Credit Ratings & Research

Credit Rating Review
Police and Families Credit Union Incorporated

Company No: 1802854

Credit Rating Synopsis

Date: 12 June 2024

Prepared for: Police and Families Credit Union Incorporated

Report prepared by: Equifax Australasia Credit Ratings Pty Limited ("Equifax")

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Currency used in this report:

This report is presented in New Zealand Dollars unless otherwise noted

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1. Synopsis for Comprehensive Credit Rating Report

Police and Families Credit Union Incorporated ("PFCU")

PFCU is a not-for-profit, Non-Bank Deposit Taking (NBDT) organisation that is domiciled in and licenced to operate in New Zealand. PFCU receives deposits from and provides loans to its members and their families.

Equifax has affirmed PFCU's credit rating at 'BB+' at Apr24, however, the rating outlook has been revised to 'Negative' from 'Stable'. The 'Negative' outlook reflects the pressures on PFCU's performance from a combination of rising funding costs and limited loan growth. The near-investment grade rating continues to be supported by PFCU's strong capitalisation, funding profile and liquidity, the quality of its loan assets (benefitting from security position over NZ Police retirement accounts and access to NZ Police payroll), and the benefits of its strategic investment in financial technology solutions provider Finzsoft Solutions (New Zealand) Limited that supports its overall earnings profile. The rating is constrained by PFCU's subdued core operating performance, competitive pressures and limited franchise, increasing exposure to residential mortgages – which has introduced property market risks to its asset portfolio and the impact of ongoing macroeconomic headwinds.

Strengths

- PFCU's Tier 1 capital ratio remains strong and better than the industry average at 25.8% at Mar24 (Jun23: 23.3%), being 3.2 times the minimum regulatory requirement of 8.0%. Capitalisation has increased and remained consistently above average due to limited loan growth in the recent past. This strong buffer provides PFCU the headroom to grow its risk weighted assets/loan portfolio while supporting its capacity to absorb performance volatility.

- The quality of PFCU's loan book remains high, supported by the strength of its client base which primarily comprises government employees who provide essential public services. A large portion of PFCU's gross loan book (~67.0% at Dec23) is secured by a charge over retirement funds in the Police Superannuation Scheme (PSS) and the Government Superannuation Fund (GSF). This collateral, along with PFCU's access to NZ Police payroll, improves the likelihood of repayment and recovery of loans advanced to members.

- PFCU's funding profile and liquidity have been supported by healthy reinvestment rates on term deposits (12-month average of 86.2% at Apr24), coupled with a modest loan portfolio. This is reflected in its above average deposit to loan ratios of 3.5x (Jun23: 3.7x, Jun22: 4.1x) and liquid assets of 71.1% at Apr24 (Jun23: 71.8%, Jun22: 71.6%).

- PFCU's strategic investment in its banking software/financial technology solutions provider Finzsoft Solutions (New Zealand) Limited ('Finzsoft') in partnership with First Credit Union continues to contribute financial and operational benefits. Whilst PFCU's investment was initially a strategic necessity to secure operational capacity, the growth of the Finzsoft investment has provided some diversification to PFCU's earnings profile. Further, PFCU's investment in digitisation using Finzsoft's capabilities to automate a majority of manual tasks is expected to drive operational efficiencies, going forward.

Constraints

- PFCU's core operating performance continued to remain subdued despite some improvement of profitability in the interim period to Apr24. After reporting a modest increase in FY23, the loan book remained broadly stable in the period to Apr24 (Apr24: $34.1m, Jun23: $34.4m, Jun22: $31.2m) while interest generated on member loans as a proportion of overall interest income declined further (Apr24: 38.2%, Jun23: 45.4%, Jun22: 66.2%). This means that PFCU is now increasingly reliant on managing the favourable spread between interest paid on member deposits and interest generated on bank deposits to meet its operating expenses. That said, we note that PFCU maintains strong capitalisation buffers to absorb potential performance volatility and it operates as a not-for profit credit union, with a mandate to service the needs of its members.

- In addition to limited loan growth, recent changes to PFCU's funding composition have also impacted its performance, in our view. In an unprecedented development, PFCU's deposits declined by 6.8% in the interim period, while deposits on call declined by a cumulative 14.5% across FY23 and 10MFY24. While a reduction in term deposits primarily impacts funding stability, the reduction of lower cost call deposits within the funding mix has the potential to pressure profitability and net interest margins, going forward, in the absence of meaningful loan growth.

- Operating as an NBDT focused on its membership and their families, PFCU's competitive position is influenced by its limited franchise. If PFCU is unable to grow its active membership and provide services desired by memebers, its competitive position and capacity to operate sustainably will be impacted. That said, we note that PFCU recently launched its services to NZ Defence Force members and their families, which presents an opportunity to increase its addressable market and grow its operations.

- Macroeconomic headwinds continue to present challenges to the NBDT sector while impacting growth potential over the near to medium term. Persistent inflation and higher interest rates are likely to weigh on mortgage affordability and debt servicing while adverse movement in property prices could also impact industry participants' asset quality and collateral coverage. PFCU's overall exposure to residential mortgages and market risks related to property prices has increased further at Apr24, stemming from lending to traditional mortgages as well as its new product offering – 'First Home Together'. As a result of this growth, asset quality is more exposed to the impact of adverse property price movements while the change in income mix may also lead to net interest margins trending lower than PFCU's historical averages.

A rating upgrade, while unlikely over the near term, would require a sustainable improvement in loan book size and the core earnings profile, while sustaining overall balance sheet strength. However, the rating may migrate lower in the following instances on an individual or collective basis if there is:

a. a continued deterioration in core operating profitability and/or a contraction in the loan book/deposit base, and
b. a weakening of current balance sheet strength.

Risk Rating

BB+

Outlook: Negative

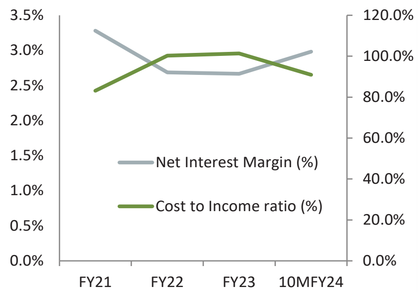
Type: Public, Monitored

Industry Percentiles

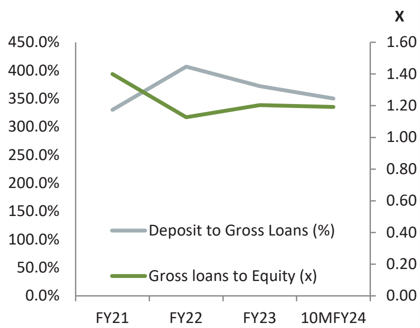
Scale:	Percentile
Total Assets	38%
Gross Loans	23%
Profitability:	
NIM	23%
ROE	31%
ROA	31%
Efficiency Ratio	31%
Capitalisation:	
Leverage (Gross loans to Equity)	100%
Capital Ratio	92%
Capital to Total Assets	85%
Funding and liquidity:	
Deposits to Loan Ratio	100%
Liquid Assets to Total Assets	100%
Asset Quality:	
Net Charge-offs	31%
Impaired Loans	100%
Provision for Loan Losses	77%

Key Trends

Cost-to-income ratio and NIMs



Leverage and Funding ratio



2. Scope of Report

The purpose of this report is to provide a Credit Rating Synopsis on Police and Families Credit Union Incorporated ("PFCU").

We have complied with our rating services guidelines in order to derive the credit rating on Police and Families Credit Union Incorporated. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. The details pertaining to this report are outlined below:

Report Details	
Date of Report	**12 June 2024**
Request Type	**Issuer (Self-assessment)**
Assessment Type	**Under ongoing monitoring**
Rating Initiation	**Issuer based (solicited)**
Rating Distribution	**Public**
Report Distribution	**Unrestricted**
Purchased by	**Police and Families Credit Union Incorporated**
Report Fee	**Fixed Price**
Ancillary fees	**Nil**
Issuer Name	**Police and Families Credit Union Incorporated**
Issuer First Time Rated	**No**
Issue Name	**Not Applicable**
Issue First Time Rated	**Not Applicable**
Financial Scope	**Consolidated Entity**
Entity Structure	**Credit Union**
Issuer Industry	**Financial Services**
Issuer Sector	**Non-Bank Deposit Takers**

This Report should be taken as a whole and cannot be abridged or excerpted for any reason.

We have conducted this assessment on the basis of the information provided to us by Police and Families Credit Union Incorporated, publicly available information and from our own enquiries. We have derived a credit rating on PFCU based on the understanding that it has no contingent liabilities, cross guarantees, or other liabilities to any other entity other than as disclosed to us or as detailed in the financial statements. Our duty does not include auditing the financial statements.

Information Sources	
Financial Statements	**Draft management accounts for the ten-month and six-month interim period ended Apr24 and Dec23, respectively.** **Audited Financial Statements for the years ended Jun23 (FY23) Jun22 (FY22) and Jun21 (FY21).**
Name of Auditor	**BDO**
Other Information Sources	**PFCU's website, industry and regulatory websites, management interviews, media articles, adverse searches, and other internet searches.**
Issuer Participation	**Full**
Material Financial Adjustments	**None**
Limitations of Assessment	**None noted**
Outsourced Assessment Activities	**No**
Confidentiality Agreement	**No**
Material Client	**No**
Rating Amended Post Issuer Disclosure	**No**
Potential Conflict of Interest	**None noted**
Rating Methodology	**Financial Institutions Rating Criteria**

This report should be read within the context of Equifax's Ratings Services Guide.

APPENDICES

1. Explanation of the Equifax's credit rating

1.1 What is a rating?

Credit ratings provide an Agency's opinion as to the capacity, viability and willingness of an entity, issuer, or counterparty to meet their respective financial commitments. As such, Equifax assigns ratings based on the credit worthiness of an entity, commitment, or product, and provides probabilistic assessments of default over the short, medium, and long-term.

Credit ratings are a critical measure used extensively in commercial, financial, and capital markets to support key business decisions. Equifax's credit ratings are used to support debt and bonding decisions, loan origination and recovery, insurance and warranty, funds management, portfolio management, tendering and procurement, counterparty risk assessments and other commercial contracts.

Equifax provides credit ratings on government and commercial agencies, international conglomerates, infrastructure consortia, financial institutions, publicly listed entities, private corporations, and small-to-medium sized enterprises across a range of industry sectors both domestically and internationally. As such, Equifax is also able to provide detailed industry intelligence, benchmarking reports, and analysis across a wide range of sectors.

1.2 Equifax's credit rating

Equifax and other credit rating agencies all attempt to measure the probability of an entity being able to honour its financial commitments as and when they fall due. The most recognised credit rating is that based on Bond Rating Equivalents (BRE) used over the past eighty years to determine the proximity of an entity's securities to default (non-payment of interest or principal). The accuracy of this method has been extensively tested and is accepted worldwide.

The Equifax's database contains more than 100,000 financial years of information spanning more than twenty-five years. As such Equifax is in a unique position, having developed a large and empirical data source on entities across various industry sectors with long data histories covering a range of economic conditions and one or more complete business cycles. Equifax has therefore been able to use a variety of quantitative validation tools and comparisons using this information to adequately verify the stability, accuracy, and consistency of its rating models.

Equifax's rating models have been designed to assess the proximity of an entity to defaulting on its financial commitments and obligations. Proprietary risk analytics are used to evaluate the multivariate interrelationship of key risk indicators using scientifically based and empirically derived risk metrics. These models evaluate the financial performance, position, and profile of an entity in the context of its industry, size, and structure. They have been validated on Australian and international data with the assistance of Professor Edward Altman, an internationally recognised leader in the field of credit risk analysis and bankruptcy prediction.

Equifax uses its comprehensive benchmarking database to evaluate the financial position, performance and credit quality of an agency, institution, corporation, or entity relative to an industry and its peers. This enables the identification of key sensitivities, trends, cautionary alerts, and exception reports based on identified anomalies and/or outliers across key credit indicators of a select benchmarking group.

While there is no single method to discriminate unambiguously between firms that will default and those that will not, Equifax can make probabilistic assessments of default. This requires a large database of actual defaults to enable an assessment of default probabilities and actual default rates from empirical evidence. The Australasian market has a comparatively small number of corporate bond issues and a relatively benign credit climate over recent decades, and as such empirical data on Australian default rates is limited. Therefore, Equifax considers it is more appropriate to apply default probabilities using empirical data from international markets over several economic cycles.

Equifax's default statistics have been derived from nearly twenty years' experience analysing mainly US non-financial, non-utility corporate bond issuers. The analysis covered a relatively large number of companies (approximately 1,000 rated each year) and follows the well-established static pool approach used by Credit Rating Agencies to report their default experience. Static pools were created for bond issuers each year by both notch and grade, and the history of these bond issuers was then analysed over the period. The pools were then combined so that long-term average default experience by duration could be calculated, and both annual and cumulative default experience was calculated from the pools.

Equifax's risk analytics enable analysts to evaluate the most critical and sensitive financial and risk items through the Risk Assessment Platform by analysing key indicators to derive a definitive credit risk score and Bond Rating Equivalent (BRE), providing Probabilities of Default (PoD) over the short-, medium- and long-term horizon.

1.3 Rating Definitions

Credit ratings provide an Agency's opinion as to the capacity, viability, and willingness of an entity to meet their respective financial and contractual commitments. As such credit ratings are assigned in accordance with the entity, commitment, or product's proximity to default. Equifax adheres to internationally recognised grades and are similar to other agency classifications, providing ratings across twenty-two credit notches from ‘D’ (in default) to ‘AAA’ (extremely strong).

Moody’s	Fitch	S&P	Rating	Default rates (5 years)	Classification	Risk Level
Aaa	AAA	AAA	AAA	0.17	High Grade	Negligible
Aa1	AA+	AA+	AA+	0.31		
Aa2	AA	AA	AA	0.44		
Aa3	AA-	AA-	AA-	0.55		
A1	A+	A+	A+	0.76	Investment Grade	Very Low
A2	A	A	A	0.81		
A3	A-	A-	A-	1.47		
Baa1	BBB+	BBB+	BBB+	2.08		Low
Baa2	BBB	BBB	BBB	3.19		
Baa3	BBB-	BBB-	BBB-	4.37		
Ba1	BB+	BB+	BB+	7.13	Near Prime	Low to Moderate
Ba2	BB	BB	BB	7.49		
Ba3	BB-	BB-	BB-	10.52		
B1	B+	B+	B+	16.34	Sub Prime	Moderate
B2	B	B	B	22.21		
B3	B-	B-	B-	24.16		High
Caa1	CCC	CCC+	CCC+	28.16	Credit Watch	Very High
Caa2		CCC	CCC	29.90		
Caa3		CCC-	CCC-	39.16		
Ca		CC	CC	52.87	Distressed	Extremely High
		C	C	55.00		
C	D	D	D	100.00		

Equifax assigns ratings based on the credit worthiness of an entity or a specific financial commitment, and provides probabilistic assessments of default over the short, medium, and long-term. Every entity or commitment has some probability of default over a period of time, even those assigned with the strongest of ratings. An Investment Grade classification is attributed to credits that exhibit a lower probability of default, while a Sub-Prime classification has a greater expectancy of default.

An Equifax's credit rating may also be assigned additional clarification markers (symbols) to qualify the credit risk assessment. These may include:

Conditional Rating (#)

A Conditional Rating is used where Equifax has rated an entity on the basis of significant risk factors and/or report qualifications, with recommendations providing one or more conditions precedent and/or mitigation action(s) to reduce identified uncertainty and risk.

Provisional Rating (*)

A Provisional Rating is used when the most recent financial figures are based on draft management accounts or are deemed out-of-date. Entities with a provisional rating should be re-evaluated as soon as finalised financial statements become available.

Indicative Rating (^)

An Indicative Rating is used where Equifax is engaged to conduct preliminary analysis only, and as such an official rating assignment would require a more detailed and comprehensive investigation and due diligence assessment prior to the provision of our professional opinion.

1.4 Rating Outlooks

Equifax's forward estimates help ascertain the trajectory of ratings as well as the risks to ratings. Ratings with a positive trajectory are assigned 'Positive Outlooks'. Ratings with a negative trajectory are assigned 'Negative Outlooks'. Where Ratings are expected to remain unchanged, a 'Stable Outlook' assigned.

Rating trajectories are closely related to the outlook for the corporate's earnings. Earnings growth that is within sustainable growth parameters together with an attenuation of earnings volatility provide upward rating pressure and so may warrant the assignment of a Positive Outlook.

Credit Concepts measured

The main credit concepts measured against Australian and New Zealand Standard Industry Classifications (ANZSIC) and specific Peer Groups based on entity size are available in Corporate Scorecard's Rating methodology, which can be found at the below-mentioned links

http://www.corporatescorecard.co.nz/services_credit_ratings.php

https://www.corporatescorecard.co.nz/docs/RatingMethodologyFinancial.pdf

2. Regulatory Disclosures and Disclaimer

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Equifax Credit Ratings also holds an Australian Financial Services License (AFS License no. 341391) which licenses it to provide credit ratings to wholesale clients in Australia.

The credit rating issued by Equifax Credit Ratings reflects our current opinion of the relative credit risk of the institution. This opinion has been formed in accordance with Equifax's published credit ratings methodology - financial institution rating criteria (Issue 8, November 2022).

https://www.corporatescorecard.co.nz/docs/RatingMethodologyFinancial.pdf

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