Credit Ratings & Research

Credit Rating Report
Police and Families Credit Union Incorporated

Company No: 1802854

Credit Rating Report

Date: 29 November 2023

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.

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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 Jun23. The rating reflects PFCU's strong capitalisation, healthy funding profile and flexibility, the quality of its loan assets (benefitting from security position over NZ Police retirement accounts and access to NZ Police payroll) and the benefits of its strategic investment in financial technology solutions provider, Finzsoft - that support its overall earnings profile. The rating is constrained by PFCU's subdued core operating performance, increasing exposure to residential mortgages – which introduces market risks to its asset portfolio while impacting net interest margins (NIM's) The rating is also constrained by the potential impact of ongoing macroeconomic headwinds and competitive pressures.

Strengths

- PFCU's Tier 1 capital ratio remained strong at 23.3% at Jun23 (Jun22: 19.4%), being 2.8 times the minimum regulatory requirement of 8.0%. Capitalisation which has consistently remained above average, provides PFCU headroom to grow its risk weighted assets/loan portfolio while supporting some capacity to absorb unexpected performance volatility.

- PFCU's funding profile continues to be healthy and provides sufficient headroom to withstand funding shocks. A significant deposit book (Jun23: $128.0m), healthy reinvestment rates (12-month average of 88% at Jun23), coupled with a modest loan portfolio, have supported good funding flexibility, which is reflected in an above average deposit to loan ratio of 3.7x at Jun23 (Jun22: 4.1x, Jun21: 3.3x).

- The quality of PFCU's loan book remains supported by the strengths of its client base, which comprises government employees who provide essential public services. A large portion of PFCU's gross loan book (~65.0% at Jun23) 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/financial technology solutions provider Finzsoft Pty Ltd ('Finzsoft') in partnership with First Credit Union continues to contribute financial and operational benefits. Whilst PFCU's investment was initially a strategic necessity to secure operational capacity, the growth of the Finzsoft investment has provided some diversification to PFCU's earnings profile. Further, PFCU's investment in digitisation using Finzsoft's capabilities, to automate a majority of current manual tasks, is expected to improve application process times and drive operational efficiencies, going forward.

Constraints

- PFCU's underlying operating performance remained subdued in FY23 primarily due to rising funding costs. Despite growth in the loan book, there was no improvement in its core operating performance due to the repricing differences between funding costs and loan & deposit yields. We note however, that several new strategies to support loan growth resulted in gross loans increasing year-on-year for the first time since 2015 (Jun23: $34.4m, Jun22: $31.2m). Going forward, some improvement in core operating performance is likely, as deposits with banks and, loans to members reprice – leading to increased interest income. While PFCU operates as a not-for profit credit union, in our view, maintenance of stable operating performance is imperative in order to service its membership's needs sustainably.

- Macroeconomic headwinds continue to present challenges to sector asset quality while impacting growth potential over the near to medium term. Together with the wider economy, the NBDT sector, including PFCU, are likely to face the impact of inflation, which remains somewhat persistent due to demand pressures and global macroeconomic, geopolitical developments. If interest rates remain consistently high, this is likely to weigh on mortgage affordability and debt servicing while adverse movement in property prices could also impact industry participants' asset quality and collateral coverage.

- PFCU's overall exposure to residential mortgages and market risks related to property prices has increased at Jun23, stemming from lending for traditional mortgages as well as its new product offering – 'First Home Together'. As a result of this growth, asset quality is more exposed to the impact of adverse property price movements while the change in income mix will also lead to reported net interest margins trending lower than PFCU's historical averages. Meanwhile, we note that PFCU's current impaired assets remain very low due to borrowers primarily being government employees with relatively high job security and wage stability.

- Operating as a membership and family focused NBDT, PFCU's competitive position is influenced by its limited franchise. If PFCU is unable to grow its active membership while continuing to provide services desired by its existing members, its competitive position and capacity to operate sustainably could be impacted. We noted that in Feb23 PFCU expanded its definition of 'family' and proposed to provide products and services to employees of Fire and Emergency NZ, NZ Defence Force, St Johns and Wellington Free Ambulance, in a bid to expand its addressable market. Furthermore, recent membership drives, new product launches and reduced turnaround time on existing product applications have helped PFCU achieve a modest level of loan growth, potentially reflecting increased appeal for services from its membership.

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

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

Risk Rating

BB+

Outlook: Stable

Type: Public, Monitored

Industry Percentiles

Scale:	Percentile
Total Assets	38%
Gross Loans	23%
Profitability:	
NIM	15%
ROE	31%
ROA	31%
Efficiency Ratio	23%
Capitalisation:	
Leverage (Gross loans to Equity)	100%
Capital Ratio	92%
Capital to Total Assets	85%
Funding and liquidity:	
Deposits to Loan Ratio	100%
Liquid Assets to Total Assets	100%
Asset Quality:	
Net Charge-offs	31%
Impaired Loans	100%
Provision for Loan Losses	77%

Key Trends

Rising cost-to-income ratio and falling NIM

Net Interest Margin (%)
Cost to Income ratio (%)
FY20 FY21 FY22 FY23

Reducing leverage and increasing funding ratio

Deposit to Gross Loans (%)
Gross loans to Equity (x)
FY20 FY21 FY22 FY23

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	**29 November 2023**
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	**Management accounts for the three-month interim period to Sep23.** **Audited Financial statements for the years ended Jun23 (FY23), Jun22 (FY22) and Jun21 (FY21).**
Name of auditor	**BDO**
Other Information Sources	**PFCU's response to our requests for information, PFCU 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.

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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. Members can use PFCU-issued Debit MasterCard to access their funds through ATMs and carry 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 amended its rules to 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

Economic growth likely to remain weak in the near term as monetary policy remains restrictive.

On Wednesday 4 October, the Monetary Policy Committee (MPC) reached a consensus to maintain the official cash rate at 5.50%. MPC discussed the risks around the lagged effect of previous monetary tightening on households and businesses, and recent data showing continuing weak demand for credit other than for business working capital requirements. It was agreed the ongoing slowdown in economic activity is not even across sectors of the economy, due to global factors and the varied impact of high domestic interest rates - pockets of stress have emerged for some in the household, commercial property, and agricultural sectors. The Committee agreed that interest rates will need to remain at a restrictive level for the foreseeable future, to ensure consumer price inflation returns to the 1.0% to 3.0% target range while supporting maximum sustainable employment.

The MPC noted that globally, core inflation remains elevated and central banks are expected to keep monetary policy tight for some time. While the global economy's adjustment to higher interest rates has been relatively benign so far, the full impact is still to be seen and there are several tail risk scenarios. Key global risks in the near term include the possibility that central banks need to tighten monetary policy further, unanticipated impacts from previous tightening, potential spillovers from the current slowdown in the Chinese property market and escalation of the war in the Middle East.

New Zealand households and businesses are facing higher debt costs, but borrowers appear to be adapting so far.

The MPS noted that mortgage borrowers in New Zealand are relatively more exposed to higher interest rates because of higher household debt levels and the relatively short fixed-rate periods of New Zealand mortgages. Therefore, against the backdrop of heightened cost-of-living pressures, rising debt servicing commitments have squeezed households' budgets. More borrowers are under pressure on their debt obligations. Early-stage arrears have increased over the past six months and have now surpassed the levels seen at the start of the pandemic.

[1] The RBNZ Financial Stability Report Nov23, the RBNZ Monetary Policy Statement Aug23, the RBNZ Website and various Publications of RBNZ.

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RBNZ expects an increasing share of borrowers will face significant debt servicing stress. For many households that borrowed in 2020 and 2021, current interest rates exceed the test rates used by banks to assess affordability, and some may be particularly vulnerable to debt servicing stresses. Households that borrowed at high debt-to-income (DTI) ratios over this period are at risk, with estimated debt servicing ratios (DSRs) for borrowers from these two years expected to rise to around 50 percent by late 2023. While household incomes have grown strongly in recent years, further increases in interest rates may result in a larger rise in loan defaults. Banks report that the arrears which have occurred to date have largely been associated with unexpected individual events, such as illness or job loss, rather than hardship due to higher interest rates alone. However, there is a portion of lending still to reprice to higher interest rates and this will create more financial difficulties for some borrowers.

House Prices have stabilised, but recovery in prices and market activity has been broad-based as lending conditions remain tight.

The New Zealand housing market has stabilised following a decline in prices and activity since late 2021. Recent months have seen house prices rise modestly across most regions, supported by strong net immigration, though high interest rates continue to suppress buyers' borrowing capacity. The recovery in prices and sales activity has been broad-based across regions, and inventories of properties for sale have been gradually declining. The outlook for residential development has continued to deteriorate given the headwinds of high and uncertain interest rates, ongoing construction cost inflation, and the steady supply into the market of previously committed new builds. Pre-sales activity remains subdued, limiting the number of viable projects for which developers can obtain finance.

New Zealand's banking system is well placed to handle domestic and international pressures.

New Zealand's banking system remains well placed to handle potential external shocks and a downturn in the economy, as shown by recent stress tests. New Zealand banks' profitability has been robust in recent quarters, with a pick-up in net interest margins (NIMs) supporting a return of most profitability metrics to around pre-pandemic levels. Recent profitability partly reflects the lagged adjustment of banks' deposit funding costs to tightening monetary policy.

The four domestic-systemically important banks (D-SIBs) have been required to hold more CET1 capital since 1 July 2023, when the D-SIB buffer rose from 1 to 2 percent as part of the implementation of the Capital Review decisions. Requirements will continue to rise incrementally through to 2028, strengthening the buffers banks can use to cope with loan losses, and further improving the resilience of the banking system to manage severe shocks. Banks' liquidity positions are strong and capital ratios are well progressed towards meeting the higher requirements being phased in by 2028. Asset quality is currently high, but there remains a risk of a more significant and broad-based decline in asset quality if there is a material deterioration in the economy and the labour market.

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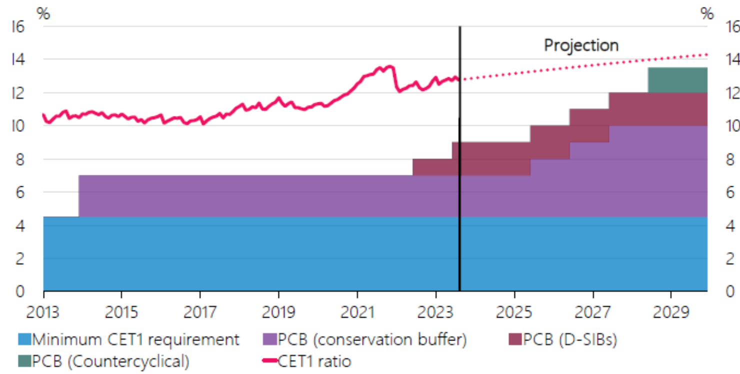
Common equity tier 1 ratio for domestic-systemically important banks[39]



Source: RBNZ *Bank Balance Sheet survey*, RBNZ estimates.

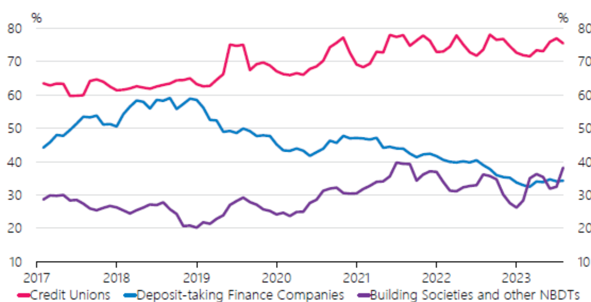
Note: CET1 is Common Equity Tier 1. PCB is the Prudential Capital Buffer.

(Source: RBNZ Financial Stability Report Nov23)

There has also been a broad-based slowdown in new lending by NBDTs over the last 12 months, driven by higher interest rates and the uncertain economic outlook. Some NBDTs with business particularly concentrated in residential mortgages have reported strong competition from banks for new lending. Non-performing loans have generally increased from low levels over 2023, most materially for deposit-taking finance companies. The resilience of New Zealand's NBDTs varies across the sector. While the NBDT sector as a whole continues to build capital buffers and improve operational efficiency, some NBDTs face ongoing challenges, largely due to a lack of scale. Building resilience is more difficult for these NBDTs, which may need to make changes to their businesses should challenges persist.

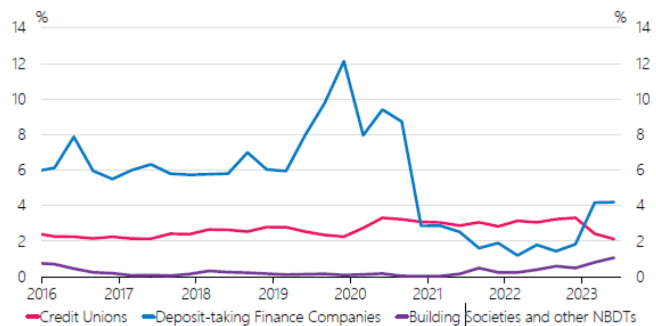
NBDT operating expenses to total income ratio

(3-month moving average)



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

NBDT non-performing loans ratio



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

(Source: RBNZ Financial Stability Report Nov23)

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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.

<u>New Zealand economy is in the midst of a necessary, policy induced slowdown.</u>

New Zealand recovered faster than most other advanced economies due to efficient management of the Covid pandemic. This supported activity and, together with generous fiscal and monetary support, resulted in strong investment, and private consumption. But this came at the cost of overheating against capacity constraints exacerbated by restrictions on labour movement due to border closures, and disruptions in global supply chains. Following significant monetary policy tightening, the economy is now slowing, but significant and persistent labour market constraints and the large positive output gap have kept inflation high. Labour market conditions remain extremely tight with record high labour force participation and historically low unemployment and underemployment rates. This has put upward pressure on wages, particularly in the services and construction sectors (Source: IMF, Mission Concluding Statement).

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 Oct23, the Monetary Policy Committee ('MPC' or 'the Committee') kept the Official Cash Rate (OCR) on hold at 5.5% (vs 5.25% at Ap23) after twelve consecutive rate hikes spanning a period of 20 months. MPC noted that inflation is still expected to decline within the target band by the second half of 2024 indicating that monetary policy will remain tight for the foreseeable future.

The above decision was taken in the light of recent data which suggests that tight monetary conditions are constraining domestic spending as expected. While GDP growth in the June quarter was stronger than anticipated, the growth outlook remains subdued amidst the restrictive monetary conditions.

Asset Price Movements

Rising interest rates reduce the current market value of long-term financial assets such as government bonds and mortgage-backed securities, potentially creating large unrealised losses for institutions holding these assets. Since early March 2023, a number of financial institutions in the United States and Europe have encountered difficulties and had their regulators intervene to mitigate the spread of panic to other institutions. However, New Zealand banks generally take on little interest rate risk, by having relatively short repricing profiles for their lending and funding, and using hedging instruments. Agriculture and commercial property stand out as business sectors where rising interest rates could lead to financial stresses, given these sectors' reliance on debt-financed physical assets such as property.

The New Zealand equity market outperformed markets in many other advanced economies initially during the COVID-19 pandemic, but it has weakened more recently. The recent underperformance may partly reflect the higher weighting of interest rate-sensitive sectors in the NZX50 index relative to many overseas indices. In the near term, the outlook for global equity prices is likely to depend on how much economic growth slows and how fast inflation declines.

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 been among the weakest performing major currencies in 2023 due to indication by the Reserve Bank to keep the interest rates on hold for the foreseeable future as opposed to potential further hikes in interest rates in other major developed economies. Other factors contributing to the weak performance include GDP contraction and volatile commodity prices particularly dairy and meat products, which are New Zealand's key export products.

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. 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.

There are currently 14 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 property lending products. At Jun23 total net lending by NBDTs was around $2.2bn, compared to $550bn 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.

Consolidation in the NBDT sector continues, particularly among credit unions. Overall, since 2018, the number of credit unions operating in New Zealand has fallen from 13 to 4. Many of the profitability challenges faced by the credit union sector are due to lack of scale and 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.

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Key metrics for Non-Bank Deposit Takers (NBDTs)

Metric	Segment	Value (end of June)				
		2019	2020	2021	2022	2023
Total assets ($m)	Finance Companies[1]	270	218	296	357	416
	Credit Unions	1,131	1,152	1,126	1,110	1,057
	Building Societies and Other[2]	1,217	1,303	1,400	1,550	1,608
Capital ratio (%)	Finance Companies	14.8	17.8	15.7	17.2	19.6
	Credit Unions	14.7	14.1	12.9	12.7	13.5
	Building Societies and Other	11.6	12.4	13.7	13.7	13.9
Non-performing loan ratio (%)	Finance Companies	7.3	10.3	1.9	1.9	4.8
	Credit Unions	2.5	3.3	2.9	3.1	2.1
	Building Societies and Other	0.1	0.2	0.2	0.4	1.1
Return on assets, before tax (%)	Finance Companies	1.7	1.9	1.8	2.4	2.9
	Credit Unions	-0.6	0.0	0.4	0.1	-0.8
	Building Societies and Other	0.9	0.9	1.2	1.5	1.0
Number of operating entities	Finance Companies	7	6	6	6	6
	Credit Unions[3]	9	9	8	5	4
	Building Societies and Other	4	4	4	4	4

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

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

2 Other NBDT refers to Christian Savings Limited.

3 Firefighters Credit Union merged with NZCU Auckland in June 2022, Westforce Credit Union merged with First Credit Union in August 2022, and Steelsands Credit Union merged with First Credit Union in December 2022. Fisher & Paykel Credit Union merged with First Credit Union in October 2023.

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, Loan-to-value ratio (LVR) and Debt Serviceability Restrictions (DSRs). 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 Jun23, RBNZ eased LVR restrictions on lending to investors, with loans having LVR above 65% being classified as high-LVR (vs previous limit of 60%) and restricts high-LVR lending to no more than 5% of a bank's total new

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investor lending. In addition, the maximum share of new lending to owner-occupiers with LVRs over 80% was increased from 10% to 15% from 1 Jun 2023. RBNZ noted that the previous restrictions built resilience in the financial system, which was evident in the house prices which fell without widespread impacts to financial stability. RBNZ noted that risks to financial stability posed by high-LVR lending have reduced to a level where they believe the previous restrictions may be unnecessarily reducing efficiency.

Debt serviceability restrictions, including DTI ratio limits, were added to the Reserve Bank's Memorandum of Understanding (MoU) on macro-prudential policy with the Minister of Finance in August 2021. Finalised debt-to-income (DTI) restriction framework was released 3 April 2023, however, does not immediately activate DTI restrictions or set a calibration for them. Instead, it provides banks with:

- clarity in terms of the definitions of debt and income and future data reporting requirements, and
- a timeframe for making any changes to their internal systems and processes to be able to comply with a possible DTI restriction in future.

DTI restrictions on residential mortgage lending, when implemented, set limits on the amount of debt borrowers can take on relative to their income.

Regulatory developments in New Zealand

The enactment of the Deposit Takers Act (DTA) in July 2023 was a major milestone and lays the groundwork for modern regulation and supervision of the deposit taking sector. The DTA creates a single regulatory framework for banks and non-bank deposit takers.

Commentary on RBNZ website and its other public releases note that it will take some years to develop and consult on the secondary legislation that will implement the regulatory requirements for the new regime and complete a licensing process for deposit takers to operate under the regime. The parts of the current Banking (Prudential Supervision) Act 1989 relating to the regulation and supervision of registered banks and the Non-bank Deposit Takers Act 2013 will remain in force until the remaining parts of the DTA have been fully implemented. The Depositor Compensation Scheme provisions of the Act are intended to be in place late 2024, before the rest of the Bill. Various industry engagements and consultants will continue to be held to develop policy, standards and regulations to support the commencement of the new regime by 2028.

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

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5. Prudential 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.

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 at least two independent directors and the chairperson must not be an employee of either the licensed NBDT or a related party and. 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. The trustee can require the licensed NBDT to have its risk programme reviewed, although RBNZ expect trustees would rarely need to exercise this power.
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%, or 12% under the Non-bank Deposit Takers (Credit Ratings Minimum Threshold) Exemption Notice 2016.
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	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".

directors and senior officers	
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

Interest Rate Risk

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 two 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 24.7% PFCU's total loans as at Jun23 (Jun22: 10.6%, Jun21: 9.5%).

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 period at 30 June 2023 Fixed Interest Rate Maturing:				
	Weighted average effective interest rate*	Floating Interest Rate	Within 6 months	6 months to 1 Year	1 to 5 Years	Non-interest sensitive	Total
		$ 000	$ 000	$ 000	$ 000	$ 000	$ 000
Monetary Assets							
Cash & Bank	**4.00%**	7,990	-	-	-	-	7,990
Term Deposits	**4.33%**	-	38,189	32,493	33,877	-	104,558
Loans to Members - Fixed	**6.37%**	-	889	1,101	5,931	-	7,921
Loans to Members - Floating	**9.56%**	26,360	-	-	-	-	26,360
Total Monetary Assets		**34,350**	**39,078**	**33,594**	**39,808**	**-**	**146,829**
Monetary Liabilities							
Members' Deposits	**2.94%**	72,822	34,250	16,985	3,969	-	128,026
Trade and Other Payables	**n/a**	-	-	-	-	292	292
Total Monetary Liabilities		**72,822**	**34,250**	**16,985**	**3,969**	**292**	**128,317**

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As at Jun23, PFCU modelled the sensitivity of its assets and liabilities to a 3.0% fluctuation in interest rates. Based on FY23 unaudited accounts, the impact on earnings from a 3.0% adverse movement in interest rates is estimated at ~$436k or ~76.1% of FY23 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 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 deposits maturing within 183 days in its computation of internal liquidity. Liquidity based on deposits maturing within 183 days was computed at 28.6% as at Jun23[1] (31.1% at Jun22[1] and 31.2% as at Jun21[1]), and in Equifax's view, it is deemed to be conservative, relative to peers.

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 (28.6% as at Jun23[1], 31.3% as at Jun22[1] and 31.4% as at Jun21[1]). Additionally one-year funding ratio (ratio of estimated 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 (78.4% as at Jun23[1], 75.4% 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.

[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.

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 two 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 Jun23) of unsecured loans. Exposure to loans secured by residential mortgages increased to 24.7% as at Jun23 (Jun22: 10.6%, Jun21: 9.5%, Jun20: 8.7%) driven by an increase in lending under this segment, including those in relation to its new product offerings. A large proportion (~65.0%) of PFCU's loan portfolio remains 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 relatively low concentration risk as the loans are spread across a large number of borrowers, however, with an increased lending towards mortgages the aggregate outstanding amounts over six largest borrowers has shown a modest increase, representing 13.1% of gross loans at Jun23 (Jun22: 6.5%).

- Credit risk on the PFCU portfolio is also mitigated by limited concentration to any particular geographic area. Residential mortgages are spread across main cities such as 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 the 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 372% as at Jun23. 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.

Service Delivery Platform

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 (comprising traditional residential mortgages, shared home ownership mortgages and reverse 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 has implemented a system to perform automatic review of members bank statements. 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. That said, we note that the change in lending mix (with increasing loans to residential mortgages versus its traditional PSS secured personal loans) exposes PFCU's asset quality metrics to adverse trends in property prices.

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
Gail Gibson	Director
Natasha Rodley	Director
Helen Hatchard	Director
Stuart Taylforth	Director
Bronwyne Rozier	Manager Operations/ Blue Trust
Denise Roberts	Lending & Credit Risk Manager
Amy Linwood	Manager Market and Products
Craig Pomare	Chief Executive Officer
Mathew Gray	Chief Financial Officer

PFCU's Board currently comprises six members – a Chair, a Vice Chair and four directors.

6.7 Governance and Oversight

Internal

PFCU's internal Credit Risk Policy governs the approval parameters for the loans to members. PFCU's exposure to mortgage lending has increased over the recent periods and offers fixed rates for a maximum term of two 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 PFCU's prices for fixed / floating home loans and personal loans, and deposit rates. The rates are compared with the big five 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 FY23 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	Jun23	Jun22	Jun21	Jun20	Trust Deed	Regulatory
Risk weighted capital ratio	Tier 1 capital as a percentage of risk weighted assets	23.3%	19.4%	20.8%	25.0%	>10%	>8%
Liquidity ratio	Cash equivalents and short-term deposits (<183 days) as a percentage of total assets	30.0%	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)	30.6%	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.	78.4%	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	0.0%	0.1%	0.6%	0.1%	<15%	<15%

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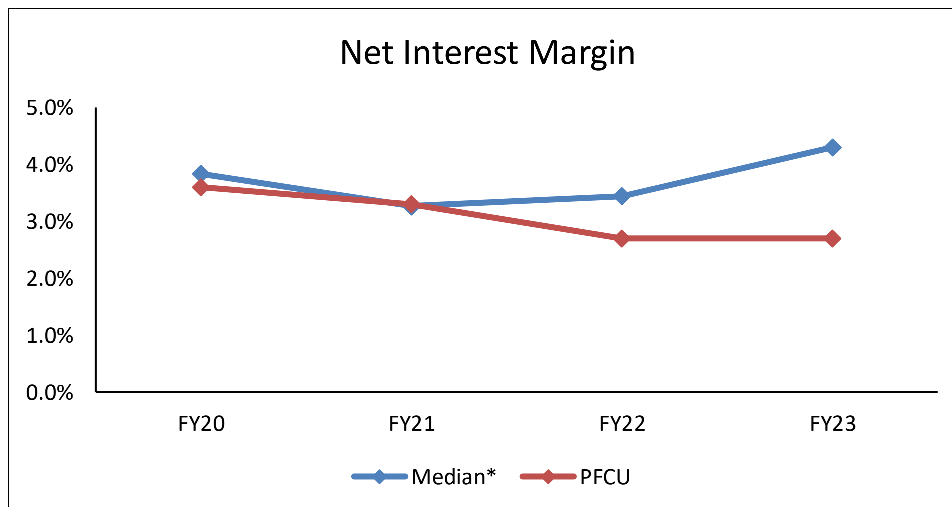
7. Financial Indicators

7.1 Profitability

Net interest Margin



Source: Reported financial statements of Peer Group from FY20 – FY23.

**Median figure for FY23 is based on entities for which financial statements were available at Nov23.*

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 historically did not write many property loans, however, its exposure to residential mortgages has increased more recently and the proportion of personal loan as a percentage of total loan book has reduced to 75.3% at Jun23.

PFCU's NIMs have trended downward since FY20, due to loan book contraction and is now worse than peers as noted in the graph above. However, we note that PFCU's NIM stablised at 2.7% in FY23 (FY22: 2.7%, FY21: 3.3%, FY20: 3.6%) supported by loan growth in the period. PFCU's interest cost increased during FY23, and despite the increase in income generating assets at Jun23 its interest income did not benefit from a rising interest environment primarily due to the timing of repricing on its term deposits held with NZ registered banks.

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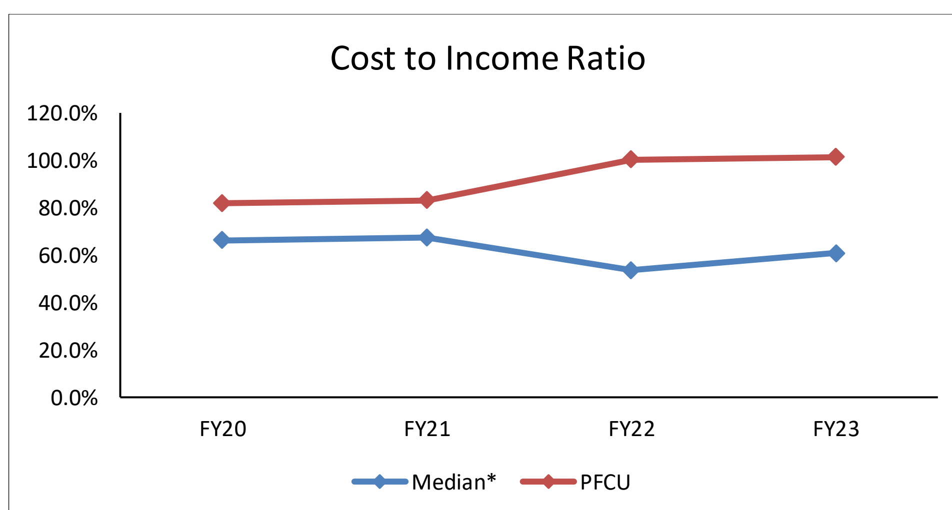
The gap between loan contraction and deposit growth (calculated as the sum of % decline in loan book and % increase in members' deposits) increased to 19.2% in FY22 from 17.2% in FY21. PFCUs focus on increasing its loan book through an improved marketing strategy and the introduction of new loan products, has resulted in a modest level of growth in loan book to $34.4m at Jun23 (Jun22: $31.2m), however, sustained results of the same are yet to materially benefit its loan book and operating performance.

Excluding the share of profits from Finzsoft, PFCU reported an underlying loss of $61k in FY23 (FY22: $15k), indicative of increased competitive pressures, slow growth in loan book in FY23 and lagged repricing on its term deposits. PFCU's term deposits at Jun23 have repriced at improved rates (based on weighted average rates on term deposits) and anticipated to benefit its underlying operating performance. We note PFCU's strong capitalisation and funding profile supports the liquidity and solvency of the business.

Operating Efficiency



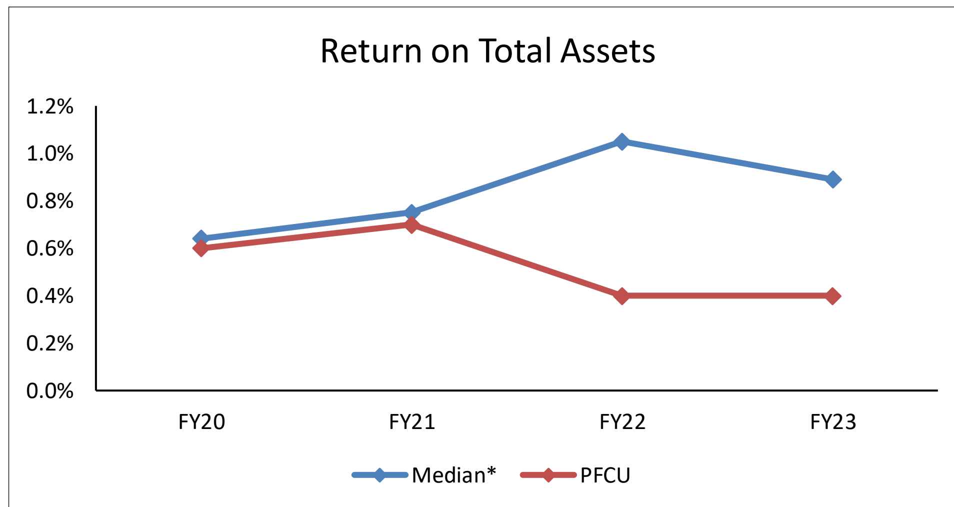
Source: Reported financial statements of Peer Group from FY20 – FY23.

**Median figure for FY23 is based on entities for which financial statements were available at Nov23.*

PFCU's cost to income ratio has steadily deteriorated (since FY15) and has remained worse than its peers over the last four years. A 1.3% increase in operating costs in FY23 combined with minimal increase in operating income underpinned further deterioration in PFCU's cost to income ratio to 101.3% in FY23 (FY22: 100.3%, FY21: 83.1%, FY20: 81.9%).

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

Return on Total Assets (ROA)



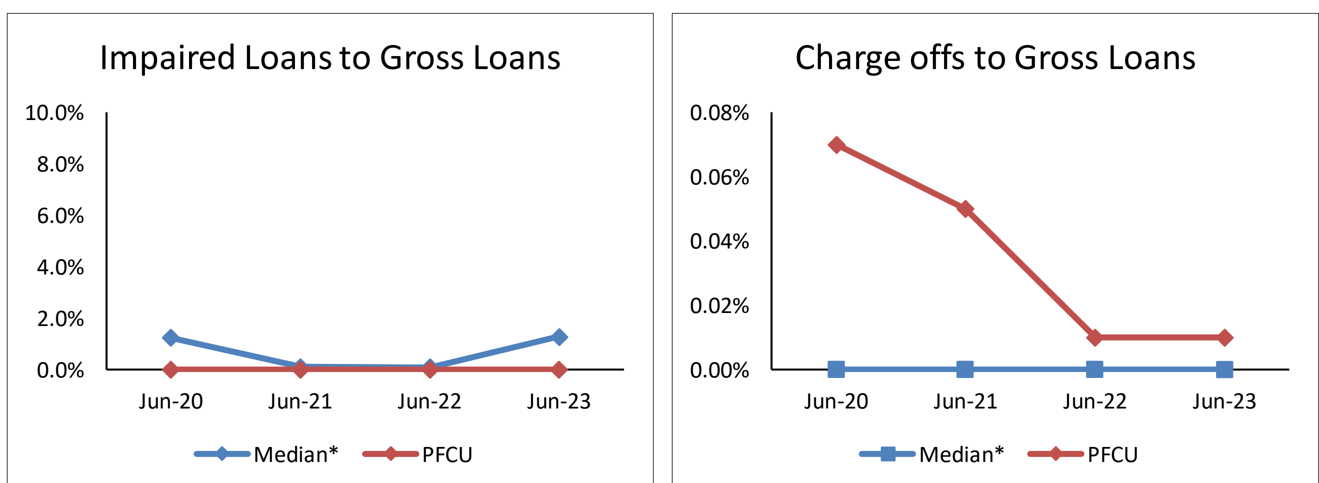
Source: Reported financial statements of Peer Group from FY20 – FY23.

**Median figure for FY23 is based on entities for which financial statements were available at Nov23.*

PFCU's return on total assets remained stable at 0.4% in FY23 (FY22: 0.4%, FY21: 0.7%, FY20: 0.6%), yet below the sector average FY23. The decline stems from the combined effect of the subdued earnings profile and the continued growth in assets, particularly driven by the increase in member deposits.

7.2 Asset Quality

Impaired Loans

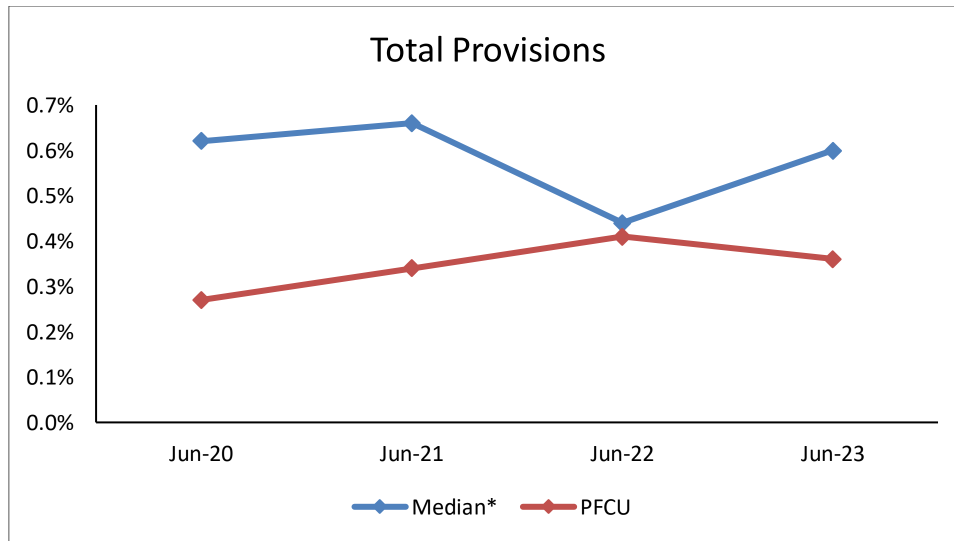


Source: Reported financial statements of Peer Group from FY20 – FY23.

**Median figure for FY23 is based on entities for which financial statements were available at Nov23.*

Despite its significant exposure to personal lending products, PFCU's portfolio currently exhibits low delinquency levels which in our view, reflects the quality of its borrowers and the security position over retirement accounts and access to NZ Police payroll . We note that PFCU's exposure to residential mortgages has increased recently to be 24.7% of its loan book at Jun23 (Jun22: 10.6%, Jun21: 9.5%, Jun20: 8.6%) in line with its focus on loan book growth.

Provisioning

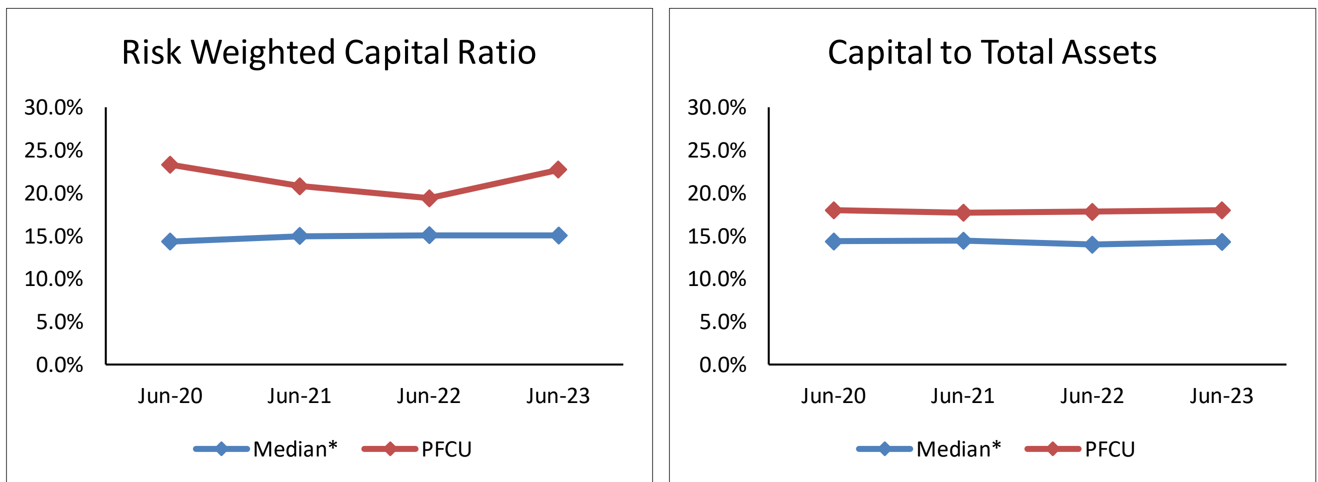


Source: Reported financial statements of Peer Group from FY19 – FY23.
**Median figure for FY23 is based on entities for which financial statements were available at Nov23.*

PFCU's loan provisioning (specific and collective provisions) remained stable at 0.4% of gross loans at Jun23 (Jun22: 0.4%, Jun21: 0.3%, Jun20: 0.3%). The total provisions remained largely stable at $123k at Jun23 (Jun22: $129k).

While growing exposure to mortgage lending increases market risks, in our view, PFCU's borrowers primarily comprise government employees who provide an essential public service. PFCU's borrowers' stability of 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 – FY23.

**Median figure for FY23 is based on entities for which financial statements were available at Nov23.*

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 improved at Jun23, with the ratio being reported at 23.3% (Jun22: 19.4%, Jun21: 20.8%, Jun20: 23.3%). PFCU had extended a total of $5.5m in subordinated debt to Finzsoft as at Jun22. As at Jun23, $4.5m of this debt was repaid to PFCU which underpinned the improvement in its net regulatory capital, resulting in an improved tier 1 capital ratio over the previous two years. PFCU 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 was 22.8% at Sep23.

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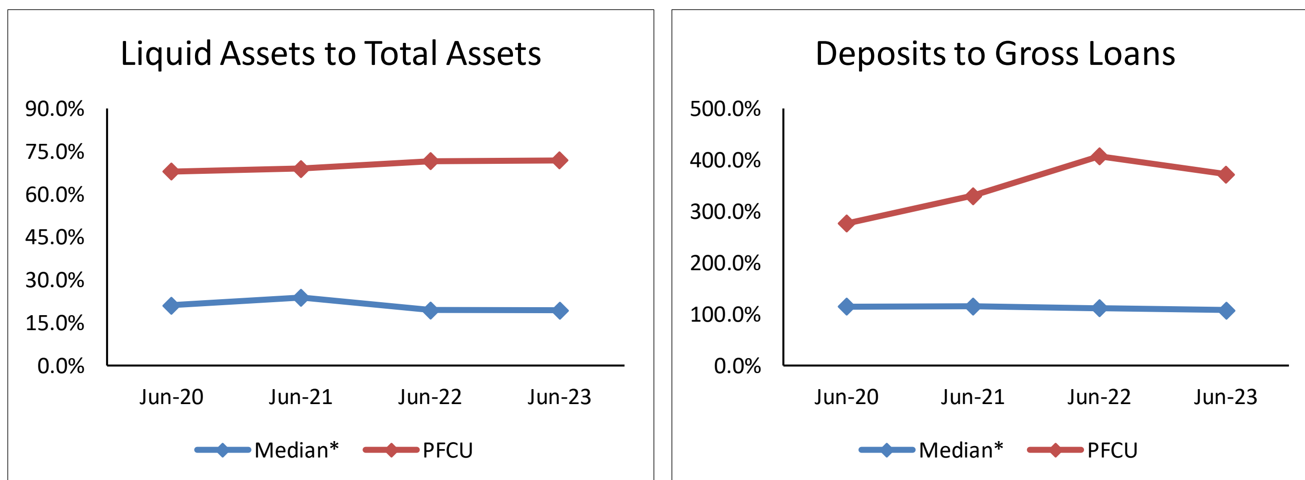
7.4. Funding and Liquidity



Source: Reported financial statements of Peer Group from FY20 – FY23.

**Median figure for FY23 is based on entities for which financial statements were available at Nov23.*

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 its 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 (available in <183 days) as a percentage of total assets, was 29.9% as at Jun23 (Jun21: 31.1%, Jun20: 31.2%), 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 Jun23, the average monthly reinvestment rate and the annual reinvestment rate were sound at ~91% and ~88% respectively.

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8. Financial Benchmarks

Description	Percentile	Liberty Financial Limited	General Finance Limited	Mutual Credit Finance Limited	Xceda Finance Limited	GoldBand Finance Limited	Finance Direct Limited	Nelson Building Society	Unity Credit Union	First Credit Union Incorporated	Christian Savings Limited	Wairarapa Building Society	Hertaunga Building Society	Credit Union Auckland	PFCU
Financial Year		FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY22	FY23
Scale:															
Operating income ($ 000s)	38%	2,859	7,555	3,954	6,410	3,281	3,492	33,322	37,054	27,276	6,187	6,634	453	2,358	3,912
Total Assets ($ 000s)	62%	67,546	128,462	60,192	89,454	50,303	19,518	1,138,268	412,215	460,964	285,805	164,135	38,918	29,527	156,775
Gross loans ($ 000s)	23%	52,542	109,611	57,621	71,819	44,453	17,311	894,577	259,058	332,326	211,169	148,429	25,360	20,619	34,404
Profitability:															
Net Interest Margin (%)	15%	4.1%	4.7%	5.9%	5.5%	5.6%	7.9%	2.9%	7.4%	4.3%	2.4%	3.8%	1.9%	5.9%	2.7%
Non Interest Income to total operating income (%)	15%	0.0%	29.1%	23.1%	37.2%	20.2%	64.1%	5.3%	18.2%	31.9%	4.9%	13.2%	-52.5%	37.4%	1.8%
ROE (%)	31%	9.5%	25.2%	18.7%	10.5%	15.7%	-0.4%	9.3%	-27.1%	3.5%	9.9%	3.1%	-4.3%	-9.1%	2.0%
Return on total assets (%)	31%	1.3%	2.8%	2.8%	1.2%	2.9%	-0.1%	0.9%	-3.3%	0.5%	1.2%	0.5%	-0.7%	-1.1%	0.4%
Cost to Income (%)	23%	25.6%	35.1%	45.3%	75.2%	36.9%	99.7%	50.4%	107.8%	87.9%	50.9%	60.9%	146.2%	107.6%	101.3%
Capitalisation:															
Leverage (Gross loans to Equity) (x)	100%	5.1	6.9	6.9	7.8	4.6	4.5	8.1	5.9	4.9	6.7	5.9	4.0	6.4	1.2
Capital ratio - risk adjusted (%)	92%	27.0%	21.8%	13.1%	15.4%	20.1%	16.5%	13.2%	10.3%	14.6%	14.2%	15.0%	20.1%	11.8%	23.3%
Capital to total assets ratio (%)	85%	15.1%	12.4%	13.9%	10.2%	19.4%	19.9%	9.7%	10.7%	14.8%	12.7%	15.4%	16.2%	11.0%	18.0%
Funding and liquidity:															
Gross loans as a % of total assets (%)	0%	77.8%	85.3%	95.7%	80.3%	88.0%	88.7%	78.6%	62.8%	72.1%	84.9%	90.4%	65.2%	69.8%	21.9%
Deposits to gross loans (%)	100%	105.9%	100.3%	86.8%	110.4%	84.6%	83.8%	113.6%	135.1%	116.3%	101.4%	91.0%	127.3%	122.1%	372.1%
Liquid assets to total assets (%)	100%	21.3%	14.3%	2.5%	18.3%	11.7%	4.8%	20.4%	32.8%	22.2%	13.1%	5.5%	25.0%	27.1%	71.8%
Asset Quality:															
Write-offs to gross loans (%)	31%	0.0%	0.0%	0.0%	0.4%	0.0%	0.0%	0.0%	4.3%	0.0%	0.1%	0.0%	0.0%	0.2%	0.0%
Impaired loans to gross loans (%)	100%	2.0%	3.7%	1.3%	6.2%	0.0%	2.0%	1.2%	2.3%	1.4%	0.0%	1.1%	0.0%	2.0%	0.0%
Total provision to gross loans (%)	77%	2.2%	0.7%	0.6%	0.5%	0.0%	2.1%	0.6%	4.4%	0.6%	0.1%	0.5%	0.0%	1.6%	0.4%

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9. Summary Financial Data

Police and Families Credit Union Incorporated					
$'000s	**Trend**	**FY20**	**FY21**	**FY22**	**FY23**
Income Statement					
Net Interest Income		4,858	4,642	3,828	3,840
Non Interest Income		156	152	75	72
Operating Income		5,014	4,794	3,903	3,912
Operating Expense		4,107	3,986	3,915	3,964
Pre Provision Operating Profit		907	1,041	675	575
Credit Impairment Charge / (Reversal)		29	19	3	9
Operating Profit Before Tax		878	1,022	672	566
Other non Operating Income / (Expense)		-	-	-	-
Net Profit		878	1,022	672	566
Financial Position					
Total Assets		144,051	152,232	155,486	156,775
Customer Deposits		117,605	124,812	126,976	128,026
Gross Loans		42,517	37,793	31,195	34,404
Liquid Assets		43,793	47,424	48,287	46,825
Ratios					
Profit Before Tax to Operating Income Margin (%)		17.5%	21.3%	17.2%	14.5%
Net Interest Margin (%)		3.6%	3.3%	2.7%	2.7%
Cost to Income (%)		81.9%	83.1%	100.3%	101.3%
Return on Total Assets (%)		0.6%	0.7%	0.4%	0.4%
Return on Equity (%)		3.4%	3.9%	2.5%	2.0%
Capital Ratio - Risk weighted (%)		23.3%	20.8%	19.4%	23.3%
Capital to Total Asset Ratio (%)		18.0%	17.7%	17.8%	18.0%
Leverage Ratio - (Gross Loans / Equity) (x)		1.5	1.4	1.2	1.3
Charges-offs to Gross Loans (%)		0.1%	0.1%	0.0%	0.0%
Neither Impaired or Past Due to Gross Loans (%)		1.4%	2.1%	1.3%	0.5%
Non-Performing Loans to Gross Loans (%)		0.0%	0.0%	0.0%	0.0%
Loan Loss Provision to Gross Loans (%)		0.3%	0.3%	0.4%	0.4%
Deposits to Gross Loans (%)		276.6%	330.3%	407.0%	372.1%
Liquid Assets to Total Assets (%)		30.4%	31.2%	31.1%	29.9%

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

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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.

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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.

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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		

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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.

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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 2022).

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

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