Credit Ratings & Research

Credit Rating Report
Police and Families Credit Union Incorporated

NZBN: 9429043039197

Credit Rating Report

Date: 30 November 2022

Prepared for: Police and Families Credit Union Incorporated

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

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Job Number: 367922

Currency used in this report: This report is presented in New Zealand Dollars unless otherwise noted.

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1. Executive Summary

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 affirmed PFCU's credit rating at 'BB+' with a 'Stable' outlook at Jun22. The rating reflects PFCU's strong capitalisation, funding profile & flexibility, and the quality of its loan assets (benefitting from security position over NZ Police retirement accounts and access to NZ Police payroll) that support a near-prime credit profile. The rating is constrained by competitive pressures faced by PFCU - reflected in its modest loan book that has been declining in the recent past, and the resulting deterioration in its core operating performance and operating risk profile.

Strengths

- PFCU's Tier 1 capital ratio of 19.4% (at Sep22 and Jun22) is ~2.4 times the minimum regulatory requirement (8.0%). A strong capital buffer means that PFCU has adequate headroom to grow its risk weighted assets/loan portfolio.

- 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 strong deposit to loan ratio of 4.1x at Sep22 (Jun22: 4.1x, Jun21: 3.3x).

- Despite the loan book declining, loan quality remains supported by PFCU's niche client base, which comprises government employees who provide essential public services. As such, PFCU's borrowers' employment, and their capacity to repay, are not materially linked to or likely to be impacted by macroeconomic volatility, in our view.

- Additionally, a majority of PFCU's gross loan book (~76% at Jun22) 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 strategic investment in its banking software provider, Finzsoft Pty Ltd ('Finzsoft') in partnership with First Credit Union continues to contribute financial and operational benefits. Whilst the investment was initially considered to be a strategic necessity in order to secure operational capacity, positive financial contributions from Finzsoft have provided diversification to PFCU's earnings profile.

Constraints

- The continued contraction of PFCU's loan book weighs on its core operating performance and operating risk profile. PFCU's loans to customers decreased to \$30.6m at Sep22 (Jun22: \$31.2m, Jun21: \$37.7m, Jun20: \$42.5m), necessitating it to increasingly invest excess customer deposits in lower yielding bank term deposits. Coupled with declining net interest margins, this resulted in PFCU's core operating income (excluding its share of profits from Finzsoft Pty Ltd) being at a breakeven level for FY22. However, as deposits reprice upwards due to rising interest rates, PFCU's margins are likely to receive benefit, going forward.

- In our view, competitive pressures continue to impact the sustainability of PFCU's profitable operations. PFCU's small scale and limited service offerings 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. That said, management has noted that new product launches (in Apr22 and Sep22) and reduced turnaround time on existing product applications have resulted in reversing the loan book decline post Sep22, with moderate growth expected in the near-term.

- PFCU's exposure to residential mortgages and market risks related to property prices, is expected to increase marginally with the launch of its new product – 'First Home Together'. PFCU provides up to 10% of an interest-free deposit for its borrowers to meet the deposit requirements towards their first home. While this gives PFCU a proportionate ownership in the property, the underlying nature of the transaction allows it to make slightly riskier loans (with up to 90% LVR) and in our view, would make it susceptible to a degree of downside risks during an economic downturn.

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 on a sustained basis, and
b. there is a weakening of current balance sheet strength.

Risk Rating

BB+

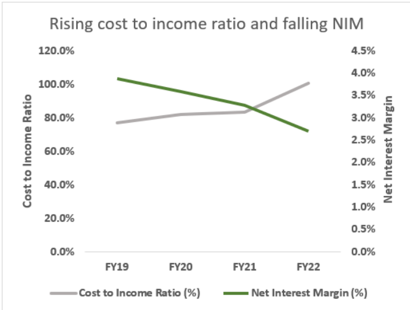
Outlook: Stable

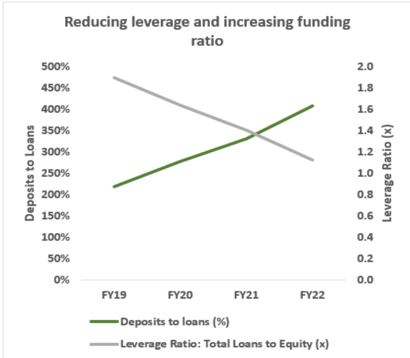
Type: Public, Monitored

Industry Percentiles

Scale:	Percentile
Total Assets	46%
Gross Loans	23%
Profitability:	
NIM	38%
ROE	15%
ROA	38%
Efficiency Ratio	15%
Capitalisation:	
Leverage (Gross loans to Equity)	100%
Capital Ratio	92%
Capital to Total Assets	92%
Funding and liquidity:	
Deposits to Loan Ratio	100%
Liquid Assets to Total Assets	100%
Asset Quality:	
Net Charge-offs	62%
Impaired Loans	62%
Provision for Loan Losses	69%

Key Trends





2. Scope of Report

The purpose of this report is to provide a credit rating and associated rationale 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	**30 November 2022**
Request Type	**Issuer**
Assessment Type	**Under Ongoing Monitoring**
Rating Initiation	**Issuer based (solicited)**
Rating Distribution	**Public Rating**
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**
Issue Name	**Not Applicable**
Issuer First Time Rated	**No**
Issue First Time Rated	**Not Applicable**
Financial Scope	**Consolidated Entity**
Structure	**Credit Union**
Industry	**Financial Services**
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 three-month interim period ended Sep22, and Audited Financial Statements for the years ended Jun22 (FY22), Jun21 (FY21), and Jun20 (FY20).**
Name of auditor	**BDO**
Other Information Sources	**PFCU's website, industry and regulatory websites, management interviews, media articles, adverse searches, and other internet searches.**
Subject participation	**Full**
Material financial adjustments	**None**
Limitations of assessment	**None noted**
Outsourced rating activities	**No**
Confidentiality agreement	**No**
Material client	**No**
Rating amended post issuer disclosure	**No**
Potential conflict of interest	**No**
Rating methodology	**Financial Institution Rating Criteria**

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

3. General Background of the Subject

Subject Name	Police and Families Credit Union Incorporated
Type of Entity	Credit Union – licenced as an NBDT with the RBNZ, and registered as number 610 under Part III of the Friendly Societies and Credit Unions Act 1982
Head Office Address	Level 11, 57 Willis Street Wellington 6011 New Zealand
Date of Incorporation	12 Nov 2014
Principal Activities	PFCU provides secured and unsecured personal loans, residential mortgages, transactions and savings accounts, and term deposit services to its members. The members can use PFCU-issued Debit MasterCard to access their funds through ATMs, and while carrying out transactions.
History	Police and Families Credit Union Incorporated is a Non-Bank Deposit Taking (NBDT) institution licensed with the Reserve Bank of New Zealand (RBNZ). PFCU is a not-for-profit credit union with membership open to current and retired police employees and their families. PFCU was established initially to meet the borrowing needs of police employees and their families and has since evolved into a provider of a comprehensive range of banking services to meet the needs of its members. Pursuant to legislative changes, PFCU has amended its rules and has become an incorporated entity effective 1 Jan 2020.

4. Industry Risks

Systemic risk factors (GDP, unemployment, economic cycles, interest rates etc), level of competition and market structure, and the legal and regulatory framework are key sources of industry risks that determine the operating environment of financial institutions (FIs). A summary[1] of the above risk factors and their outlook in the context of the New Zealand economy is included in paragraphs below.

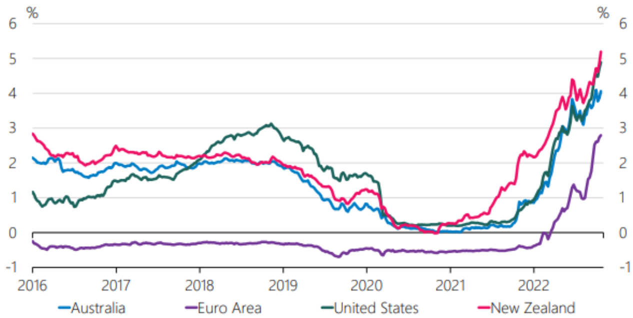
Systemic Risk Factors

Inflationary measures and economic uncertainty are likely to remain for some time

Strong and persistent inflationary pressures are requiring continued monetary tightening, as acute challenges from COVID-19 and global supply chain issues lessen. Most countries have now removed COVID-19 restrictions, and global supply chain pressures that built up at the height of the pandemic have reduced somewhat in recent months. However, Russia's invasion of Ukraine in February 2022 sparked a large increase in global commodity prices, particularly for energy, metals, and food, and they remain elevated compared to historical norms. These global supply shocks, when combined with the lagged effects of significant fiscal and monetary policy stimulus provided in 2020 and early 2021, have caused inflation to rise substantially across major economies, to higher levels than had been anticipated by policymakers.

After a decade of low interest rates and muted inflationary pressures, central banks are having to tighten their monetary policy settings at a faster pace than in previous tightening cycles. In doing so, they aim to ensure that high inflation does not become embedded in inflation expectations. Financial market pricing indicates a substantial monetary tightening over the next two years (figure 1.1).

Figure 1.1
2-year wholesale interest rates
(swap rate, weekly average)



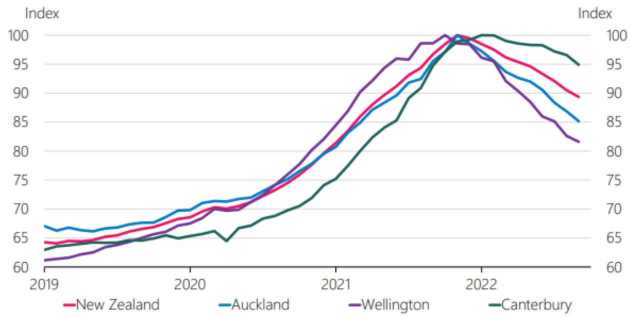
Source: Reuters.

[1] The RBNZ Financial Stability Report Nov22, the RBNZ Monetary Policy Statement Nov22, the RBNZ Website and various Publications of RBNZ.

<u>Asset prices, including New Zealand house prices, are declining in the face of tighter financial conditions</u>

The rising interest rate environment and deteriorating global economic outlook have also seen prices decline across a broad range of asset classes in recent months. In New Zealand, house prices have fallen 11.0% since their peak in November 2021, with notable divergences across regions (figure 1.2). Wellington, which experienced a relatively large increase in prices in recent years, has declined 18.0% since its peak, while Auckland has fallen by 15.0%. Potential buyers' borrowing capacity has been reduced by rising mortgage rates, loan-to-value ratio (LVR) restrictions, and tougher serviceability assessments following changes to lender processes under the Credit Contracts and Consumer Finance Act 2003. House sales have fallen to levels seen in the aftermath of the global financial crisis (GFC), and housing lending growth has slowed considerably in recent months. The relative attraction of buying a property compared to renting or investing elsewhere has declined, given the outlook for mortgage rates, the still high level of house prices, tax policy changes, and the potential for further price falls.

Figure 1.2
New Zealand house prices
(seasonally adjusted, indexed to peak values)



Source: REINZ, Reserve Bank estimates.

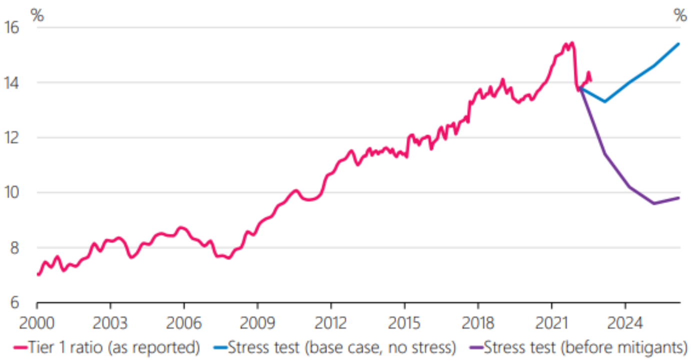
<u>Financial systems remain sound and financial institutions robust</u>

The RBNZ notes that New Zealand's financial system is well positioned to handle an environment of rising interest rates and slower economic growth. Registered banks' profitability has been robust, with very low levels of non-performing loans and slight increases in their net interest margins in the past six months. Banks have retained earnings and begun to issue additional capital instruments, as they build their capital levels in anticipation of higher regulatory requirements in the next few years. Since 1 July 2022, the four domestic systemically important banks have been subject to an additional one percentage point capital buffer requirement, which will increase to two percentage points in July 2023.

The banking system's liquidity and funding positions also remain strong. The end of pandemic-related support measures, namely the 'Large Scale Asset Purchase' programme and 'Funding for Lending Programme', will normalise funding conditions for banks. Banks will likely seek to increase the proportion of their deposits in term accounts rather than on call, to support their liquidity positions. With mortgage lending slowing due to reduced mortgage demand, banks' reliance on wholesale funding markets is expected to be modest in the near term, insulating them to an extent from current market volatility.

Figure 1.4

Banking system capital and 2022 stress test projections



Source: RBNZ *Capital Adequacy survey, Disclosure Statements*, Reserve Bank.

Cyclicality

Due to strong linkage between economic activity and interest rates financial institutions remain vulnerable to vagaries of economic cycles. During recessionary times interest rates drop and business sentiment remains weak, thus undermining the ability of financial institutions to raise deposits and make loans. Similarly, during periods of inflation, interest rates usually rise and purchasing power of households dwindles thereby exposing financial institutions to asset quality risks. NBDTs' strong reliance on retail deposits for funding, limited product range, geographically concentrated operations, and smaller scale makes them more susceptible to the adverse operating and financial impacts of cyclicality compared to systemically important banks and other tier-2 banks. As a result, a study of economic cycles and its phases is vital to accurately assess the exposure to various market risks.

<u>Strong balance sheets and accommodative policy settings have supported economic recovery, although there are early signs that growth may be slowing.</u>

Households have been resilient to the increase in interest rates and fall in house prices seen so far. In general, credit conditions for households have tightened owing to higher interest rates, changes to the CCCFA, and the higher cost of living that banks are reflecting in their serviceability assessments. Vulnerabilities are concentrated in borrowers who took out loans in late 2020 and in 2021, in terms of the risk of negative equity and debt serviceability stress. LVR restrictions have reduced borrowing by households with low deposits. As a result, recent borrowers will be better able to absorb further house price declines without falling into negative equity. In addition, borrowers in recent months are more likely to be able to absorb the impacts of rising interest rates, as the test rates used by banks to assess loan serviceability have increased.

The range of factors driving up operating expenses for businesses have remained broadly unchanged during the past six months. The most significant challenge has been a shortage of labour in all sectors, a major hurdle to businesses benefiting from the currently strong demand. Staff turnover and absences have been elevated, primarily as employees have caught COVID-19 or other illnesses. Wage inflation has continued to be high across all industries as firms compete for workers. Inflation in other input costs, particularly transportation, and supply chain disruptions have remained persistent problems, although firms have been better able to adapt to these than they have been with respect to labour supply. Firms have generally increased prices to maintain their margins, but the extent to which they have been able to do so has varied across industries. Cost inflation may persist for some time, presenting a downside risk to profitability

The economic outlook points to a weakening in spending growth as monetary policy is tightened. The main risk to the business sector is a sharp downturn in the economy, alongside a large increase in the unemployment rate, which would curtail household demand. Should this occur, the high demand growth that businesses have benefited from in recent quarters would reverse quickly. A weaker economic outlook together with higher debt servicing burdens would put pressure on businesses. Weighted average interest rates on banks' business loans increased to 5.5% in September 2022 from their mid-2021 lows, and they tend to adjust to interest rate increases relatively quickly compared to other types of lending. While asset quality is currently strong, a greater utilisation of credit limits and the demand for working capital in recent months are potentially early signs of cash flow pressure in the business sector.

Market Risk

Market risk refers to the impact on profitability due to adverse changes in interest rates, assets prices, commodity prices and exchange rates. Interest rates remain the key and most direct source of market risk to financial institutions due to the nature of their operations and the strong interplay between interest and currency rates and interest rates and asset prices.

NBDTs primarily faces interest rate risk given their limited appetite for transactions denominated in foreign currency and relatively small scale of operations. As a result, paragraphs below discuss the recent movements in the prevailing interest rates and asset prices in New Zealand.

<u>Interest rate movements</u>

In Nov22, the Monetary Policy Committee (MPC) increased the Official Cash Rate (OCR) to 4.25% from 3.5%. The MPC observed that core consumer price inflation is relatively high, employment is beyond its maximum sustainable level, and near-term inflation expectations have risen. Global consumer price inflation is broad based and remains heightened. Food and energy prices, and persistent core inflation, have combined to create very high headline inflation in many countries. Central banks are tightening monetary conditions in an effort to slow spending and reduce inflation pressure. The ongoing slowdown in global growth will affect New Zealand through both financial and trade channels, and impact on people's confidence due to uncertainty.

Asset Price Movements

Given the recent fall in house prices, the gap between the current price level and RBNZ estimates of its sustainable level has narrowed. However, their assessment of the sustainable level of house prices has also declined, owing to market expectations for higher long-term interest rates and historically low levels of rental yields, both of which make residential properties relatively less attractive compared to six months ago. Despite the fall in prices so far, rising interest rates have meant that the debt servicing burden for new buyers remains at an historically high level. Furthermore, the removal of tax deductibility on interest expenses substantially worsens the cash flows generated by investment properties at high levels of gearing. In the near term, prices are expected to continue to fall towards more sustainable levels as the effects of higher mortgage rates feed through to declining demand for housing. A sharp decline from the current price level remains plausible, as the low mortgage rates that drove the recent run-up in prices reverse.

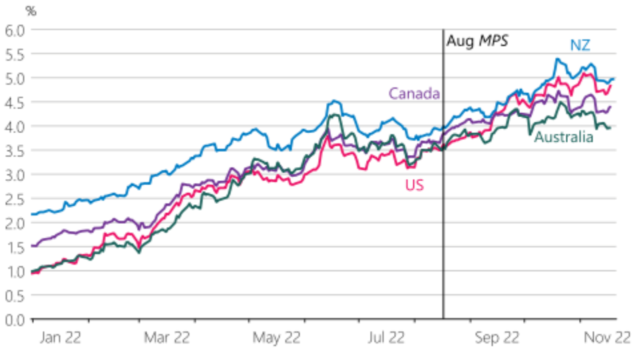
Foreign Currency Risks

The adverse movement in exchange rate poses direct and indirect risks to financial institutions depending on its balance sheet and contribution of foreign trade to overall economy. For economies highly reliant on foreign trade adverse changes in exchange rates can affect overall GDP levels and business profitability thus heightening the financial institutions vulnerability to asset quality risks. Further financial institutions may raise capital from or lend to foreign investors / borrowers and hence adverse movement in the exchange rates may impact the financial institutions borrowing costs / lending incomes.

New Zealand Exchange Rate

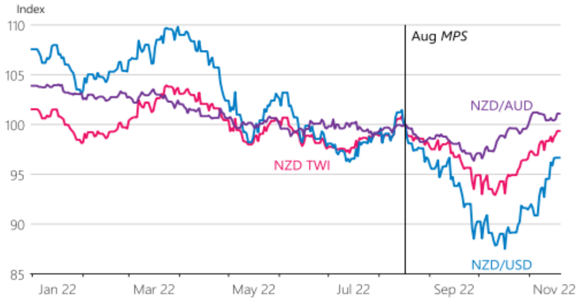
The New Zealand dollar has depreciated slightly on a trade-weighted basis since the RBNZ's August Monetary Policy Statement. Market risk sentiment remains weak and continues to support investor demand for the US dollar, given its status as a 'safe haven' currency. Lower prices for New Zealand's export commodities have contributed to lower demand for the New Zealand dollar. Interest rates in major economies such as the US and the euro area have increased at a faster pace than those in New Zealand, also contributing towards the recent weakness in the New Zealand dollar. However, New Zealand interest rates have risen at a faster pace than some other trading partners. This includes Australia, as the Reserve Bank of Australia has slowed down the pace of its monetary policy tightening. As a result, the New Zealand dollar has appreciated against the Australian dollar.

Figure 5.2
Global 2-year interest rate swaps



Source: Bloomberg.

Figure 5.4
New Zealand dollar TWI and selected bilateral exchange rates
(index=100 at August Statement)



Source: RBNZ, NZFMA.

Level of Competition and Market Structure

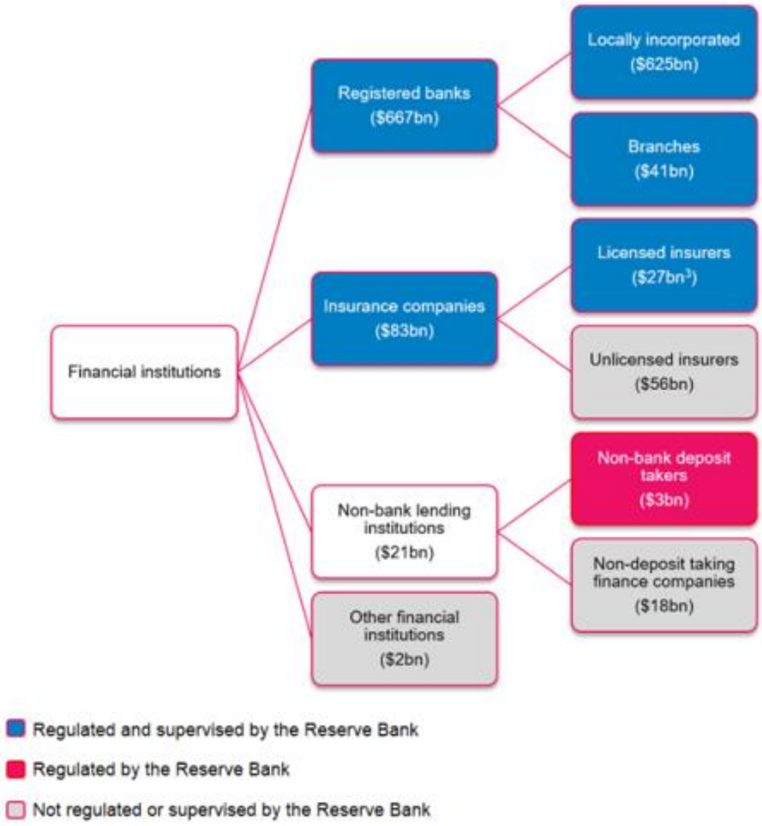
The financial institutions face stiff competition on an ongoing basis to attract capital and funding. In addition to peers, the financial institutions must compete with other finance intermediaries like managed funds, insurance companies and other intermediaries that offer alternative avenues for households and businesses to park savings or borrow funds. Further, the advent of fintech, payment banks and rise of buy now pay later sector has heightened competition in the short-term lending segment.

Overview of Competitive Landscape in New Zealand

The New Zealand financial system is dominated by the banking sector, with banking assets accounting for a very large share of overall financial system assets (Figure 4). Structural entry barriers benefit the systemically relevant banks and offer them a competitive advantage in attracting customers and pricing, lending and savings products. These advantages allow these large scale financial institutions to access a diversity of liquidity pools including retail deposits and wholesale funding. This diversity offers them the flexibility to absorb shocks to funding costs and to partly insulate their earnings from capital market volatility. Moreover, top tier banks offer a broad range of products like savings, deposit and transaction accounts, superannuation, trading accounts, financial advice, wealth management and a network of branch and ATM services providing a level of convenience, range and quality.

In contrast, equity and debt capital markets are relatively less developed in New Zealand, with the total market capitalisation of equities listed on the New Zealand Stock Exchange at ~$167bn, while the domestic bond market is estimated at ~$171bn (excluding government debt). The managed funds industry is also small compared to banks, with around $200bn of assets under management.

Financial institutions' total assets (as at 31 March 2022)



Note: numbers may not sum due to rounding
Source: RBNZ Bank Balance Sheet (BBS), RBNZ Standard Statistical Return (SSR), RBNZ Non-Bank Deposit Taker Prudential Return (NBDTPR), individual insurer financial statements.

Direct capital market funding (issuance of corporate bonds) and non-bank lending institutions (NBLIs) together account for only 6% of non-financial private sector borrowing. NBLIs account for just over 3% of intermediated credit since they have a limited offering and specialise in raising deposits to lend to higher risk consumer and business segments underserved by the traditional banks. NBLIs include non-bank deposit-taking institutions (NBDTs) and non-deposit-taking finance companies. While the Reserve Bank of New Zealand regulates NBDTs it does not regulate or supervise non-deposit-taking finance companies.

There are currently 15 NBDTs actively operating in New Zealand, which include building societies, credit unions, and deposit taking finance companies. They have a diverse range of business models, with credit unions having a high share of their lending in a mix of residential and consumer loans to their members, while building societies and finance companies tend to focus on a range of types of property lending. Total net lending by NBDTs is around $2.3bn, compared to $540bn in lending by banks. While small relative to the rest of the financial system, the NBDT sector covers a diverse range of organisations that support financial inclusion by serving communities that may traditionally be under-serviced by the banking system.

There has been consolidation in the NBDT sector in recent years, particularly among credit unions. Overall, since 2018, the number of credit unions operating in New Zealand has fallen from 13 to 5. Many of the profitability challenges faced by the credit union sector are due to lack of scale, with high operating costs relative to income. Combined with a limited ability to raise external equity given their mutual structure, some institutions have had a limited capacity to build up the capital buffers that are needed to absorb unexpected shocks while maintaining credit growth. While attaining economies of scale has been challenging for some credit unions, net interest margins have moderately increased in recent years as interest rates have declined, supporting their financial sustainability.

Table 3.2
Key metrics for NBDTs (year ended June)

Metric	Segment	2018	2019	2020	2021	2022
Total assets ($m)	Finance Companies[1]	220	270	218	296	357
	Credit Unions	1,149	1,131	1,152	1,126	1,106
	Building Societies and Other[2]	1,084	1,217	1,303	1,400	1,553
Capital ratio (%)	Finance Companies	15.6	14.8	17.8	15.7	17.2
	Credit Unions	14.9	14.7	14.1	12.9	12.7
	Building Societies and Other	11.0	11.6	12.4	13.7	13.7
Non-performing loan ratio (%)	Finance Companies	5.6	7.3	10.3	1.9	1.9
	Credit Unions	2.6	2.5	3.3	2.9	3.1
	Building Societies and Other	0.3	0.1	0.2	0.1	0.3
Return on assets, before tax (%)	Finance Companies	2.5	1.7	1.9	1.8	2.4
	Credit Unions	0.1	-0.6	0.0	0.4	0.1
	Building Societies and Other	0.8	0.9	0.9	1.2	1.5
Number of operating entities	Finance Companies	7	7	6	6	6
	Credit Unions	13	9	9	8	7
	Building Societies and Other	4	4	4	4	4

Source: RBNZ *Non-Bank Deposit Takers survey.*

1 Datas for finance companies exclude FE Investments Limited from March 2020, when it entered receivership.

2 Other NBDT refers to Christian Savings Limited.

Legal and Regulatory Framework

The financial institutions are highly regulated due to their vital role and high failure costs. The scope of regulations extends to various aspects of the FI's business including but not limited to capital and liquidity requirements, risk management and governance controls.

Regulatory landscape in New Zealand

Part 5 of the Reserve Bank of New Zealand Act 1989 (the Act) gives the Reserve Bank of New Zealand ('RBNZ' or 'the Reserve Bank') the powers to register and supervise banks for the purposes of promoting the maintenance of a sound and efficient financial system; and avoiding significant damage to the financial system that could result from the failure of a registered bank. The Reserve Bank has a responsibility to promote the integrity of the financial system as a whole, and, accordingly, also has responsibilities in relation to non-bank deposit takers, insurance companies and the payments system. While the Reserve Bank monitors registered banks' compliance with banking supervision policies, neither it nor the government guarantees that a registered bank will not get into difficulty or fail.

Macro Prudential Policy

The purpose of macroprudential policy is to reduce the risk that the financial system amplifies a severe downturn in the real economy. An unsustainable boom in credit and asset prices can result in a bust that creates losses for banks, businesses and households, and hampers the ability of banks to continue lending to the economy. This is important because financial instability – a disruption to the supply of essential services provided by the financial system – can have significant and lasting economic and social costs. Macroprudential policy aims to reduce the likelihood and severity of these costs. To achieve objectives of its macro prudential policy the RBNZ uses tools like Countercyclical Capital Buffer, Sector Capital Requirement, Core Funding Ratio and Loan-to-value ratio (LVR) restrictions. The limits prescribed under above are revised from time to time.

LVR restrictions are the main tool currently used to address financial system risks related to the housing market. In May 2021, RBNZ tightened LVR restrictions on new lending to investors above 60%. In addition, the maximum share of new lending to owner-occupiers with LVRs over 80% was reduced from 20% to 10% from 1 November 2021. By limiting a build-up of homeowners at risk of a fall in house prices, these adjustments will further support financial stability.

Various other regulatory initiatives are continuing to future-proof the resilience of the financial system, including changes to the Credit Contracts and Consumer Finance Act (CCCFA) and Regulations, and the Proposed Deposit Takers Act (DTA) - aligning regulation of all deposit takers under one framework. Included within the DTA are proposals for a Depositor Compensation Scheme to cover bank depositors in the event of bank, or non-bank deposit taker such as a building society, failing. Depositors will be covered for a total of $100,000 per institution per depositor.

While the introduction of more stringent regulatory oversight of NBDTs are expected to reduce the operating environment risks of the industry and promote public confidence in the sector, a public consultation on the draft Deposit Takers Bill received submissions from various NBDTs highlighting issues that were considered to be challenging to smaller NBDTs. Amongst the several issues highlighted in the submissions, the following points were noted to directly impact the costs incurred to an NBDT and thereby impact its net earnings:

- NBDTs noted that the cost of deposit insurance will disproportionately fall on smaller deposit takers and such levies would potentially be a risk to their ongoing viability under the new regime.
- NBDTs suggest a proportionate approach should be taken in setting levies; NBDTS said they strongly believed risk-based levies are likely to be problematic and prefer a flat rate with DSIBs being required to pay a premium to reflect the systemic risk and the implicit supports likely required for them and signalled through proposed changes to the Public Finance Act.

- The Bill should include the safeguard implemented in Australia and the United Kingdom, where levies may not exceed 0.5% of the entity's insured deposits in any calendar year.

Some of the other key points include:

- Many of the NBDT's trust deeds provide for a charge over assets in favour of depositors; the Bill needs to mitigate the risk to depositors of the loss of that charge (or preserving it).
- NBDTs below a certain size should be exempt from the requirement to have a credit rating

The RBNZ expects the Deposit Takers Bill to be passed into law in mid-to-late 2023, with a depositor compensation scheme expected to be up and running in early 2024.

Prudential Requirements currently applicable to NBDTs are discussed in the below Section 5 – Prudential Framework.

5. Prudential Framework

The RBNZ regulates non-bank deposit takers (NBDTs) in New Zealand for the purposes of promoting the maintenance of a sound and efficient financial system and avoiding significant damage to the financial system that could result from the failure of an NBDT. NBDTs are entities that make an NBDT regulated offer (as defined in section 5 of the Non-bank Deposit Takers Act 2013) and carry on the business of borrowing and lending money, or providing financial services, or both. The prudential regulation of NBDTs is provided under the Non-bank Deposit Takers Act 2013 and associated regulations. Trustee companies also have obligations under the Act. These include ensuring certain prudential content is included in licensed NBDTs' trust deeds. Trustees must report to the Bank any non-compliance with the Act and regulations by the licensed NBDT. Trustees are licensed by the Financial Markets Authority under the Financial Markets Supervisors Act 2011. The table summarises certain key prudential requirements for NBDTs currently in force.

Credit Rating	Licensed NBDTs are required to have a local currency (New Zealand dollar), long-term, issuer rating given by approved rating agencies, unless an approved exemption applies.
Governance	Licensed NBDTs that are companies or building societies must have a chairperson who is not an employee of either the licensed NBDT or a related party and must have at least two independent directors. Licensed NBDTs that are subsidiaries of another person are prohibited from including provisions in their constitutions that would allow directors to act otherwise than in the best interests of the NBDT.
Risk Management	Licensed NBDTs are required to have a risk management programme that outlines how the licensed NBDT identifies and manages its credit, liquidity, market, and operational risks. This programme is to be submitted to, and approved by, the licensed NBDT's trustee.

Capital Ratio	A minimum capital ratio (the level of capital in relation to the credit exposures and other risks of the NBDT or its borrowing group) is required to be included in licensed NBDTs' trust deeds. This ratio must be at least 8% for licensed NBDTs with a credit rating from an approved credit rating agency. For licensed NBDTs without a credit rating from an approved rating agency, the minimum capital ratio specified in the trust deed must be at least 10%.
Related party exposure limits	The exposures to related party, as defined in the Act, shall not exceed a maximum limit of 15% of capital.
Liquidity	Liquidity regulations require every licensed NBDT and its trustee to ensure that the licensed NBDT's trust deed include one or more quantitative liquidity requirements that are appropriate to the characteristics of the licensed NBDT's business, and that take into account the liquidity of the licensed NBDT and the liquidity of any borrowing group.
Suitability assessment of certain directors and senior officers	Licensed NBDTs must notify the RBNZ when one of its directors or senior officers (or a person who is proposed to be appointed as a director or senior officer) raises a "suitability concern".
Change in ownership	An application must be made to the RBNZ to approve a transaction that will result in a person: 1. having the direct or indirect ability to appoint 25% or more of a licensed NBDT's governing body; or 2. having a qualifying interest in 20% or more of the voting securities issued by the licensed NBDT.

6. Business Risks

6.1 Market Risk Exposures and Controls

<u>Interest Rate Risk</u>

PFCU controls and manages the impact of interest rate changes by minimising the duration mismatch between its assets (members' loans) and liabilities (members' deposits). The duration gap is measured monthly by the Asset and Liability Committee (ALCO) to identify any large exposures to interest rate movements and any such exposures are rectified through management of or change in interest rates on member deposit accounts and/or member loan accounts.

PFCU offers fixed rate terms only on its home loans and for a maximum period of 3 years. All other loan facilities are offered on variable interest rates. PFCU has historically had minimal exposure to residential mortgages. However, with the decline in the overall loan book and competitive pressures affecting the personal loan portfolio, residential mortgages accounted for 10.6% and 10.7% of PFCU's total loans as at Sep22 and Jun22 (Jun21: 9.5%, Jun20: 8.7%).

PFCU has an internal policy in place to maintain a majority of its total term deposits with NZ registered banks with a maturity shorter than 12 months. PFCU monitors this on a regular basis and as at Jun22, they were in-line with the internal policy requirements.

Repricing Gap Analysis ($ - Jun22)	Total	<6 months	7-12 months	13-60 months	>60 months
Financial Assets	**156,530,000**	**53,067,000**	**30,498,000**	**60,510,000**	**12,455,000**
Cash & equivalents	**8,509,000**	8,509,000			-
Bank term deposits	**105,555,000**	40,634,000	26,744,000	38,177,000	-
Loans to members	**42,466,000**	3,924,000	3,754,000	22,333,000	12,455,000
Financial liabilities	**127,507,000**	**111,179,000**	**12,996,000**	**3,332,000**	**-**
On-call shares	**79,158,000**	79,158,000			-
Fixed term shares	**48,349,000**	32,021,000	12,996,000	3,332,000	-
Difference	**29,023,000**	**- 58,112,000**	**17,502,000**	**57,178,000**	**12,455,000**

As at Jun22, PFCU modelled the sensitivity of its assets and liabilities to a 3.0% fluctuation in interest rates. Based on FY22 annual report, the impact on earnings from a 3.0% adverse movement in interest rates is estimated at ~$450k or ~67.0% of FY22 profits. The same is a sizeable proportion of PFCU's earnings, however, its impact to the credit profile is partially mitigated by PFCU's strong capitalisation and funding profile.

Liquidity Risk

PFCU manages liquidity risk by investing in short-term liquid deposits with NZ registered banks. PFCU monitors its liquidity via a daily cash summary report that aims to highlight any breaches in liquidity policy. PFCU's liquidity, when calculated as cash equivalents and short-term deposits (maturing <183 days) as a percentage of total assets is 31.5% at Jun22 (Jun21: 31.6%, Jun20: 31.2%, Jun19: 50.2%) and in Equifax's view, it is deemed to be conservative, relative to peers.

PFCU has an internal policy is place which details the necessary steps and contingency plans to be undertaken and implemented by the CFO and CEO should the liquidity ratio fall below an internally set target [Note: This target is set comfortably above the minimum liquidity ratio requirement under its Trust Deed (10%) as well as the Deposit Takers Regulations 2010 (8%)].

Moreover, PFCU's trust deed stipulates a minimum liquidity ratio of 10.0%. PFCU's calculation of liquidity ratio as per its trust deed is more conservative than the industry standard. PFCU only includes (from Jul17) deposits maturing within 183 days in its computation of internal liquidity. Liquidity based on deposits maturing within 183 days was computed at 28.5% as at Sep22[1] (31.2% at Jun22[1] and 31.6% as at Jun21[1]).

PFCU also monitors a one-month mismatch ratio (calculated as adequacy of liquid assets and next month's net cash flows, to total funding), which is not to reduce below 0% at any time as per the trust deed (28.2% as at Sep22[1], 31.3% as at Jun22[1] and 31.4% as at Jun21[1]). Additionally one-year funding ratio (ratio of estimated

[1]Calculated as per the trust deed requirements. The calculation methodology for liquid assets has been changed to include all deposits maturing within 183 days from Jul17 onwards.

funding that is expected to stay in place at least one year, to total assets of PFCU) is monitored on an ongoing basis and is covenanted at greater than or equal to 70.0% of total balance sheet assets (75.9% as at Sep22[1], 75.8% as at Jun22[1] and 77.7% as at Jun21[1]).

Liquidity Management Policies also require that the mix of Deposits be controlled for reasons of deposit base stability and minimising average cost of funds. PFCU requires that the amount of deposit by any individual member shall not exceed $250,000 individually or $500,000 jointly across all share accounts to mitigate the concentration risk associated with deposits. Management monitors this on a regular basis and takes suitable action, if required.

6.2 Credit Risk Exposures and Controls

Credit risk is the risk that the counterparty will be unable to meet obligations to PFCU under the terms of any loan or advance (with members), or terms deposits (with banks). PFCU is exposed to credit risk on both term deposits held with NZ registered banks, and loans granted to members in the form of mortgages or personal or other loans. Measures and controls have been adopted by PFCU to minimize risk of loss due to concentration to any individual counterparty.

Term deposits with banks –The policies require that PFCU does not maintain more than 50% of its total investment funds being held with any individual counterparty (NZ registered banks).

Loans to members – Loans are made in accordance with PFCU's lending policy. Key features of this policy are:

- Fixed rate offerings are only for mortgages and up to 3 years, and all remaining offerings are on variable rates.
- PFCU has set a maximum limit on the amount of loan and the maximum tenure for the loan offered is 30 years.
- The loan amounts are secured by a charge on PSS/GSF. Deposit ranges and tenures depend upon the security cover provided.
- PFCU has set limits for the maximum tenure and loan amount to purchase a motor vehicle or for any other approved purpose using motor vehicle as security. PFCU also has a minimum-security cover target.
- PFCU has set limits for the maximum tenure and loan amount for unsecured loans.

- PFCU has a very low proportion (less than 0.5% of total loan book as at Jun22) of unsecured loans. Exposure to loans secured by residential mortgages increased, however, remained conservative at 10.7% as at Jun22 (Jun21: 9.5%, Jun20: 8.7%). That said, we note that this increase was on account of a contraction in the absolute amount of personal loans and not from an increase in lending towards mortgages.

- A vast majority of the loan portfolio is secured by a charge over retirement funds in PSS and GSF for current and former NZ police employees and their family members. PFCU's credit risk for loans secured by PSS and GSF is low.

- PFCU's loan book has low concentration risk as the loans are spread across a large number of borrowers.

- Credit risk on the PFCU portfolio is also mitigated by limited concentration to any particular geographic area. Residential mortgages are spread across main cities like Auckland, Christchurch, Wellington as well as regional towns and areas.

6.3 Structure and Service Delivery Platform

Structure

In Apr17, the Friendly Societies and Credit Unions (Regulatory Improvements) Amendment Bill was introduced to amend the Friendly Societies and Credit Unions Act 1982. This Bill was intended to;

- remove unnecessary operating and compliance costs,
- promote greater efficiency, innovation, and accountability,
- bring credit unions into alignment with other financial service providers in New Zealand, and
- maintain the element of mutuality and the requirement of a common bond between members.

This bill received the Royal Assent on 4 Jul 2018 and the Friendly Societies and Credit Unions (Regulatory Improvements) Amendment Act 2018 was passed with a commencement date of 1 Apr 2019.

Some of the most important changes as a result of the Friendly Societies and Credit Unions (Regulatory Improvements) Amendment Act 2018 are as follows;

- No person, society, or body of persons (whether incorporated or unincorporated) may trade or carry on business as a credit union unless it is registered. Existing credit unions were given 6 months from the commencement date (1 Apr 2019) to apply for incorporation. This eliminated the need for trustees with credit unions becoming entities in their own right.

- Credit unions can extend loans to Small and Medium-sized Enterprises (SME) related to a member (provided the member has the power, directly or indirectly, to exercise, or to control the exercise of, the rights to vote attaching to 25% or more of the voting products) so long as the related SMEs have no more than 19 full-time equivalent employees. The loan is to be used for the purposes of a business being carried on by that SME.
- The minimum number of members of an association of credit unions is reduced from seven to two.

In order to ensure compliance with the new provisions, PFCU held a special general meeting and amended its rules in Jun19. Pursuant to its application for incorporation under the new provisions within the relevant deadline, PFCU's incorporation by the Registrar of Credit Unions was effective from 1 Jan 2020.

PFCU has ownership of itself rather than trustees owning it on behalf of the members.

In spite of the above changes, PFCU's structure is considered simple, and the lack of structural complexity improves transparency and reduces operating risks.

PFCU does not carry any external debt and hence, there is minimal risk of structural subordination or double leverage to increase asset portfolio. PFCU's ability to raise wholesale funding is adversely affected by limitations imposed by its trust deed. PFCU is prohibited by its trust deed from creating security interest over any of its assets. The risk from this limitation is considered quite low in our view, given PFCU has a very strong funding profile with an industry leading deposit to gross loan ratio of 407.0% as at Jun22. Moreover, PFCU being a not-for-profit entity does not have any return on capital objective and reinvests 100% of its surplus earnings into the business, which further reduces the risk from its inability to access wholesale funding.

<u>Service Delivery Platform</u>

The business offers three main classes of product in the form of accepting deposits from members, granting personal loans (secured and unsecured) including motor vehicle loans, and residential mortgages. There is a single customer segment consisting of NZ Police employees (current and retired) and their family members.

PFCU's members can join PFCU through completion of a web-based form on its website. The website also provides internet banking services for the members to keep track of and manage their funds. Additionally, PFCU provides its members with access to their accounts through a mobile application and personal banking services. PFCU also enables its members to apply for loans using its website and the mobile application. To improve customer experience and shorten the application processing time, PFCU has recently implemented an electronic identification and verification system. Further, PFCU is looking to implement a system to perform automatic review of members bank statements in the near future. 1 Oct 2017 onwards, PFCU solely uses Westpac for settling transactions of its issued Debit MasterCards which in our view, enables PFCU to better manage operational risks.

6.4 Strategic Vision

PFCU's main strategic objective is to service the financial needs of its members better through competitive pricing and financial health offerings.

PFCU assists its members to save and invest funds with PFCU, which are, in turn, used to make loans to other members in need of borrowing products. PFCU's purpose is not to maximise profitability but to provide value to members while ensuring long-term profitability and solvency of the business.

6.5 Execution of Strategy

PFCU operates and looks to achieve its strategic goals through the implementation of a fairly simple and conservative business model. PFCU aims to provide competitive, above market average deposit and below market borrowing rates to its members, and to minimise the interest rate reset gap between its assets and liabilities. With the ongoing contraction in the loan book, PFCU's management has recently engaged a new marketing platform and launched new product offerings over the last few months –

- Retire Easy (Reverse Mortgage): A loan for members aged 70+ to free up the cash in their home to help make retirement more comfortable; typically called a "reverse" or "reverse equity" mortgage.
- First Home TOGETHER (shared ownership): A home loan package where PFCU provides a deposit help of up to 10% of the price of the home (interest free for up to 10 years) and the borrower shares ownership of their first home with PFCU.

Substantial benefits from the above new products are yet to materialise and are expected to evolve over the next 6-12 months.

In addition to the business of accepting deposits and extending loans to members, PFCU has taken a number of initiatives for the welfare of its members. Some of the important initiatives undertaken by PFCU in the recent past are as follows:

Blue Trust Financial Capability Programme: Blue Trust is a financial education foundation that PFCU established for its members during FY16. The main aim of Blue Trust is to enhance the financial capability of PFCU's members by providing educational programmes and courses. These programmes and courses are offered nationwide, free of cost to the members. These programmes and courses help members improve their financial literacy and take better control of their money. Spending reduced during FY21 and FY20 owing to COVID-19 related social restrictions. However, PFCU continued to provide programmes and courses through webinars.

Scholarships: PFCU offers up to 60 scholarships per year of $1,000 each to support various opportunities for members who want to improve their financial well-being through training, education, or self-development activities. Each year applications open in December and successful applicants are advised in January. PFCU has been offering scholarships for the last 5 years. Scholarships were provided for various activities which include beekeeping, completing a PhD, obtaining a skipper's restricted licence, speech language therapy and sporting goals, among others.

6.6 Management

Name	Position
Lane Todd	Chair
Ian Harris	Vice Chair
Amelia Steel	Director
Gail Gibson	Director
Natasha Rodley	Director
Helen Hatchard	Director
Stuart Taylforth	Director
Bronwyn Rozier	Manager Operations/ Blue Trust
Richard Dunn	Manager Member Services
Amy Linwood	Manager Market and Products
Craig Pomare	Chief Executive Officer
Mathew Gray	Chief Financial Officer

PFCU's Board currently comprises seven members – a Chair, a Vice Chair and five directors.

A number of changes in the management team were noted post FY20. In our view, this has impacted the management team's 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 recently appointed senior management, in our view, the adoption of these products by PFCU's clientele and any material benefit to its loan book and performance are only expected to be evidenced over the next 6-12 months.

6.7 Governance and Oversight

<u>Internal</u>

PFCU's internal Credit Risk Policy governs the approval parameters for the loans to members. PFCU has maintained minimal exposure to mortgage lending and offers fixed rates for a maximum term of 3 years on mortgages. PFCU does not offer fixed rate terms on any of the other loan products.

PFCU's board and all employees are responsible for risk management activities, which include –

- The Board reviews upcoming legislative changes through updates from their external lawyers and other material and discuss any impact at Board meetings.
- A checklist of all existing regulatory filing requirements is completed monthly. This is reviewed as part of the Internal Controls program.
- Compliance with AML/CFT policies and procedures is assessed monthly as part of the internal controls program.

In order to manage risk on an ongoing basis and have built-in checks, PFCU has three lines of defence:

- First Line, Business Operations – Risk and control policies in the business lending criteria.
- Second Line, Oversight functions – Internal Controls Programme that monitors lending portfolio on a periodic basis through pricing committee and ALCO.
    - PFCU's pricing committee meets weekly and analyses the PFCU's prices for fixed / floating home loans and personal loans, and deposit rates. The rates are compared with the big 5 banks and other banks like RaboDirect and the Cooperative Bank. Changes to the rates are recommended to maintain competitiveness and relative attractiveness to the members.
    - ALCO meets monthly and reviews the funding and liquidity positions with respect to concentration risk to any individual counterparty for term deposits, and member loans and deposits, and liquidity risk in form of proportion of deposits with maturity over 12 months. The committee also assesses the capital ratio, liquidity ratio, retention ratio for matured member deposits, one-month mismatch ratio and one-year funding ratio, against the internal management targets or trust deed mandated levels. In case of a breach or possible risk of significant deviation, measures are suggested to bring the ratio within levels of comfort.
- Third Line, Independent assurance – KPMG as the Internal Auditor and BDO as the External Auditor act as independent assurance providers for the internal control processes and highlighting any significant or material weaknesses.

In our view, PFCU's risk management system prima facies appear to be in line with widely accepted risks management practises and is deemed to be adequate in our view in absence of any information to suggest otherwise.

External

BDO, as PFCU's external auditor, acts as an independent assurance provider for the internal control processes and is responsible to highlight any significant or material weaknesses. BDO's latest audit report for FY22 revealed no significant or material weakness.

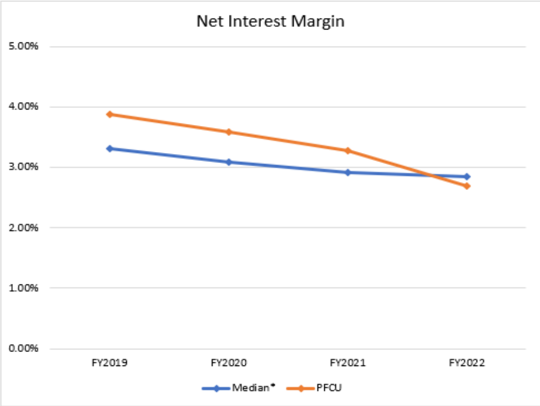
The Trust deed and the prudential norms prescribed by the RBNZ are the key source of external governance measures with which PFCU must comply. The details of the RBNZ's prudential requirements are mentioned in Section 5 and the table below summarises PFCU's compliance with select requirements of the trust deed and the RBNZ's prudential norms.

Ratio	Calculation	Sep22	Jun22	Jun21	Jun20	Trust Deed	Regulatory
Risk weighted capital ratio	Tier 1 capital as a percentage of risk weighted assets	19.4%	19.4%	20.8%	25.0%	>10%	>8%
Liquidity ratio	Cash equivalents and short-term deposits (<183 days) as a percentage of total assets	28.5%	31.2%	31.2%	30.3%	>10%	As appropriate
One-month mismatch ratio	Adequacy of liquid assets and next month's cash flows to total funding (or member deposits)	28.2%	31.3%	31.4%	31.3%	>0%	As appropriate
One-year funding ratio	Estimated funding that is expected to stay in place at least one year to total assets.	75.9%	75.8%	77.7%	84.0%	>70%	As appropriate
Related party ratio	Aggregate credit exposures to all the related parties as a percentage of tier 1 capital	1.3%	0.1%	0.6%	0.1%	<15%	<15%

7. Financial Indicators

7.1 Profitability

Net interest Margin



Source: Reported financial statements of Peer Group from FY19 – FY22.

**Median figure for FY22 is based on entities for which financial statements were available at Nov22.*

Most credit unions and NBDTs are largely dependent on retail deposits for funding, and hence, the NIM differences amongst peers is largely a function of variations in asset mix, and differing proportions of unsecured loans, secured personal loans, residential mortgages and term deposits with banks. Some credit unions have a higher-than-average NIM due to a greater exposure to higher risk personal loans which are advanced at a higher interest rate than traditional mortgages.

Loans to members (by PFCU) are extended in the form of personal loans secured by a charge on PSS/GSF, motor vehicle loans, unsecured loans, and residential mortgages. PFCU does not write low equity property loans and only offers one-year and two-year fixed interest rate mortgages.

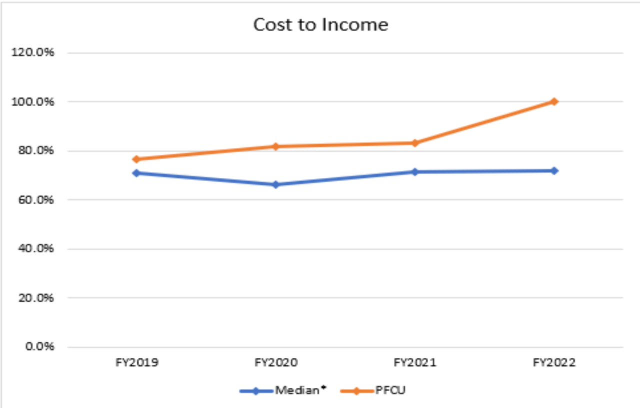
PFCU's net interest margin was better than the benchmark peers until FY21, however, the continued contraction in its NIM in FY22 has led to it now being worse than peers as shown in the graph above. PFCU's low interest cost during FY22 was supported by a reduction in term deposits (37.7% of total FY22 deposits, FY21: 39.4%), against call deposits (62.3% of total FY22 deposits, FY21: 39.4%) which attract minimal interest. However, a continued contraction is its loan book generated lower interest income, resulting in its net interest margin (NIM) deteriorating further to 2.7% in FY22 (FY21: 3.3%, FY20: 3.6%, FY19: 3.9%).

The gap between loan contraction and deposit growth (calculated as the sum of % decline in loan book and %

increase in members' deposits) increased to 19.2% in FY22 from 17.2% in FY21. While PFCU has noted that it seeks to manage this gap with an increased focus on increasing its loan book through an improved marketing strategy and the introduction of new loan products, the results of the same are yet to materially benefit its loan book and are likely to evolve over the next 6-12 months.

Excluding the share of profits from Finzsoft, PFCU reported a loss of ~$15k in FY22, indicative of increased competitive pressures and is evidenced in the continued contraction of its loan book. That said, we note PFCU's strong capitalisation and funding profile supports the liquidity and solvency of the business, and its ability to withstand periods of adverse operating performances.

Operating Efficiency



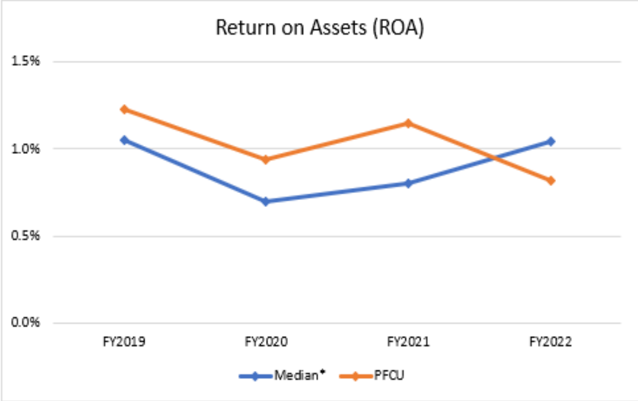
Source: Reported financial statements of Peer Group from FY19 – FY22.

**Median figure for FY22 is based on entities for which financial statements were available at Nov22.*

Owing to steady deterioration in NIMs and increasing overheads in recent years, PFCU's cost to income ratio has steadily deteriorated (since FY15) and has remained worse than its peers over the last four years. Despite a 1.8% reduction in operating costs in FY22, PFCU's cost to income ratio deteriorated to 100.3% (FY21: 83.1%, FY20: 81.9%, FY19: 76.8%).

The continued deterioration in PFCU's cost-to-income ratio mirrors the contraction of PFCU's NIM, which was worse than its peers. PFCU's efficiency is expected to remain under pressure until it can further reduce its operating costs and/or improve its earnings profile going forward.

Return on Assets (ROA)



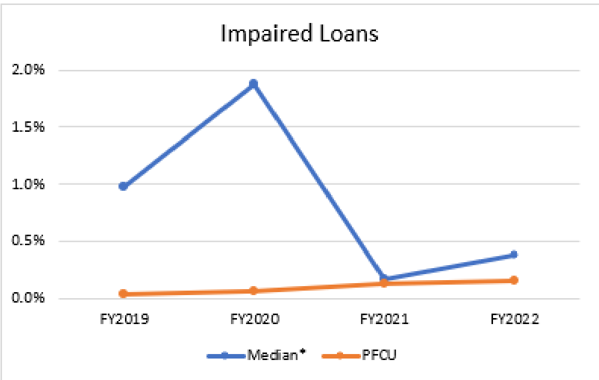
Source: Reported financial statements of Peer Group from FY19 – FY22.

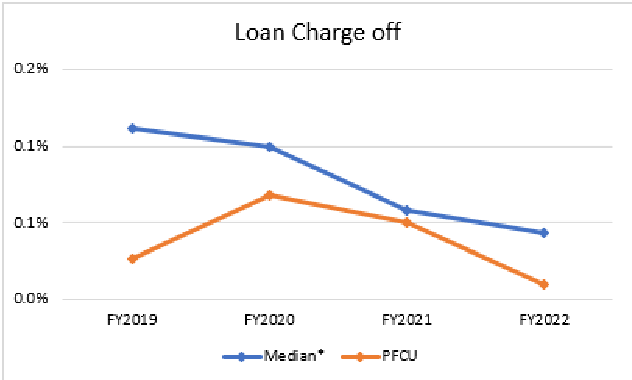
**Median figure for FY22 is based on entities for which financial statements were available at Nov22.*

PFCU's return on average risk weighted assets has declined to 0.8% in FY22 (FY21: 1.2%, FY20: 0.9%, FY19: 1.2%), falling below the sector average FY22. The decline stems from the compounding effect of a decline in earnings – which are primarily driven by an increase in lower yielding bank deposits and a contraction in its loan book. During FY22, PFCU's underlying earnings declined significantly (loss of ~$15k, excluding the share of profit from Finzsoft).

7.2 Asset Quality

<u>Impaired Loans</u>





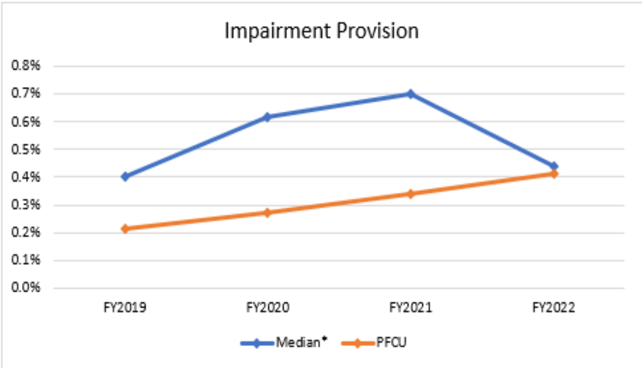
Source: Reported financial statements of Peer Group from FY19 – FY22.

**Median figure for FY22 is based on entities for which financial statements were available at Nov22.*

PFCU's portfolio exhibits low delinquency levels which reflects its high asset quality. PFCU's asset quality benefits from its relatively low exposure to residential mortgages (Jun22: 10.7%, Jun21: 9.5%, Jun20: 8.7%), low levels of unsecured loans in its portfolio (Jun22: 0.4%, Jun21: 0.7%, Jun20: 0.6%), and exclusive access to member's police payroll for loan repayments.

Non-performing loans (as a percentage of gross loans, 'NPLs') marginally increased to 0.2% at Jun22 (Jun21:0.1%), however, it remained better than the sector average. The increase was largely on account of declining loan book as the absolute value of impaired loans remained stable at $129k at Jun22 as compared to the prior year. Loans amounting to $61k were past due over 90 days but not impaired as at Jun22 (Jun21: $277k).

<u>Provisioning</u>

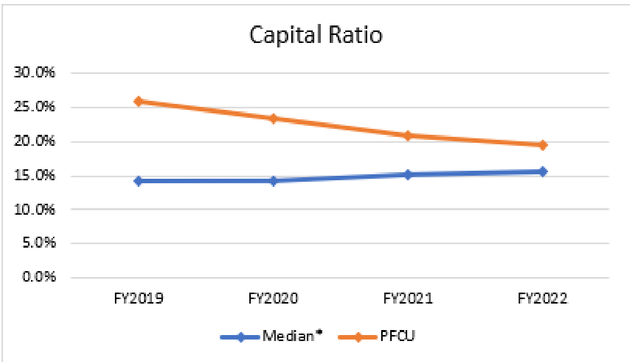


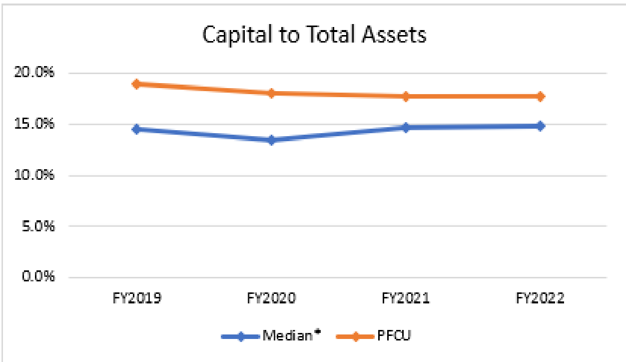
Source: Reported financial statements of Peer Group from FY19 – FY22.
**Median figure for FY22 is based on entities for which financial statements were available at Nov22.*

PFCU's loan provisioning (specific and collective provisions) increased to 0.4% of gross loans at Jun22 (Jun21: 0.3%, Jun20: 0.3%, Jun19: 0.2%). The total provisions remained stable at $129k at Jun22 as compared to the prior year, however, the percentage increase was attributed to a reduction in the gross loan amount.

Overall, PFCU's high asset quality is supported by its niche client base, which comprises government employees who provide an essential public service. PFCU's borrowers' employment, and hence capacity to repay, is not materially linked to macro-economic volatility.

7.3. Capitalisation





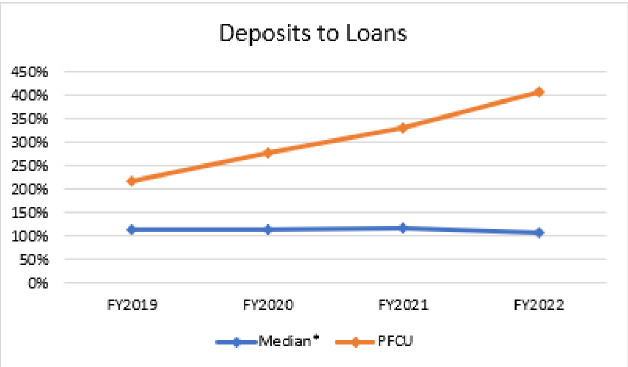
Source: Reported financial statements of Peer Group from FY19 – FY22.

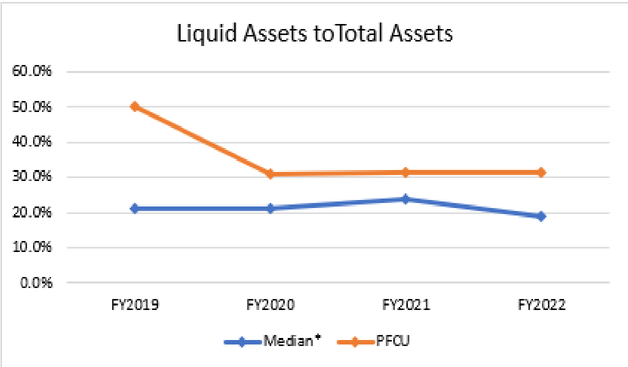
**Median figure for FY22 is based on entities for which financial statements were available at Nov22.*

PFCU's Capital ratio (Tier 1 capital to risk weighted assets ratio) is better than benchmark average as a result of its conservative financing (as its trust deed disallows raising of debt) and business strategy. The regulatory capital requirement for PFCU under the RBNZ guidelines is 8% (relates to credit unions that are rated by an RBNZ licenced credit rating agency). PFCU's Tier 1 capital requirement under its trust deed is 10%.

PFCU's tier 1 capital to risk weighted assets ratio declined marginally, with the ratio being reported at 19.4% in Jun22 (Jun21: 20.8%, Jun20: 23.3%, Jun19: 25.9%). While PFCU reported an increase in retained earnings and a contraction in its loan book as earlier, its $7.0m investment (Jun21: $6.3m) $5.5m (Jun21: $2.8m) subordinated loan to Finzsoft, are both deducted from the calculation of total assets and from the calculation of regulatory equity, resulting in a progressively lower tier 1 capital ratio over the last two years. While we note a downward trend in PFCU's tier 1 capital to risk weighted assets ratio over the last few years, it continues to maintain ample headroom above the regulatory/trust deed requirements, enabling it to adapt, in case regulatory changes require it to hold higher capital. We also note PFCU's tier 1 capital to risk weighted assets ratio remained stable at 19.4% at Sep22.

7.4. Funding and Liquidity





Source: Reported financial statements of Peer Group from FY19 – FY22.

**Median figure for FY22 is based on entities for which financial statements were available at Nov22.*

PFCU lacks access to wholesale funding. Member deposits, at call and fixed term, constitute more than 80% of the total funding for PFCU, the balance comprises retained earnings. A potential funding risk, posed by PFCU's constitutional prohibition on the use of wholesale funds, is mitigated by PFCU's above industry-average deposit to loan ratio.

Deposits in excess of loans are invested in highly liquid term deposits with major NZ registered banks, which provides a substantial liquidity buffer. PFCU's calculation of its liquidity ratio as per its trust deed is more conservative than the industry standard and only includes deposits maturing within 183 days in its computation of internal liquidity. PFCU's liquidity ratio, when calculated as cash equivalents and short-term deposits (<183 days) as a percentage of total assets, was 31.5% as at Jun22 (Jun21: 31.6%, Jun20: 31.2%, Jun19: 50.2%), which Equifax deems to be extremely conservative.

PFCU was assessed as having sufficient headroom to trust deed requirements with respect to liquidity, which supports PFCU's capacity to withstand a funding shock. Moreover, PFCU's members' deposits have a consistently healthy reinvestment rate. As of Sep22, the monthly reinvestment rate and the annual reinvestment rate were sound at ~88% and ~86% respectively.

8. Financial Benchmarks

Description	Percentile	XF	CSL	CUB	FD	FCU	GB	HBS	LF	MCF	NBS	WBS	GF	NZCUA	PFCU
Financial Year		FY2022	FY2021	FY2021	FY2022	FY2022	FY2021	FY2022	FY2022	FY2022	FY2022	FY2022	FY2022	FY2022	FY2022
Scale:															
Operating income ($ 000s)	46%	5,536	4,829	39,095	2,160	22,203	2,440	736	1,961	3,443	29,320	5,558	4,032	2,955	3,903
Total Assets ($ 000s)	69%	59,074	239,435	480,137	14,663	444,653	39,153	42,914	72,455	41,310	1,091,866	152,860	99,354	29,333	155,486
Gross loans ($ 000s)	23%	50,503	184,349	321,752	12,375	300,579	34,462	27,538	58,160	39,095	865,907	124,499	80,230	20,619	31,195
Profitability:															
Net Interest Margin (%)	38%	4.93%	-0.65%	7.03%	6.46%	3.38%	4.14%	1.54%	2.23%	5.71%	2.50%	3.01%	2.31%	6.94%	2.69%
Non Interest Income to total operating income (%)	8%	43.17%	8.06%	17.42%	57.55%	32.91%	21.56%	0.00%	2.29%	22.71%	3.66%	16.19%	34.57%	33.81%	1.92%
ROE (%)	15%	5.88%	6.22%	5.81%	-3.11%	4.96%	14.26%	13.83%	9.63%	19.44%	12.87%	6.49%	19.44%	-18.42%	2.46%
Return on assets (%)	38%	0.85%	0.80%	0.69%	-0.49%	0.71%	3.05%	2.11%	1.16%	3.15%	1.23%	0.92%	1.87%	-2.18%	0.82%
Cost to Income (%)	15%	84.79%	56.76%	93.17%	108.70%	83.06%	43.48%	87.91%	37.23%	45.51%	46.30%	61.07%	47.36%	119.52%	100.31%
Capitalisation:															
Leverage (Gross loans to Equity) (x)	100%	6.25	5.90	5.23	5.16	4.66	4.64	4.19	6.26	5.81	8.42	5.35	8.21	6.54	1.13
Capital ratio - risk adjusted (%)	92%	15.40%	14.90%	10.82%	13.30%	13.53%	16.58%	19.40%	22.80%	14.50%	12.39%	15.70%	17.92%	11.84%	19.43%
Capital to total assets ratio (%)	92%	13.62%	13.04%	12.70%	15.93%	14.39%	18.75%	15.33%	12.82%	16.20%	9.42%	15.17%	9.81%	10.75%	17.80%
Funding and liquidity:														0	
Gross loans as a % of total assets (%)	0%	85.12%	76.99%	66.33%	82.13%	67.60%	87.08%	64.17%	80.27%	94.05%	79.31%	81.45%	80.55%	70.29%	20.06%
Deposits to gross loans (%)	100%	99.34%	111.61%	124.87%	92.25%	124.53%	90.28%	130.68%	108.13%	85.69%	113.33%	107.69%	110.02%	122.14%	407.04%
Liquid assets to total assets (%)	100%	12.13%	21.01%	27.48%	6.91%	27.15%	11.46%	25.87%	18.78%	3.78%	19.94%	12.30%	18.97%	27.20%	31.46%
Asset Quality:															
Write-offs to gross loans (%)	62%	0.32%	0.00%	1.18%	0.00%	0.50%	1.81%	0.00%	0.56%	0.67%	0.01%	0.08%	0.00%	0.75%	0.01%
Impaired loans to gross loans (%)	62%	0.65%	0.00%	0.95%	2.76%	2.26%	1.83%	0.00%	4.68%	0.15%	0.02%	0.15%	0.61%	2.02%	0.16%
Impairment provision to gross loans (%)	69%	0.44%	0.00%	1.76%	2.68%	0.92%	1.07%	0.00%	0.62%	0.62%	0.44%	0.39%	0.25%	1.99%	0.41%

9. Summary Financial Data

Police and Families Credit Union Incorporated (PFCU)					
NZ$ 000s	Trend	FY19	FY20	FY21	FY22
Income Statement					
Net Interest Income		5,070	4,858	4,642	3,828
Non interest income		173	156	152	75
Operating Income		5,243	5,014	4,794	3,903
Operating Expense		4,029	4,107	3,986	3,915
Pre-Provision Operating Profit		1,214	907	1,041	675
Credit impairment charge		13	29	19	3
Operating Profit Before Tax		1,201	878	1,022	672
Other non Operating Income/(Expense)		0	0	0	0
PBT		1,201	878	1,022	672
Financial Position					
Total Assets		132,031	144,051	152,232	155,486
Customer Deposits		106,041	117,605	124,812	126,976
Loans		48,437	42,517	37,793	31,195
Liquid assets		48,902	44,889	48,046	48,914
Ratios					
PBT to operating income margin (%)		22.9%	17.5%	21.3%	17.2%
Net Interest Margin (%)		3.9%	3.6%	3.3%	2.7%
Cost/income Ratio (%)		76.8%	81.9%	83.1%	100.3%
Return On Assets (%)		1.2%	0.9%	1.2%	0.8%
Return on Equity (%)		4.8%	3.4%	3.9%	2.5%
Tier 1 Risk-Based Capital Ratio (%)		25.9%	23.3%	20.8%	19.4%
Tier 1 Capital to Total Assets Ratio (%)		19.0%	18.0%	17.7%	17.8%
Leverage Ratio - Total loans to Equity (x)		1.89	1.64	1.40	1.13
Charge-offs/Total loans (%)		0.03%	0.07%	0.05%	0.01%
Non-Performing Loans to Gross Loans (%)		0.04%	0.07%	0.13%	0.16%
Non-Performing Loans & Past Due to Gross loans (%)		1.0%	1.5%	2.2%	1.5%
Loan Loss Provision/Loans (%)		0.2%	0.3%	0.3%	0.4%
Deposits to loans (%)		218.9%	276.6%	330.3%	407.0%
Liquid assets to total assets (%)		50.2%	31.2%	31.6%	31.5%

*Liquid assets include cash reserves and term deposits maturing within 183 days.

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

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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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