Highly rated fixed-income securities dominate investments
- Substantial property exposure drives risky-assets ratio
- Modest equity investments

Highly Rated Fixed-Income Securities Dominate Investments

The society has 75% of its investments in cash (including term deposits) and fixed-income investments (no sub-investment-grade securities) at FYE18 (FYE17: 77%). Fixed-income securities comprised 50% of total investments, and were mainly bank, corporate, local authority and state-owned entity senior debt.

The strong credit quality of MUFS's cash and fixed-income portfolios is due to its conservative investment policy. Cash investments are restricted to at least 'A+' rated banks and fixed-income security investments are limited to mainly investment-grade issuers. The society can invest in subordinated and sub-investment-grade instruments, but most securities are highly rated senior issues. In the fixed-income portfolio 55% of the total bonds were rated 'AA-' or higher at FYE18 and MUFS held no sub-investment-grade securities.

Substantial Property Exposure Drives Risky-Assets Ratio

MUFS's risky-asset ratio of 80% was largely driven by its property portfolio. It was much below Fitch's criteria guideline of 160% to 224% for 'BB' rated insurer. The property portfolio, which stood at NZD20.3 million at FYE18 compared with NZD18.0 million at FYE17, included various commercial and leasehold properties (NZD16.1 million) and holiday homes (NZD4.2 million).

The risks in the commercial buildings appear reasonably modest, with all properties being single level, tenanted and not requiring any earthquake strengthening. Risks are low on the remaining property investments, with the society receiving ground rent on its leaseholds. It has no exposure to buildings on these properties. The holiday homes are run to cover costs and provide subsidised holiday accommodation to members.

Modest Equity Investments

MUFS's equity investments in FY18 were unchanged from FY17 and only represented investments of NZD14, 200 in United Friendly Society. MUFS's statement of investment policy and objectives (SIPO) was reviewed in July 2017 and adopted by the board in October 2017.

The society is determined to continue its conservative investment strategy and to keep the majority of its investment portfolio in liquid assets (minimum of 50% of the portfolio at any one time). SIPO allows total equity investments to make up 0% to 17% of all investments, with a maximum allowable exposure to a single equity issuer restricted to NZD0.4 million.

Asset/Liability and Liquidity Management

(%)	FY14	FY15	FY16	FY17	FY18	Fitch's expectation
Liquid assets / net technical reserves - excluding unit linked (total)	124	122	146	145	149	Liquidity to be supported by conservative approach to investments.
Cash and cash equivalent / net technical reserves - excluding unit linked	34	44	24	55	50	
Duration gap (years)	n.a	n.a	n.a	-9	-9	

Source: Fitch Ratings, Fitch Solutions, MUFS

Sound Liquidity Position Supports its Insurance Liabilities

- Strong liquidity
- Manageable asset-liability mismatch

Strong Liquidity

MUFS's liquidity ratios have been very strong for the previous five years, reflecting a conservative investment approach and large investment portfolio compared with the size of the society's policyholder liabilities. Its liquid assets/policyholder liabilities ratio of 149% at FYE18 compares well against our median criteria ratio guidelines. We have included all fixed-income investments in the liquidity ratio due to the strong credit quality of the portfolio.

Manageable Asset-Liability Mismatch

The asset and liability duration mismatch is manageable, despite the insurance liabilities having a significantly longer average duration than the society's investments. MUFS's insurance liabilities have an average duration of around 11 years against around two years for the cash and fixed-income portfolios. The duration mismatch will reduce over time with the run-off of the closed insurance funds.

The asset and liability duration mismatch is mitigated by a strong liquidity position, and policyholder liabilities that, due to their design, discourage early redemption and are mainly payable on death. Voluntary discontinuance rates over the previous five years have averaged a low 1.1% and 0.5%, respectively, for the increasing assurance benefit fund and the funeral fund. Cash flow modelling is supported by a highly predictable liability profile.

No Reinsurance Cover Used

MUFS does not use and has never used reinsurance for its insurance business. MUFS says there is little concentration risk, with members being spread geographically. In addition, policy sums insured are low, and with the majority of the insurance exposure being a portfolio of mature whole of life or endowment policies with amounts payable on death, the cost from a potential pandemic event is adequately provided for in the valuation liability.

Appendix A: Industry Profile and Operating Environment

This section discusses New Zealand's life and non-life insurance sectors.

Regulatory Oversight

Fitch takes into consideration the regulatory environment in New Zealand to be developed and transparent, with regular enforcement. Insurers are governed by the Insurance (Prudential Supervision) Act 2010, and they are regulated by the RBNZ. The regulatory capital regime in New Zealand follows a solvency approach. Licensing requirements also include 'fit and proper' person and documented risk-management requirements, as well as disclosure of credit ratings. RBNZ consistently reviews insurers' capital adequacy and relevant management processes, and steps in to take action when required to maintain confidence in the sector.

Technical Sophistication of Insurance Market; Diversity and Breadth

The domestic market is sophisticated, and characterised by a reasonably broad range of products offered in both the life and non-life segments, for both corporates and individuals. The New Zealand insurance market is small but benefits from the presence of large international insurers, which in turn contribute to the effective pooling and diversification of risks. The demand for non-life insurance has been supported by the country's exposure to natural hazards. The use of life insurance as a retirement-savings product is lower compared with other markets, but the country's high household debt provides significant growth potential for life insurance products in the longer term.

Competitive Profile

The competitive landscape is generally rational, with some challenging periods. New Zealand's life and non-life markets are dominated by subsidiaries of large international players. The top five insurers in life and non-life segments make up over 50% of total premiums despite the presence of a large number of companies. Tighter capital requirements for banks in Australia have prompted Australian banks to sell their New Zealand insurance operations, and these have been bought by large multinational insurers. The sector has been slow to adopt digital distribution channels and high acquisition costs, driven by dependence on agents to bring in new business, weigh on the sector's profitability.

Financial Markets Development

Fitch takes into consideration New Zealand's debt and equity markets to be relatively deep and liquid. The country has established debt and equity markets. The equity market is small, partly due to the presence of foreign entities that are funded by their parents. The government and banks issue debt on a regular basis to meet funding and liquidity needs. However, the depth of debt markets may pose some challenges for insurers due to lack of long-duration bonds. The government introduced the Financial Markets Conduct Act in 2013 to promote and facilitate market development. New Zealand's banking system also exhibits stability and active compliance with Basel III framework.

Country Risk

Fitch rates the local-currency sovereign obligations of New Zealand at 'AA+' with a Stable Outlook. Therefore, the mid-point of the six-notch industry profile and operating environment score is derived based on the score's range suggested by the performance of the above sub-factors.

Peer Comparison

	Financial year end	Gross premiums written (NZDm)	Assets (NZDm)	Shareholder equity (NZDm)	Regulatory capital ratio (%)	Pre-tax return on assets (%)	Return on average equity (%)
Sovereign Assurance Co Ltd.	30 June 2018	717	2,164	745	114	7	14
Asteron Life Limited	30 June 2018	238	724	424	108	8	9
Southsure Assurance Limited (BBB+/Stable)	30 March 2018	12	20	9	125	18	33
MARAC Insurance Limited (BBB+/Stable)	30 June 2018	6	13	6	117	14	23
Manchester Unity Friendly Society (BB-/Stable)	31 May 2018	1	83	26	168	3	10
First Insurance Limited (BB+/Stable)	Forecast – 30 June 2019	2	6	6	120	8	11

Source: Fitch Ratings, Insurers, New Zealand Companies Office

Appendix B: Peer Analysis

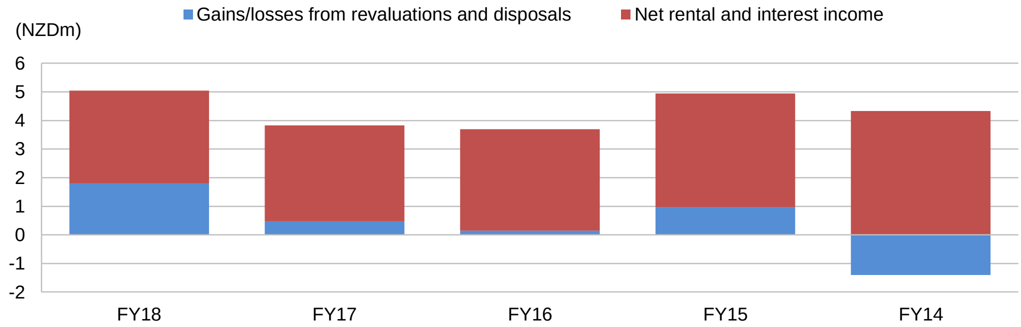
Mutual Design of Products Lowers Profitability

New Zealand's insurance sector is dominated by the subsidiaries of major international insurance groups. A comparison of selected major New Zealand insurers and smaller insurers owned by financial institutions shows that the latter's operating models are characterised by satisfactory distribution channels and robust earnings. Moreover, these attributes have supported higher returns on equity than that of the major insurers.

MUFS's earnings performance is towards the bottom of peers, but as a mutual company without shareholders, profit is distributed to members through product pricing, features and other member benefits rather than through the distribution of earnings through dividends.

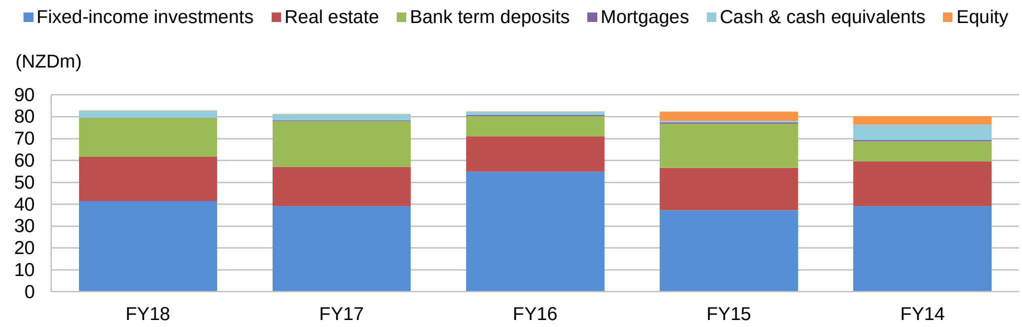
Appendix C: Additional Financial Exhibits

Investment Income



Source: Fitch Ratings, Fitch Solutions, MUFS

Breakdown of Invested Assets



Source: Fitch Ratings, Fitch Solutions, MUFS

Appendix D: Other Ratings Considerations

Below is a summary of additional ratings considerations that are part of Fitch's ratings criteria.

Group IFS Rating Approach

Not applicable.

Notching

For notching purposes, the regulatory environment of New Zealand is assessed by Fitch as being Effective, and classified as following a Ring-Fencing approach.

Short-Term Ratings

Not applicable.

Hybrids – Equity/Debt Treatment

Not applicable.

Corporate Governance and Management

Corporate governance and management are adequate and neutral to the rating. MUFS's board consists of five members and one independent.

Transfer and Convertibility Risk (Country Ceiling)

None.

Criteria Variations

None.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.