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 17
Gross written premiums (NZDm)	1.4
Total assets (NZDm)	81.3
Pre-tax operating return on assets (%)	2
ROAE (%)	6
Equity/total assets (%)	29
Liquid assets/policyholder liabilities (%)	145

Source: Fitch

Related Research

2017 Outlook: Australian and New Zealand Insurers (December 2016)

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Key Rating Drivers

Moderately Weak Fundamentals: Manchester Unity Friendly Society's (MUFS) rating reflects its weak business profile, limited market franchise and small membership base. Its capital level is good, albeit small in terms of absolute amount, and might be vulnerable to unexpected shocks and changing economic conditions. The rating also incorporates support from MUFS's loyal member base, low-risk insurance exposures and conservative investment portfolio.

Small Market Presence: MUFS is a small player in New Zealand's life insurance sector, with a market share of less than 1%. The society underwrites three simple medical plans that provide low-cost cover to members; to become a policyholder an individual must also become a member. With a declining membership (FY17: 13,180; FY16:14,000), Fitch Ratings expects premium volumes to be lower in the future.

Moderately Weak Capital: MUFS's coverage of the regulatory requirement was 163% at FYE17 (FYE16: 161%). Insurance exposures are declining and the regulatory ratio is sensitive to changes in the discount rate, but we expect capital ratios to remain relatively constant in FY18. However, MUFS's small absolute capital base and limited access to new capital leaves MUFS potentially vulnerable to any unexpected operational risks and changes in the external operating environment.

Non-Profit Maximising: MUFS is not a profit maximising entity, given its mutual status. The society's FYE17 earnings (NZD3.8 million) remained in line with FYE16 earnings (NZD3.7 million), while its net profit after tax decreased by NZD0.8 million to NZD1.5 million as a result of its directors' decision to make appropriations to the participating insurance business funds.

Low-Risk Investment Portfolio: MUFS has a conservative investment strategy, with 79% of its investments in cash (including term deposits) and highly rated fixed-income investments. Fixed-income securities comprised 52% of total investments at FYE17, and were a mix of bank, corporate, local authority and state-owned entity senior debt. Investments in cash and term deposits increased to 27% in FY17 compared with 13% in FY16. This is due to some fixed-income securities maturing during FY17 and not being re-invested.

Asset-Liability Mismatch Mitigated: A strong liquidity position and policyholder liabilities that, due to their design, discourage early redemption, and are mainly payable on death, mitigate the 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. However, the society's liquid assets/policyholder liabilities ratio was a strong 145% at FYE17 (FYE16: 146%), and the duration mismatch will ultimately decline with the run-off of the closed insurance funds.

Rating Sensitivities

Business Profile and Capital: Downgrade triggers would include a continued deterioration in the weak business profile and a fall in the number of lodges due to a significantly declining membership base. Additional triggers would be a fall in the coverage of MUFS's regulatory capital requirement below the management target of 150% for an extended period of time, and if the society is unable to rectify the ratio to back above this trigger point.

Modest Franchise: An upgrade of MUFS's rating in the near term is unlikely – given its weak business profile, limited franchise, small absolute capital base and limited financial flexibility.

Business Profile

Weak Market Franchise

- Limited market share
- Simple products; small sums insured

Limited Market Share

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 compared with other market offerings. MUFS's strategies did not include business development activities or selling objectives with a view to maximising its member base.

The society had a membership of 13,180 in FY17. Individuals must become members to hold a policy.

Simple Products; Small Sums Insured

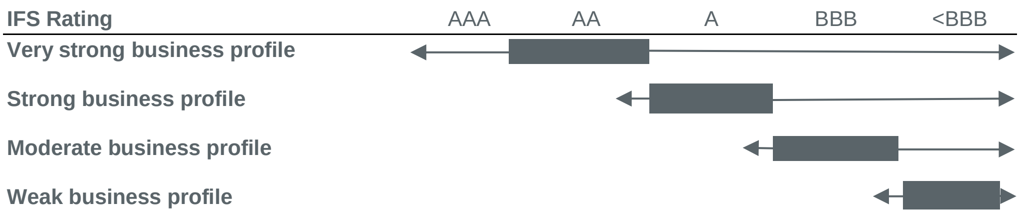
MUFS's business is to provide financial products, holiday accommodation and fraternal services for the benefit of its members. Its core financial product is insurance. The society underwrites simple funeral cover and medical insurance for its members, and has an arrangement with AON New Zealand for a number of non-life personal line products.

MUFS offers three medical plans: a low-cost plan that covers day-to-day medical bills to a maximum of NZD3,800 per year, a comprehensive plan that provides extended coverage for medical practitioners and surgery to a maximum of NZD27,250 per year, and a surgical plan that provides cover of up to NZD25,000 per year. Dental, optical and hospital riders are also available. Pre-existing conditions are excluded from the cover; and under the plans, regulations the board is able to cancel a contract at the end of the fund year.

The funeral plan cover provides up to NZD10,000 as a lump sum to the estate after a two-year stand down period. If a member dies before the two year period, the estate is able to receive the premiums back as long as the cover was in force.

MUFS does not currently receive any commission on the non-life products but instead has negotiated discounts for its members. MUFS also has a number of plans providing 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. The society can adjust bonus rates, appropriation rates and surrender values where payable.

Ratings Range Based on Business Profile



Source: Fitch

Related Criteria

Insurance Rating Criteria (November 2017)

Ownership is Neutral to Rating

Corporate Governance and Management

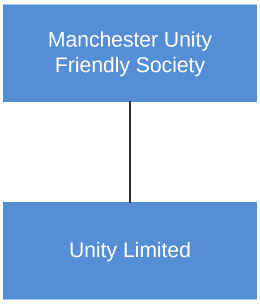
Corporate governance and management are adequate and neutral to the rating.

MUFS's board consists of five members and one independent.

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 30 lodge branch network 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.

Structure Diagram



Source: Transaction documents, Fitch

Sovereign and Country Related Constraints

Fitch rates the local currency sovereign obligations of New Zealand at 'AA+' with a Stable Outlook, and the Country Ceiling is 'AAA'. Therefore the ratings of New Zealand insurance organisations and other corporate issuers are not constrained by sovereign or macroeconomic risks.

Industry Profile and Operating Environment

NZ's Insurance Market Supports a Wide Range of Ratings

The Asia-Pacific (APAC) region consists of both developed and emerging markets. The majority of Fitch-rated APAC insurers in developed markets have IFS ratings in the 'A' category, while most insurers in emerging markets have IFS ratings in the 'A' to 'BBB' category within Fitch's rated universe. Fitch regards the natural IFS rating range for New Zealand's life insurance companies as 'AA' to 'BB', based on the industry's profile. This reflects a diverse range of insurers operating in a recently strengthened regulatory environment, although the sector is dominated by subsidiaries of larger financial institutions. The regulatory environment includes a licensing regime that has fit and proper person and documented risk-management requirements as well as risk-based solvency standards.

Changes to New Zealand's tax regime that applied from 1 July 2010 and included a five-year grandfathering period have resulted in life insurers losing significant concessions. This contributed to a fall in profitability, as market participants have been reluctant to implement the required premium increases to fully offset the change. However, a high level of underinsurance and high national household debt provide significant growth potential for life insurance products in the longer term.

Solid Growth in Larger Health Insurance Policies

The total number of New Zealanders with private health insurance increased to NZD1.37 million as at September 2017, compared with NZD1.35 million in September 2016. The growth appears to be driven by an increase in the numbers of people with employer-subsidised health insurance as part of an increased focus on wellness in the workplace. Annual premium for the year ended 30 September 2017 was NZD1.4 billion, up by 5.3% or NZD71 million on premium income for the September 2016 year.

Ratings Range Based on Industry Profile/Operating Environment

IFS Rating category	AAA	AA	A	BBB	<BBB
APAC developed markets[a]					

[a] Consist of Australia, New Zealand, Hong Kong, Korea, Taiwan and Singapore
Source: Fitch

Peer Analysis

Member Distribution Channel Bolsters Performance

New Zealand's insurance sector is dominated by the subsidiaries of major Australian financial institutions and insurance groups; although the insurance subsidiaries of New Zealand's smaller financial institutions, including a number of mutual organisations, have performed well.

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

Peer Comparison Table

(NZDm)	FYE	IFS Rating	GPW	Assets	S/H equity	Operating leverage (%)	Pre-tax return on assets	ROAE
MUFS	31 May 17	BB-	1	81	24	2	2	6
Southsure Assurance Limited	31 Mar 17	BBB+	11	18	8	1	22	41
Credit Union Insurance Limited	30 Jun 17	BBB-	14	17	6	0	-1	-6
Co-operative Life Limited	31 Mar 17	NR	11	11	6	1	22	26
MARAC Insurance Limited	30 Jun 17	BBB+	6	13	6	1	11	17

Source: Fitch

Capitalisation and Leverage

	FYE13	FYE14	FYE15	FYE16	FYE17	Fitch's expectation
Shareholders' equity to total assets (%)	24	24	24	27	29	Capital to remain strong, and the society to not increase financial leverage.
Operating leverage (x)	2	3	2	2	2	
Asset leverage (x)	2	3	2	2	2	
Regulatory capital ratio (%)	159	240	163	161	163	
Financial leverage (%)	0	0	0	0	0	

Source: Financial statements

Capital is Adequate for Rating Category

- Solid regulatory capital ratio; small absolute capital base
- Low operating leverage and no debt
- Balance sheet supports financial flexibility

Solid Regulatory Capital Ratio; Small Absolute Capital Base

MUFS's coverage of the Reserve Bank of New Zealand's (RBNZ) risk-based minimum solvency was a strong 163% at FYE17 (FYE16: 161%). Fitch views MUFS's capitalisation, based on a technical assessment of the society's risk profile and coverage of the regulatory requirement, as adequate for the rating. Despite good coverage the low absolute level of 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 fall in the regulatory coverage ratio, which triggered a number of regulatory capital strengthening actions. MUFS's regulatory capital base was NZD23.3 million at FYE17 (FYE16: NZD21.8 million, FYE15: NZD19.5 million).

Low Operating Leverage and No Debt

MUFS's operating and asset leverage ratios remained unchanged at 2x over the year to FYE17. The society has very low leverage compared with Fitch's median criteria guidelines. However, these guidelines are less applicable where the technical reserves (the numerator) contain a significant investment or universal life type component (as these lower the ratio).

The society has no debt and says it has no plans to raise any in the foreseeable future.

Balance Sheet Supports Financial Flexibility

MUFS has a large equity and asset base relative to the volume of insurance underwritten, and targets investment earnings to support member benefits. Equity to assets was 29% at FYE17 (FYE16: 27%), which compares very favourably to Fitch's median criteria guidelines. Fitch believes MUFS's financial flexibility is well supported by the absolute size of the investment portfolio and its ability to contribute to earnings. However, in the long term, this will decline with the run-off of the closed insurance funds and a reduction in the asset base, and will require a reduction in expenses to maintain financial flexibility. As a mutual, MUFS has limited ability to raise capital and therefore it requires to retain earnings to support financial flexibility.

Financial Performance and Earnings

	FYE13	FYE14	FYE15	FYE16	FYE17	Fitch's expectation
Pre-tax operating return on assets (%)	1	-1	1	3	2	Probability to remain modest.
Return on average assets (%)	4	-5	5	11	6	
Change in premium written (%)	-10	-6	-8	-4	-5	
Investment yield (total) (%)	6	4	6	4	5	
Investment yield (running) (%)	6	5	5	4	4	

Source: Financial statements

Improved but Modest Earnings

- Control over appropriations supports earnings
- reduced risk strategy reduces investment returns
- Falling premium volumes

Control Over Appropriations Supports Earnings

MUFS's large asset base and investment portfolio support earnings and the provision of member benefits. MUFS's investment earnings for FY17 (NZD3.8 million) remained in line with earnings for FY16 (NZD3.7 million). The society's net profit after tax decreased by NZD0.8 million to NZD1.5 million as a result of directors' decision to make appropriations to participating insurance business funds. There were no appropriations made in FY16, however FY15 appropriations totalled NZD1.9 million.

Reduced Risk of Investment Returns

The majority (79%) of MUFS's total investments are kept in cash/term deposits and highly rated bonds. The society's Statement of Investment Policy and Objectives (SIPO) was reviewed in July 2017 and adopted by the board in October 2017. Management indicated the board will continue to adopt a conservative investment strategy and ensure better assets to liabilities match.

Falling Premium Volumes

MUFS's small and declining member base and run-off of its increasing assurance benefit product and education support plan has contributed to a decline in premium volumes in the six years to FY17. MUFS's membership is declining by approximately 400 members a year, predominantly through death. Total actual number of MUFS's members for FY17 was 13,180.

Strategically, the society has not actively targeted new members, but more recently has shown a desire to grow membership by increasing member value and promoting the benefits available to existing members. New members typically join through word of mouth, and the membership requirement to hold an insurance policy was dropped around a decade ago. Management has advised the board will be looking into a number of business development and marketing activities to increase the new joiner base. We believe premiums are likely to continue declining failing a turnaround in membership numbers.

Investment and Asset Risk

(NZD 000)	FYE13	FYE14	FYE15	FYE16	FYE17	Fitch's expectation
Total investment assets	81,333	80,323	82,342	82,315	81,174	Modest increase in cash/term deposits due to fixed-income securities having matured during FY17.
Cash and cash equivalents/invested assets (%)	27	20	25	13	27	
Fixed income securities/invested assets (%)	42	49	45	67	48	
Below investment grade fixed-income securities/adjusted equity (%)	0	0	0	0	0	
Risky assets/adjusted equity (%)	18	20	22	0	0	

Source: Financial statements

Investment Risks Low

- MUFS's equity investments
- Highly rated fixed-income securities dominate investments
- Modest property exposure

MUFS' Equity Investments

MUFS's equity investments in FY17 remained unchanged from FY16 and only represented investments of NZD14,000 in New Zealand equities. MUFS's 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). MUFS's equity investments are to make up 0% to 7% of all investments, with a maximum allowable exposure to a single-equity issuer to NZD0.4 million.

Highly Rated Fixed-Income Securities Dominate Investments

The society has 79% of its investments in cash (including term deposits) and fixed-income investments (no sub-investment-grade securities). Fixed-income securities comprised 52% of total investments at FYE17, 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. Under its policy, the society can invest in subordinated and sub-investment-grade instruments, but most securities are highly rated senior issues. At end-2017, 56% of the total bonds in the fixed-income portfolio were rated 'AA-' or higher and MUFS held no sub-investment-grade securities. This is well below Fitch's median criteria guideline ratio of 70% of shareholders' equity for a 'BBB' rated insurer.

Modest Property Exposure

The value of MUFS's property portfolio was NZD18.0 million at FYE17 compared with NZD16.2 million at FYE16, and included various commercial and leasehold properties (NZD14.1 million) and holiday homes (NZD3.9 million). The risks in the commercial buildings appear reasonably modest, with all properties being single level, tenanted and not requiring any earthquake strengthening. Risks with the remaining property investments are low, 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.

Asset/Liability and Liquidity Management

	FYE13	FYE14	FYE15	FYE16	FYE17	Fitch's expectation
Liquid assets/policyholder liabilities (%)	122	124	131	146	145	A conservative investment approach should support MUFS's liquidity position.
Cash and cash equivalents/policyholder liabilities (%)	45	34	44	24	56	

Source: Financial statements

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 relative to the size of the society's policyholder liabilities. Its liquid assets/policyholder liabilities ratio of 145% at FYE17 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 compared with around two years for the cash and fixed-income portfolios. The duration mismatch will ultimately come down with the run-off of the closed insurance funds.

The asset and liability-management 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. Over the previous five years, surrender and lapse rates have averaged a low 1.3% and 0.5% for IABF and Funeral Plans, respectively. Cash flow modelling is supported by a highly predictable liability profile.

Reinsurance, Risk Management and Catastrophe Risk

No Requirement for Reinsurance

MUFS does not use and has never used reinsurance for its insurance business. 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: Other Ratings Considerations

Below is a summary of additional ratings considerations of a “technical” nature, that are also 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.

Holding Company

Not applicable.

IFS Ratings

A baseline recovery assumption of Good applies to the IFS rating and standard notching was used from the IFS “anchor” rating to the implied operating company IDR.

Debt

Not applicable.

Hybrids

Not applicable.

Exceptions to Criteria/Ratings Limitations

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.