Credit Ratings & Research

# Credit Rating Review

# Police and Families Credit Union Incorporated

## Credit Rating Report

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**Prepared for:** Police and Families Credit Union Incorporated

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**Currency used in this report:**

This report is presented in New Zealand Dollars unless otherwise noted

Corporate Scorecard
From Equifax

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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 and licenced to operate in New Zealand. PFCU receives deposits from and provides consumer loans to current and retired police personnel and their family members.

Equifax has downgraded PFCU's credit rating to 'BB+' with a 'Stable' outlook at Mar22 from 'BBB-' with a 'Negative' outlook at Sep21. The rating has been downgraded primarily due to continued competitive pressures faced by PFCU reflected in its declining loan book, and the resulting deterioration in its core operating performance and operating risk profile. That said, PFCU's strong capitalisation, funding profile & flexibility and, the high quality of loan assets (benefitting from security position over NZ Police retirement accounts and access to NZ Police payroll) support a near-prime credit profile.

**Strengths**

- PFCU's Common Equity Tier 1 ratio of 22.8% (at Mar22) is ~2.8 times the minimum regulatory requirement (8.0%). This buffer provides PFCU with ample capacity to withstand a period of adverse operating performance before its capitalisation reaches the minimum threshold.

- PFCU's funding profile remains healthy and provides it with sufficient headroom to withstand funding shocks. A growing deposit book, coupled with a smaller loan portfolio, underpins PFCU's deposit to loan ratio of over 3.8x at Mar22 - the highest amongst peers.

- Despite the declining loan book, the quality of PFCU's loan assets remains supported by its niche client base, which comprises government employees who provide an essential public service. As such, PFCU's borrowers' employment, and hence capacity to repay, are not materially linked to macroeconomic volatility.

- Moreover, a vast majority (~85%) of PFCU's loan book 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 investment in its banking software provider, Finzsoft Pty Ltd ('Finzsoft') in partnership with First Credit Union continues to contribute financial and operational benefits. Whilst initially considered a strategic investment that supported operational capacity, Finzsoft's positive financial contributions have provided some diversification to PFCU's earnings profile.

**Constraints**

- PFCU's loan book continued to decline in the nine months to Mar22, weighing on its core operating performance and operating risk profile. PFCU's loans to customers decreased to $32.2m at Mar22 (Jun21: $37.7m, Jun20: $42.4m), necessitating it to increasingly invest in lower yielding bank term deposits. The same has led to its earnings for the interim period to Mar22 (excluding its share of profits from Finzsoft Pty Ltd) declining to below $0.2m. Continued loan book contraction coupled with declining net interest margins has the potential to result in core operating income being inadequate to cover its overheads.

- In our view, competitive pressures are continuing to impact the sustainability of PFCU's profitable operations, and recent efforts to arrest the decline of its loan book are unlikely to yield meaningful growth in the near term. PFCU's small scale and limited service offering mean the business has high exposure to competitive pressures from both existing industry operators and new entrants. New Zealand's major banks and top-tier credit unions bid to maintain their scale, and the disruptive 'fintech' businesses' agility has inundated the market with various flexible consumer finance products competing with the traditional personal loans. This has underpinned the sustained contraction in PFCU's loan book, especially over the recent past.

- PFCU has experienced a period of flux in its Senior Management (Chief Executive and Chief Financial Officer) positions over the past two years, which in our view has impacted its ability to implement effective strategies to grow the loan book and improve overall performance. While we note that new loan products are being introduced under PFCU's new Chief Executive, the adoption of these products by PFCU's clientele and any benefit to its loan book is only expected to be evidenced over the medium term.

The outlook for PFCU's rating is 'Stable'.

A rating upgrade, while unlikely over the near term, would require a sustainable improvement in PFCU's competitive position. However, the rating may migrate lower in the following instances on an individual or collective basis if:

a. a continued decrease in the loan book results in declining profitability and net interest income is inadequate to cover overheads, and
b. there is a weakening of current balance sheet strength.

## Risk Rating

**BB+**

**Outlook: Stable**

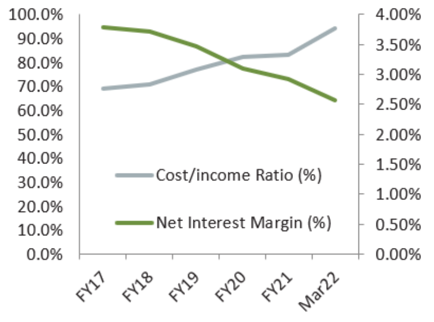
**Type: Public, Monitored**

## Industry Percentiles

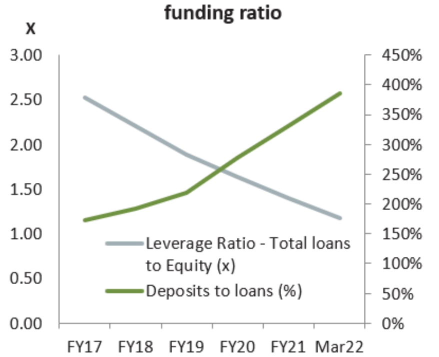
| | |
|---|---|
| **Scale:** | |
| Total Assets | 0% |
| Gross loans | 0% |
| **Profitability:** | |
| NIM | 57% |
| ROE | 0% |
| ROA | 0% |
| Efficiency Ratio | 100% |
| **Capitalisation:** | |
| Leverage (Gross loans to Equity) | 100% |
| Tier 1 Cap to RWA | 100% |
| Tier 1 Cap to total assets | 100% |
| **Funding and liquidity:** | |
| Deposits to loan ratio | 100% |
| Liquid assets to total assets | 100% |
| **Asset Quality:** | |
| Net Charge-offs | 100% |
| Non performing loans | 72% |
| Non performing and over 90day loans | 57% |
| Provision for loan losses | 86% |

## Key Trends

**Rising cost/income ratio and falling NIM**




**Reducing leverage and increasing 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 | **26 August 2022** |
| 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 nine-month interim period ended Mar22, and**<br>**Audited Financial Statements for the years ended Jun21 (FY21), Jun20 (FY20), and Jun19 (FY19).** |
| 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 Institution 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 2021).

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

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