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DBRS Confirms Short-Term Ratings of Innovation Credit Union at R-1 (low), Stable Trends

Bloomberg: DBRS Confirms Innovation Credit Union at R-1 (low), Stable

Industry Group: Financial Institutions

Sub-Industry: Credit Unions & Building Societies

Region: Canada

DBRS Limited (DBRS) confirmed the Short-Term Issuer Rating and Short-Term Instruments rating of Innovation Credit Union (Innovation or the Credit Union) at R-1 (low). The trend for all ratings is Stable.

Innovation's Support Assessment remains SA2, which reflects DBRS's expectation of timely systemic external support from the Province of Saskatchewan (Saskatchewan or the Province; rated AA with a Stable trend by DBRS) through Credit Union Central of Saskatchewan (SaskCentral; rated R-1 (low) with a Stable trend by DBRS), particularly in the form of liquidity, which is reflected in the Credit Union's short-term ratings.

KEY RATING CONSIDERATIONS

The ratings reflect Innovation's solid franchise within its operating area that is tempered by its moderate size, in addition to the benefits of being part of the well-established credit union system in Saskatchewan. The ratings are supported by Innovation's strong earnings power that is underpinned by its above-average revenue per member and steady base of non-interest income. The ratings also consider Innovation's higher proportion of commercial loans, especially agricultural loans, relative to peers; slow-growth operating footprint; and aging membership base.

RATING DRIVERS

Although DBRS views Innovation as well placed within its rating category, over the longer term, ratings could be positively affected by sustained membership growth, especially among younger members. Conversely, Innovation's ratings could come under pressure should there be a material loss of market share or deposits due to the Credit Union's decision to seek federal continuance. Furthermore, significant losses in the loan portfolio as a result of unforeseen weakness in the underwriting and/or risk management process could also have a negative impact on the ratings.

RATING RATIONALE

Innovation is the third-largest credit union in Saskatchewan, with \$2.4 billion in assets as of December 31, 2017. The Credit Union serves 10.8% of the Province's credit union system membership base through 25 branches in its footprint area, in addition to an active digital platform. With over 51,000 members, Innovation



has successfully grown its membership base and has expanded its market share within the provincial credit union system.

In December 2017, Innovation's members voted in favour of pursuing federal continuance, which would see the Credit Union fall under the supervision of the Office of the Superintendent of Financial Institutions. The Credit Union is in the process of obtaining all required provincial and federal approvals and would likely convert to a federal credit union by 2019. In addition, and ahead of federal continuance, the members of Goodsoil Credit Union and Pierceland Credit Union voted in favour of amalgamating with Innovation by January 1, 2019. The amalgamation would bring approximately 2,600 members to Innovation and add approximately \$78 million in assets.

In DBRS's opinion, while Innovation has strong fundamentals, its proposed conversion to a federal charter raises uncertainties about its prospects, most importantly around funding. With a federal continuance, Innovation would lose the unlimited deposit coverage provided by Saskatchewan's Credit Union Deposit Guarantee Corporation and become limited to the \$100,000 deposit insurance cap provided by the Canadian Deposit Insurance Corporation. Thus the Credit Union could potentially experience deposit outflows, especially large retail and institutional deposits. Conversely, a federal charter would provide Innovation with access to prospective new members or retail customers, especially through online platforms. However, remote deposit acquisition might come at a higher cost than expected, as Innovation would have to compete with banks and local credit unions. DBRS will monitor the Credit Union's plans to manage through this process.

Reflecting the mix of its loan portfolio, with a larger base of agricultural and commercial loans, Innovation enjoys a steady stream of non-interest income. In 2017, non-interest income-to-operating revenue reached 28%, the highest proportion among credit union peers. On the other hand, the net interest margin (NIM) has been pressured in the last several years due to the low-rate environment, dropping to 2.69% in 2017 from 3.08% in 2012. However, DBRS notes that despite this decline, Innovation maintains one of the highest NIMs among credit unions. Additionally, despite credit unions commonly having a high cost base due to their business model, Innovation maintains good expense control, and reflecting its emphasis on the use of technology, the Credit Union has one of the lowest efficiency ratios among peers at 69.7% in 2017.

Innovation maintains a good risk profile with improving credit quality performance over the last six years. The Credit Union's \$2.0 billion loan portfolio comprises mortgage, business and agricultural loans, much of which is secured. Reflecting its footprint area, Innovation has a higher proportion of agriculture loans, which represent 23% of the loan portfolio, nearly double peer levels. Positively, DBRS notes that the Credit Union has a strong track record of managing this asset class over time. Asset quality metrics remain favourable, with gross impaired loans representing a very low 0.07% of gross loans, as Saskatchewan continues to benefit from moderate economic growth; however, a weakening economy or pricing pressure in the agricultural sector could lead to an increase in impairment levels.



Innovation's main source of funding are branch-raised deposits, which rose 6% to \$2.1 billion in 2017 and represent 84% of total assets. The Credit Union also has access to wholesale funding in the form of securitized borrowings via the Canada Mortgage Bonds program. Furthermore, Innovation has sought to diversify its funding channels by introducing more interest rate sensitive broker-sourced deposits in 2017, although at \$30 million, they form less than 2% of funding. Innovation has various sources of liquidity, including credit facilities with SaskCentral, and reported a robust liquidity coverage ratio of 163%, well above the regulatory minimum of 80%.

In DBRS's opinion, capitalization levels are good and in line with peers with a sizable cushion over regulatory minimums to absorb potential losses. Innovation's Common Equity Tier 1 ratio, which is based on Basel III requirements, stood at 11.75% in 2017 versus the 7.00% regulatory minimum requirement. Unlike most credit unions, Innovation still pays quarterly patronage; however, earnings are generating sufficient capital to pay patronage while still supporting balance sheet growth.

Notes:

All figures are in Canadian dollars unless otherwise noted.

The related regulatory disclosures pursuant to the National Instrument 25-101 *Designated Rating Organizations* are hereby incorporated by reference and can be found on the issuer page at www.dbrs.com.

The principal methodology is Global Methodology for Rating Banks and Banking Organisations (May 2017), which can be found on dbrs.com under Methodologies.

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The rated entity or its related entities did participate in the rating process for this rating action. DBRS had access to the accounts and other relevant internal documents of the rated entity or its related entities in connection with this rating action.

For more information on this credit or on this industry, visit www.dbrs.com.

<u>Issuer</u>	<u>Obligation</u>	<u>Rating Action</u>	<u>Rating</u>	<u>Trend</u>
Innovation Credit Union	Short-Term Issuer Rating	Confirmed	R-1 (low)	Stable
Innovation Credit Union	Short-Term Instruments	Confirmed	R-1 (low)	Stable

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