Credit Ratings & Research

Credit Rating Report

Police and Families Credit Union Incorporated

Credit Rating Report

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Prepared for: Police and Families Credit Union Incorporated

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Currency used in this report:

This report is presented in New Zealand Dollars unless otherwise noted

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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 downgraded PFCU's credit rating to 'BBB-' with a 'Stable' outlook from 'BBB' with a 'Negative' outlook.

The credit rating downgrade was premised upon a continued faster than expected contraction in PFCU's loan book, the proximity of which to breakeven level of operations has increased beyond our threshold to sustain the earlier 'BBB' credit rating. The loan book contraction reflects a sustained pressure on PFCU's competitive position, posed by both large traditional competitors as well as new disruptive business models. This, together with the prolonged low interest rate environment (forecast to extend for a foreseeable period), is expected to increasingly weigh on PFCU's profitability.

That said, PFCU's strong capitalisation and funding profile, high asset quality (benefitting from security position over NZ Police retirement accounts and access to NZ Police payroll), and conservative risk management policies continue to support its investment-grade credit profile.

Strengths

- PFCU's 23.5% Common Equity Tier 1 ratio (at Sep20) is approximately 3 times the minimum regulatory requirement (8.0%). This buffer provides PFCU with ample capacity to withstand several years of adverse operating performances.
- PFCU's funding profile continues to improve and provides it with sufficient headroom to withstand any funding shocks. A steady growth in consumer deposits, coupled with a smaller loan book, underpins PFCU's strong deposit to loan ratio of over 3x at Sep20 - the highest amongst peers.
- PFCU's high asset quality is supported by its niche client base, which comprises government employees who provide an essential public service. As such, PFCU's borrowers' employment, and hence capacity to repay, is not materially linked to macro-economic volatility.
- Moreover, a vast majority (~90%) of PFCU's loan-book is secured by a charge over retirement funds in the Police Superannuation Scheme (PSS) and the Government Superannuation Fund (GSF). This collateral, along with PFCU's access to NZ Police payroll, improves the likelihood of repayment and recovery of loans advanced to members.
- PFCU's prudent risk management practices befit its business model. It takes minimal repricing risk by offering limited fixed interest rate products and manages liquidity and concentration risks through a cap on maximum deposits from individual customers.

Constraints

- PFCU's small scale and the limited service offering means the business has a high exposure to competitive pressures from both - existing industry operators and new entrants. New Zealand's major banks' and top-tier credit unions' bid to maintain their scale, and the disruptive 'fintech' businesses' agility has inundated the market with various flexible consumer finance products competing with the traditional personal loans. This has underpinned the sustained contraction in PFCU's loan book, especially over the recent past where the rate of decrease has accelerated. In our view, competitive pressures may threaten the sustainability of PFCU's profitable operations, unless PFCU maintains its relevance in the consumer finance space with proactive customer-acquisition strategies and/or by broadening its product portfolio. While the management has recently increased its focus on improving PFCU's loan book (slowing the rate of contraction initially, followed by an increase in the loan book) by targeting underutilised marketing channels and increasing customer value propositions, the results of the same are yet to materialise and are expected to evolve over the next 6-12 months.
- A steady contraction in PFCU's loan-book is weighing on its operating flexibility and recurring earnings. PFCU's loans to customers have decreased to $41.4m at Sep20 (Jun20: $42.4m, Jun19: $48.3m, Jun15: $64.3m), necessitating PFCU to increasingly invest in lower yielding bank term deposits. The same has led to its NIMs and earnings declining to 3.1% and below $1.0m in FY20 – well off their peak level of 4.1% and $2.0m respectively in FY15. A continued loan-book contraction, together with the current low interest rate environment – which is expected to persist for a foreseeable future, can potentially render PFCU's net interest income unable to cover its overheads.

The outlook for PFCU's rating is 'Stable'.
A rating upgrade 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:

a. the inability of net interest income to cover overheads, and
b. the weakening of the balance sheet strength.

Risk Rating

BBB-

Outlook: Stable

Type: Public, Monitored

Industry Percentiles

Metric	Percentile
Scale:	
Total Assets	0%
Gross loans	0%
Profitability:	
NIM	57%
ROE	29%
ROA	57%
Efficiency Ratio	71%
Capitalisation:	
Leverage (Gross loans to Equity)	100%
Tier 1 Cap to RWA	100%
Tier 1 Cap to total assets	100%
Funding and liquidity:	
Deposits to loan ratio	100%
Liquid assets to total assets	100%
Asset Quality:	
Net Charge-offs	72%
Non performing loans	86%
Non performing and over 90day loans	100%
Provision for loan losses	100%

Key Trends

Increasing liquidity and falling NIMs

Reducing leverage and increasing funding ratios

2. Scope of Report

The purpose of this report is to provide an overview of the credit rating and associated rationale of 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	**20 Nov 2020**
Request Type	**Issuer (Self-assessment)**
Assessment Type	**Under ongoing monitoring**
Rating Initiation	**Issuer based (solicited)**
Rating Distribution	**Public**
Report Distribution	**Unrestricted**
Purchased by	**Police and Families Credit Union Incorporated**
Report Fee	**Fixed Price**
Ancillary fees	**Nil**
Issuer Name	**Police and Families Credit Union Incorporated**
Issuer First Time Rated	**No**
Issue Name	**Not Applicable**
Issue First Time Rated	**Not Applicable**
Financial Scope	**Consolidated Entity**
Entity Structure	**Credit Union**
Issuer Industry	**Financial Services**
Issuer Sector	**Non-Bank Deposit Takers**

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

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

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Information Sources	
Financial Statements	**Audited Financial Statements for the years ended Jun20 (FY20), Jun19 (FY19), and Jun18 (FY18), and** **Draft management accounts for the three-month interim period ended Sep20.**
Name of Auditor	**BDO**
Other Information Sources	**PFCU's website, industry and regulatory websites, management interviews, media articles, adverse searches, and other internet searches.**
Issuer Participation	**Yes**
Material Financial Adjustments	**None**
Limitations of Assessment	**None noted**
Outsourced Assessment Activities	**No**
Confidentiality Agreement	**No**
Material Client	**No**
Rating Amended Post Issuer Disclosure	**No**
Potential Conflict of Interest	**None noted**
Rating Methodology	**Financial Institution Rating Criteria**

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

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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 Licence	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.

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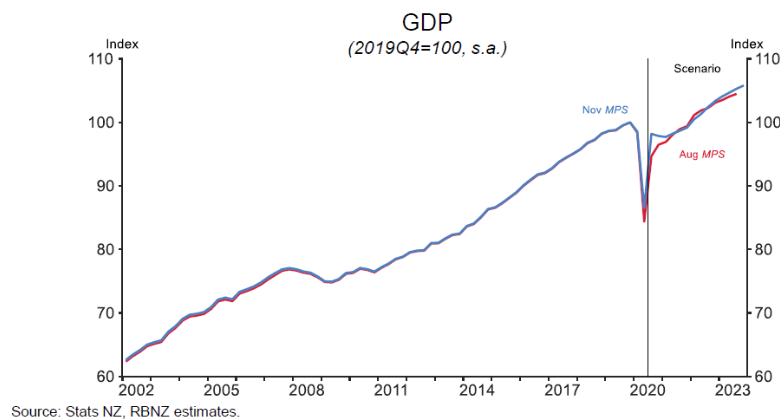
4. Industry Risk

COVID-19

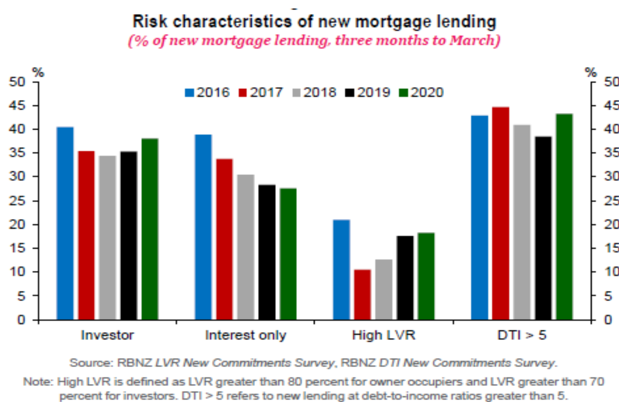
Economic activity in New Zealand and abroad has been curtailed by the outbreak of COVID-19 and the measures taken to contain it. While the initial impacts on activity in the Jun20 quarter were less severe than expected, the fall in output was the largest on record. A rebound in economic activity is under way, as social restrictions in New Zealand have eased. Household spending has returned to around the level it was at last year, although spending in some sectors remains soft. Government support and fewer New Zealanders travelling abroad through winter have helped lift domestic spending. Business sentiment has improved with the increase in demand.

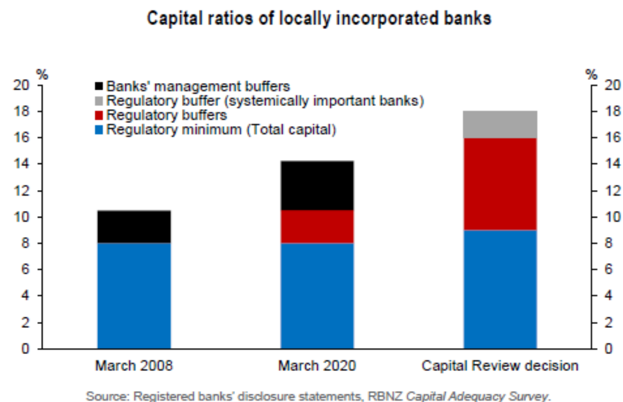
However, the virus continues to spread globally, and the economic impacts will be ongoing. Global economic conditions are softer and supply disruptions are continuing. Elevated uncertainty continues to affect business investment, and job losses are likely to dampen household spending. Meanwhile, the Wage Subsidy has more or less ended. The outlook depends on the progression of the pandemic. The baseline scenario for the economy is subdued, with inflation and employment remaining low for some time. Significant monetary stimulus remains necessary to deliver the inflation and employment objectives over the medium term.

(Source: RBNZ Monetary Policy Statement, Nov20)



Regulatory intervention is a key exogenous risk factor affecting financial institutions in the New Zealand market. It may impact the profitability as the institutions may be required to hold more regulatory capital due to an increase in minimum capital holding ratios, and/or the implementation of Basel III and Basel IV for risk-adjusted capital requirement computation. Additionally, regulatory intervention in the form of macro-prudential norms, like reductions in maximum LVR for residential mortgages, may add to demand side pressures in the financial services industry.





In Dec19, the RBNZ finalised decisions in its review of the capital adequacy framework for locally incorporated banks, including confirming the proposed increase in regulatory capital requirements from current settings. However, the transition to these higher levels of capital would be challenging for banks given the current economic environment. Hence, the RBNZ has deferred the implementation of its capital review decisions for a period of at least 12 months, with a future decision to resume the transition dependent on economic conditions.

Additionally, since Apr20, the RBNZ has prohibited banks from paying dividends to their shareholders, or redeeming non-CET1 capital instruments, until the economic outlook has sufficiently recovered to further support the capital positions of the banks.

NBDTs generally face lower risk from regulatory intervention than systemically important and tier 2 banks, however, NBDTs have less flexibility to respond to regulatory changes due to their smaller scale and lower diversity of operations. An increase in household debt-to-income and leverage ratios for the industry participants may force the RBNZ to introduce additional regulatory measures.

Complexity of operations – from multiple service delivery channels, a large range of products and/or segments, operations in multiple taxation and regulatory jurisdictions – results in operating risk. Unless mitigated by above average risk control and governance measures, such organisations would have a higher risk of loss due to process failures, fraud, and human error.

NBDTs, due to nature of their simple business model, would generally have lower complexity than systemically important and tier 2 banks.

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Market risk refers to the risk of loss due to changes in currency, commodity, asset prices, interest rates and other market traded instruments. Financial institutions that act as market makers are at greatest risk.

NBDTs have a lower willingness and tolerance for market risk than larger banks but have exposure to interest rate risk due to interest rate duration mismatch between assets and liabilities. Other forms of market risk may arise in the form of loans secured by property assets, loans in currency other than that of the domicile country, direct exposure to resources or loans to commodity producers.

The COVID-19 pandemic has disrupted economic activity globally and reduced demand for New Zealand's exports while challenging global supply chains. Cautious easing of restrictions by some countries allowing economic activity to resume, and reports of progress in vaccine development have contributed to a rebound in global equity prices and an improvement in financial conditions.

Cyclicality impacts household savings rates, corporate profitability, and asset valuations. Different stages in the economic cycle pose distinct risks. For instance, in a low rate environment, financial institutions would find it challenging to attract funding through customer deposits as savings rates fall whilst in a high-interest rate environment asset quality deterioration is the main risk. Adverse economic shocks such as a rise in unemployment, deflation or declining wages, an increase in interest rates can have an adverse impact on asset performance and give rise to credit impairments.

NBDTs heavy reliance on retail deposits for funding, limited product range, geographically concentrated operations and lack of scale makes them more susceptible to the adverse operating and financial impacts of cyclicality than systemically important banks and other tier-2 banks.

The RBNZ Monetary Policy Statement of Nov20 observes that business activity has been significantly affected by COVID-19. However, firms in some sectors and regions have been affected more than others. Since the first relaxation of the alert level restrictions, firms have noted a significant rebound in activity.

Many firms noted that demand was being underpinned by significant fiscal support, particularly from the Wage Subsidy. Most firms expected this support to be temporary. The higher alert level restrictions in Aug20 affected business and consumer confidence. For some businesses it highlighted that alert level restrictions could change with little warning, interrupting planned activity and day-to-day trading.

Starting in early 2021, many firms are expecting overall activity to weaken, following some government support schemes rolling off and potentially higher unemployment. This is contributing to the considerable uncertainty that firms are facing going into 2021.

Meanwhile, monetary policy measures such as the reduction in the Official Cash Rate (OCR), the Large-Scale Asset Purchases (LSAP) programme, the Funding for Lending (FLP) programme, and broader signalling of the monetary policy outlook have contributed to lower interest rates in the economy.

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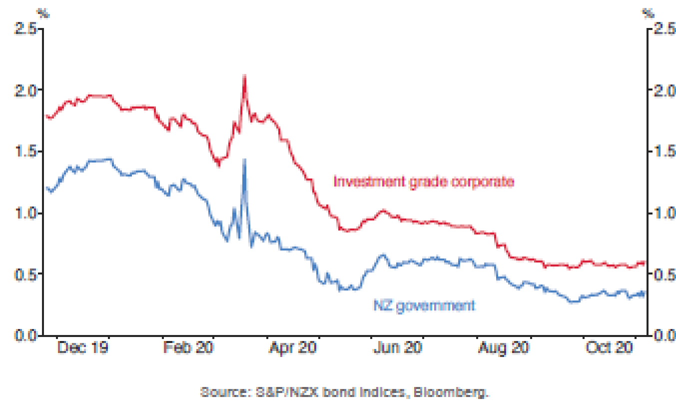


Source: S&P/NZX bond indices, Bloomberg.

Diversity of operations mitigates the risk of significant capital erosion in the event of a credit shock or contraction in demand for deposits or lending products. Risk concentration may be mitigated by a diverse product range, a wide range of customer demographic profile, operations in multiple geographies, exposure to consumer, commercial and corporate sectors, and generating higher proportion of operating income from non-interest income sources.

NBDTs offer a limited product suite and cater to a niche customer segment which limits their sources of funding, growth, and ability to respond to rapid shifts in customer preference.

Intensity of competition would, generally, be higher in markets offering lower protection in the form of regulatory entry barriers and exhibit a higher level of fragmentation. Price based competition, rather than differentiation, would also give rise to greater intensity of competition.

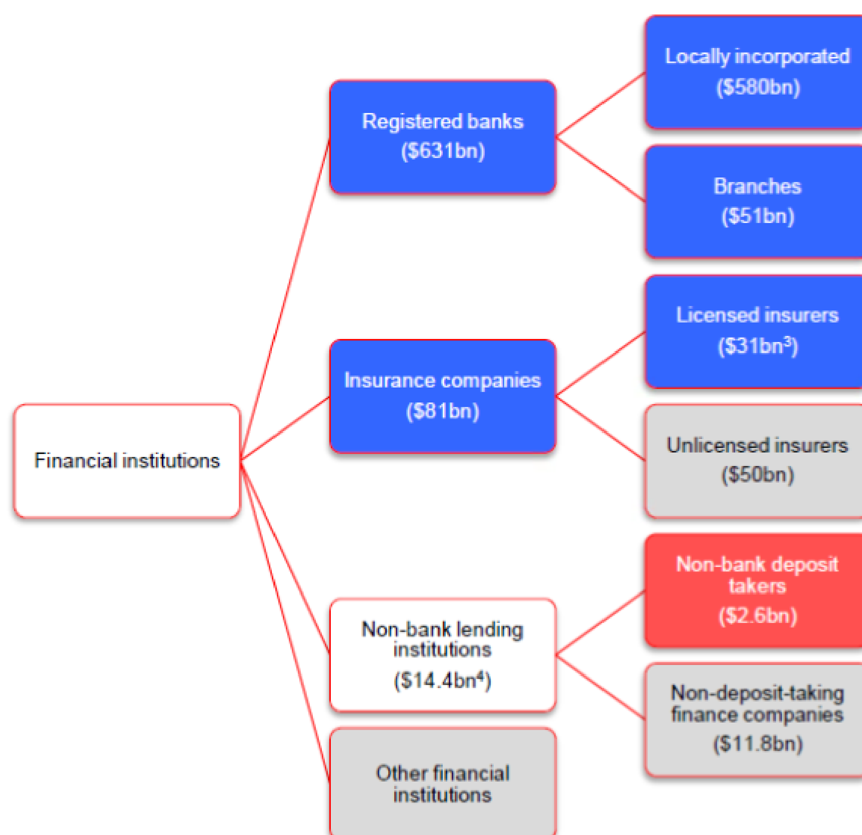
NBDTs would generally face greater competition, from traditional lenders and market disruptors like peer-to-peer lenders, than larger banks owing to the lower structural (e.g. investment) and artificial (e.g. regulatory) entry barriers vis a vis systemically relevant banks. Most NBDTs would be price takers for deposit and loan products whilst systemically relevant banks would likely compete on the basis of superior product features and pervasive branch networks.

5. Prudential Framework

The Reserve Bank of New Zealand Act 1989 gives the Reserve Bank of New Zealand (RBNZ) powers to regulate and supervise, banks and licensed insurers 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 these financial institutions.

The RBNZ also has regulatory responsibilities in relation to non-bank deposit takers. The prudential regulation of NBDTs is carried out under the Non-Bank Deposit Takers Act 2013 and associated regulations. However, the non-deposit taking non-bank lending institutions or unlicensed insurers are neither regulated nor supervised by RBNZ.

The NBDT sector is small, representing 0.6% of total deposits. There are currently 20 licensed NBDTs, of which one is in receivership.



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.

In addition to changes in ownership, credit rating, risk management process and board governance requirements, the RBNZ regulates NBDTs through the imposition of a minimum capital ratio of 10.0% (8.0% for

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NBDTs with a credit rating) and a maximum related party exposure of 15.0%. The RBNZ also requires NBDTs' trust deeds to include 1 or more quantitative liquidity requirements.

Following the Global Financial Crisis, the RBNZ developed a policy approach known as macro-prudential policy, which uses prudential instruments to manage the systemic risks that can develop during boom-bust financial cycles. The objective of the RBNZ's macro-prudential policy is to increase the resilience of the domestic financial system and counter instability in the domestic financial system arising from credit, asset price or liquidity shocks. The instruments of macro-prudential policy are designed to provide additional buffers to the financial system (e.g. through changes in capital, lending, and liquidity requirements) that vary with the macro credit-cycle.

Impacts of COVID-19 on regulatory initiatives

In Mar20, the RBNZ announced that it would delay or slow down most of its regulatory initiatives for an initial period of 6 months. This action was taken to reduce the regulatory impost on financial institutions and free up the RBNZ and industry resources to support the economy and tackle the challenges created by COVID-19.

Among other things, the RBNZ has deferred the implementation of its capital review decisions for a period of at least 12 months, with a future decision to resume the transition dependent on economic conditions. This is expected to support the banks' ability to provide credit to the economy during a period of lower earnings.

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6. Systemic Risk

NBDTs continue to have a different risk profile from banks. In spite of increased regulatory scrutiny, they can have a bigger exposure to risk, largely due to their small size, unique business models, and niche lending markets. Extending this, low or variable profitability means that NBDTs can be more vulnerable to liquidity and credit risks or may find it more challenging to adequately invest in their systems to keep pace with technology.

Impacts of COVID-19 – monetary and fiscal support

Maintaining access to credit is crucial to ensure that households and businesses that are facing temporary losses of income are able to meet their financial obligations. The RBNZ has worked alongside the banking industry and the Government to ensure credit markets remain open.

The RBNZ has delayed increasing capital requirements, imposed dividend restrictions, and relaxed few other rules to enable banks to better support customers.

In Mar20, the Monetary Policy Committee reduced the OCR to 0.25% from 1.0%, and noted that the rate was expected to remain at this level for at least the next 12 months. Also, the Committee announced a Large-Scale Asset Purchase (LSAP) programme to purchase $30bn New Zealand government bonds in the secondary market over 12 months.

In Aug20, the Monetary Policy Committee agreed to expand the LSAP programme up to $100bn to further lower retail interest rates and support the economy.

In Nov20, the Monetary Policy Committee agreed to provide additional monetary stimulus through a Funding for Lending Programme (FLP), commencing in Dec20. The FLP will reduce banks' funding costs and lower interest rates. The Committee agreed that monetary policy will need to remain stimulatory for a long time to meet the consumer price inflation and employment remit, and that it must remain prepared to provide additional support if necessary.

Further, ongoing support for domestic economic activity is being provided through significant government spending on business assistance and household income support. The NZ Government's Wage Subsidy Scheme has provided short-term support to firms that have lost income and has allowed them to retain staff. Additionally, the Government has introduced the Business Finance Guarantee Scheme, which provides small and medium firms with partially Government-guaranteed loans at a low interest rate to manage short-term income disruption.

Moreover, banks have offered household and small business customers loan deferrals, to help them manage short-term financial stress. They have also offered business customers working capital facilities to help them manage cashflow while incomes have been low. Banks have strong buffers of capital and liquidity. These have increased substantially in the past 10 years in response to increased regulatory requirements.

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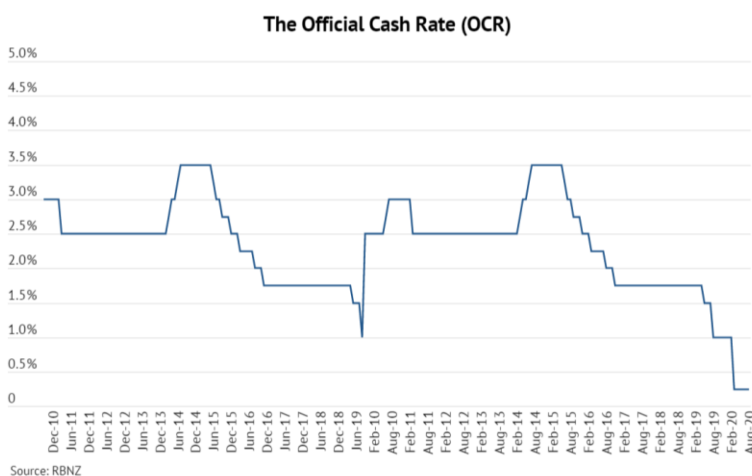
The RBNZ undertakes stress tests to understand banks' ability to absorb losses. While a considerable uncertainty about the economic outlook continues to remain, stress tests suggest that banks can withstand a broad range of adverse economic scenarios while retaining sufficient capital to continue lending.

Taken together, the above initiatives have had a significant impact on supporting the short-term financial needs of households and businesses. Maintaining the flow of credit to sound borrowers will contribute to the long-term stability of the banking system by reducing borrower defaults and preventing large falls in property prices and other asset values. Maintaining credit will also play a strong role in supporting the upcoming economic recovery.



7. Market Risk Exposure and Controls

PFCU's exposure to market risk is mainly in form of interest rate risk. PFCU has negligible exposure to currency and other price risks. It does not trade in financial instruments.

Interest rate: Interest rate risk is the possibility that the value of an asset or liability will adversely change as a result of an unexpected change in market interest rates. An entity is exposed to the effects of fluctuations in the prevailing levels of market interest rates on the cash flows relating to its financial instruments.

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 1 year. All other loan facilities are offered on variable interest rates. Also, PFCU has historically had minimal exposure to residential mortgages. Residential mortgages accounted for 9.6% and 8.7% of PFCU's total loans as at Sep20 and Jun20.

Earlier, PFCU's ALCO guidelines had stipulated that a minimum of 75.0% of total term deposits held with NZ registered banks should have a maturity shorter than 12 months. However, given the continued growth in PFCU's investment in liquid assets and the ratio of investments to its consumer loan-book, the ALCO guidelines were amended In Feb20. Accordingly, at present, PFCU's ALCO guidelines stipulate that a minimum of 70.0% of total term deposits held with NZ registered banks have a maturity shorter than 12 months. As at Sep20, PFCU remained within limits as 24.7% of its total term deposits had a duration of over 12 months. In our opinion, this recent amendment does not materially impact PFCU's interest rate or liquidity risk profile given its strong cash and cash equivalents. The interest rate risk on liabilities is minimised by limiting the duration of deposits to 24 months.

Repricing Gap Analysis ($ - Sep20)	Total	<6 months	7-12 months	13-24 months	25-60 months	>60 months
Financial Assets	**147,276,406**	**87,035,088**	**35,782,551**	**24,458,767**	-	-
Cash & equivalents	**6,915,053**	6,915,053	-	-	-	-
Bank term deposits	**98,898,265**	39,783,859	34,655,639	24,458,767	-	-
Loans to members	**41,463,088**	40,336,176	1,126,912	-	-	-
Financial liabilities	**125,553,000**	**108,091,735**	**12,844,969**	**4,616,296**	-	-
On-call shares	**72,843,239**	72,843,239	-	-	-	-
Fixed term shares	**52,709,761**	35,248,496	12,844,969	4,616,296	-	-
Difference	**21,723,406**	- **21,056,647**	**22,937,582**	**19,842,471**	-	-

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Repricing Gap Analysis ($ - Jun20)	Total	<6 months	7-12 months	13-24 months	25-60 months	>60 months
Financial Assets	**140,246,000**	**86,662,000**	**39,392,000**	**14,192,000**	-	-
Cash & equivalents	**4,636,000**	4,636,000	-	-	-	-
Bank term deposits	**93,209,000**	40,253,000	38,764,000	14,192,000	-	-
Loans to members	**42,401,000**	41,773,000	628,000	-	-	-
Financial liabilities	**117,605,000**	**100,196,000**	**13,036,000**	**4,373,000**	-	-
On-call shares	**64,556,000**	64,556,000	-	-	-	-
Fixed term shares	**53,049,000**	35,640,000	13,036,000	4,373,000	-	-
Difference	**22,641,000**	**- 13,534,000**	**26,356,000**	**9,819,000**	-	-

PFCU models the sensitivity of its assets and liabilities to a 1.0% fluctuation in interest rates. Based on FY20 annual report, the impact on earnings from a 1.0% adverse movement in interest rates is estimated at approximately $225k or 28.3% of FY20 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.

We have conducted a sensitivity analysis by testing the impact of a 0.5% reduction (from our base case forecast scenario – where the interest rates were largely based on the interest rates during the Sep20 quarter assuming no further reductions in OCR) in the interest rates on investments and loans to members for each of the next three years, while assuming no reduction on interest paid on consumer deposits. PFCU is expected to incur losses in each of the three years, thereby, highlighting a material risk to earnings from a sustained fall in NIMs. This is of particular relevance in the current low interest rate environment where there is high competition amongst industry players for personal loans and limited headroom to further reduce interest rates on member deposits (some of which are already nearing 0%) in response to any further reduction in interest rates on cash and investments. A reduction in the RBNZ's OCR from the current levels is likely to have a disproportionate impact on PFCU's net interest income.

Liquidity Risk: Liquidity risk is the risk that PFCU will encounter difficulty in meeting payment obligations associated with its financial liabilities when they fall due. It includes the risk that PFCU may not have sufficient liquid funds or be able to raise sufficient funds at short notice, to meet its payment obligations associated with financial liabilities when they fall due. This situation can arise if there is a significant mismatch of its financial assets and financial liabilities.

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 (<12 months) as a percentage of total assets is 53.2% as at Sep20 (57.8% as at Jun20 and 50.2% as at Jun19) – which Equifax deems to be conservative, relative to peers.

In the event of a breach in liquidity policy (liquidity ratio falls below 30.0% for a continuous seven-day period) it is incumbent on the CFO to provide a daily summary of cash flow movements and a weekly cash flow projection. The CEO must (in such a case) convene a Board Audit and Risk committee meeting, prepare an action

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plan, and notify the Chairman. A liquidity contingency plan is implemented if the liquidity ratio falls below 10.0% and is expected to remain below that threshold for more than 7 days.

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 30.5% as at Sep20[1] (30.3% as at Jun20[1] and 36.3% as at Jun19[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 (30.9% as at Sep20[1], 31.3% as at Jun20[1], and 39.7% as at Jun19[1]). Additionally one-year stable 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 (83.8% as at Sep20[1], 84.0% as at Jun20[1], and 84.1% as at Jun19[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 to mitigate the concentration risk associated with deposits. As of Sep20, there were 14 members that had deposits of greater than $250,000. Management advised these accounts are being monitored, with suitable actions already taken or likely to be taken in the near future.

[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.

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8. 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 form of mortgages or personal or other loans. Measures and controls adopted by PFCU to minimize risk of loss due to concentration to any individual counterparty include the following.

Term deposits with banks – The policies require that PFCU does not maintain more than 60.0% of its total liquid assets with any individual counterparty (NZ registered bank) with a credit rating of A- or better. Also, only up to 40% (amended in Feb20 from 20% earlier) of PFCU's liquid assets can be invested with any NZ registered bank with a credit rating of BBB or BBB+.

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 1 year, and all remaining offerings are on variable rates.
- Maximum tenure and loan amount for residential mortgages are set at 30 years and $500,000 respectively.
- Maximum loan amount and tenure for the loan secured by a charge on PSS/GSF and deposits ranges from $500,000 and 20 years to $10,000 and 7 years respectively depending upon the security cover provided.
- Maximum tenure and loan amount to purchase a motor vehicle or for any other approved purpose using motor vehicle as security are set at 5 years and $30,000 respectively. The minimum-security cover is 20%.
- The unsecured loans are restricted to a maximum of $20,000 and upto 5 years.
- PFCU has a very low proportion (0.4% of total loan book as at Sep20) of unsecured loans. Exposure to loans secured by residential mortgages is also conservative at 9.6% of the total loan book as at Sep20.
- 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. Also, PFCU has an exclusive access to payroll for the NZ Police employees. This access gives PFCU first right to a borrower's payroll to fund repayment dues.

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- PFCU’s loan book has low concentration risk as the loans are spread across a large number of borrowers. Residential mortgages, which are the largest loans, totalled $4.0m across 30 loans, averaging ~$133k per loan.
- 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. Maximum residential mortgage exposure is in Auckland which is more or less in line with the general population concentration in the region.

9. Competition

PFCU competes with other NBDTs, NZ registered banks and other new disruptive lenders in the domestic market for attracting deposits for funding and to underwrite loans to customers. PFCU's explicitly stated strategic intent is to service the needs of its niche client base; it prioritises the safety and attractive pricing of its products over pure profit and revenue growth motives. PFCU has policies for pricing frameworks that help it maintain the attractiveness of its pricing. PFCU's Pricing Committee meets weekly and aims to maintain a competitive interest rate position in the market for its members.

The competitive landscape in New Zealand is monitored by the RBNZ and the Financial Markets Authority. The RBNZ regulates banks, NBDTs, licensed insurers and financial market infrastructure. The Financial Markets Authority is responsible for licensing and regulating P2P lenders and ancillary financial services providers (auditors, brokers, custodians, financial advisers, fund managers and others).

The structural entry barriers protecting systemically relevant banks offer them a competitive advantage in attracting 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 insulate their customers 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 that can't be matched by NBDTs. NBDTs, like PFCU, have to offer customers a better value proposition and to compete on price to retain existing customers and win new customers.

P2P lenders are a new class of disruptors in the financial service market. They provide a platform for market participants to lend and borrow funds directly from each other rather than having to deal with an intermediary such as a bank.

The threat of new and disruptive business models that affect market structure, through a new value offering to customers, poses a threat to banks' and NBDTs' margins and market share alike. Changes in the regulation of the financial services sectors in Australia and New Zealand have made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic payments systems, mortgages, credit cards, and other loan products. In addition, it is possible for existing entities operating outside of the traditional financial services sector to obtain a banking license and offer products and services that have been traditionally provided by banks.

The effect of competitive market conditions, especially in the personal loan market, has led to an erosion in PFCU's market share, and has adversely affected its business operations, and financial position. The same is

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evidenced by the persistent contraction in PFCU's loan-book. The loan-book has decreased to $41.4m as at Sep20 (Jun20: $42.4m, Jun19: $48.3m, Jun18: $53.7m, Jun17: $57.5m, Jun16: $60.6m and Jun15: $64.3m), and the rate of decrease has accelerated in the recent years. Consequently, this has forced PFCU to invest funds freed up from this loan-book contraction, together with the increase in equity and consumer deposits, in low-interest rate earning fixed deposits with banks.

Given the current economic slowdown and the prolonged low interest environment (forecast to persist for a foreseeable future), New Zealand's major banks and top-tier credit unions are bidding to maintain and grow their scale to protect earnings. The same has led to these large lenders offering financial incentives on mortgages and re-draw facilities, which are competing with personal loans. Moreover, the agile business model of disruptive 'fintech' businesses have afforded them to offer various flexible and tailor-made consumer finance products - like peer-to-peer lending and buy-now-pay-later offerings, also competing with the traditional personal loans. Competitive pressures may threaten the sustainability of PFCU's profitable operations unless PFCU maintains its relevance in the consumer finance space with proactive customer-acquisition strategies and/or by broadening its product portfolio.

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10. 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 now owns itself rather than trustees owning it on behalf of the members.

In spite of the above recent 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 loan ratio of 303.4% as at Sep20. 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 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 expected to launch an automated document signing system in the near future.

Management also advised PFCU is currently in the process of updating its website.

1 Oct 2017 onwards, PFCU solely uses Westpac for settling transactions of PFCU issued Debit MasterCards. The operational risk management for disruption in services is outsourced but remains an operational risk.

11. Strategic Vision

PFCU’s main strategic objective is to remain relevant to its members. Its focus 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.

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12. 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. Since the aim of PFCU is not profit maximisation, it is able to offer attractive prices while maintaining long-term profitability and solvency of the business. With the recent contraction in the loan book, PFCU's management has recently increased its focus on targeting underutilised marketing channels and increasing customer value propositions. The results of the same 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. PFCU spent $48k during FY20 on this initiative (FY19: $118k, FY18: $142k, FY17: $233k, FY16: $181k, FY15: Nil). Spending reduced during 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.

Shadow Board: The shadow board initiative was implemented in FY18 to position the Board for 2025 so that it is relevant and competent, with a strong governance base, good succession planning and diversity of thought in order to take PFCU forward for another 50 years. Applications are invited at the end of the calendar year and the six positions are appointed by the following February. The shadow board meets twice a year for 2 days each time. The first day is made up of governance training with a strategic issue to focus on. The second day, the shadow board sits as observers in the full Board meeting and also presents to the Board their conclusions and recommendations to the strategic issue.

13. Management

Name	Position
Lane Todd	Chairman
Ian Harris	Vice Chairman
Amelia Steel	Director
Charles Ip	Director
Gail Gibson	Director
Richard Middleton	Director
Luke Shadbolt	Director
Helen Hatchard	Director*
Joe Bishop	Chief Executive Officer
Lucy Haberfield	Chief Financial Officer
Bronwyne Rozier	Manager Operations / Blue Trust
Amy Linwood	Manager Market and Products
Richard Dunn	Manager Member Services

*provisional on passing the suitability requirements of RBNZ

PFCU's Board currently comprises 8 members – a Chairman, a Vice Chairman and 6 directors. Subsequent to FY20, Richard Middleton was replaced by Lane Todd as PFCU's Chairman. However, Richard continues to be one of PFCU's directors. The other notable recent change was the appointment (provisional on passing the suitability requirements of RBNZ) of Helen Hatchard as a director based on her financial services experience spanning over 30 years. After ~6.5 years of service as PFCU's CEO, Helen tendered her resignation in Oct19, effective Feb20. She was replaced by Joe Bishop who started in Apr20.
Additionally, PFCU's Board includes 2 observers – an appointee each from the NZ Police Association (this position is currently vacant) and the Police Leader's Guild (Stuart Taylforth).

Overall, the Board composition is strong with none of the 8 members holding an executive position in the business. The maximum period within a given term for a member of the Board is 3 years. A member can be elected to the Board for up to 3 terms, taking the maximum total possible years of service to the Board to 9 years.

Joe Bishop, CEO

Joe joined PFCU as its CEO in Apr20. Originally from the UK, Joe has over 20 years of experience in financial services in London and Wellington. Prior to joining PFCU, he was the Chief Customer Officer at Kiwi Wealth having spent 8 years leading all aspects of Kiwi Wealth's retail proposition development, distribution, innovation, product, and marketing.

Lucy Haberfield, CFO

Lucy joined PFCU as the CFO in Oct19. Lucy has over 20 years' experience across a broad range of industries and organisations, including central government, education, health, construction and more recently banking. Lucy has held senior corporate services roles and is a Chartered Accountant. She also holds a Master of Management Studies, a Post Graduate Diploma in Accounting and Finance, and a Diploma in Marketing.

We opine PFCU's Board and Senior Management have adequate skills, experience, and expertise, and are well suited to help PFCU navigate the current competitive and regulatory challenges faced by financial sector firms worldwide.

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14. Governance and Oversight

Internal

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 1 year 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 3 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 4 banks and other banks like KiwiBank, 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.

External

PFCU is an RBNZ-licenced NBDT and is governed by the RBNZ under the Non-Bank Deposit Takers Act 2013. Licensed NBDTs are required to comply with prudential requirements outlined in the Non-Bank Deposit Takers Act 2013, the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010 and the Deposit Takers (Liquidity Requirements) Regulations 2010. The governance under the NBDT regime requires PFCU to adhere to the following requirements in form of minimum capital ratio covenant, liquidity requirements, and other negative/positive affirmation covenants on an ongoing basis –

1. Credit ratings (in force since 1 Mar 2010) – Licensed NBDTs are required to have a local currency (New Zealand dollar), long-term, issuer rating, given by one of the approved rating agencies.
2. Governance (in force since 1 Dec 2010) – 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.
3. Risk management (in force since 1 Sep 2009) – Licensed NBDTs are required to have a risk management programme that outlines how the licensed NBDT identifies and manages its key risks.
4. Capital (in force since 1 Dec 2010) – 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 the licensed NBDTs' trust deeds. This ratio must be at least 8.0% 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 10.0%.
5. Related party exposure limits (in force since 1 Dec 2010) – Related party restrictions require a limit on the aggregate credit exposures of a licensed NBDT, or its borrowing group, to all related parties to be specified in licensed NBDTs’ trust deeds. The related party exposures should not exceed a maximum limit of 15.0% of capital.
6. Liquidity (in force since 1 Dec 2010) – 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.
7. Suitability assessment of directors and senior officers (in force since 1 May 2014) – Licensed NBDTs must notify the RBNZ when one of its directors or senior officers (or a person who it is proposed to be appointed as a director or senior officer) raises a "suitability concern". The RBNZ will then carry out a suitability assessment of that person.
8. Changes of ownership (in force since 1 May 2014) – An application must be made to the RBNZ to approve a transaction that will result in a person:

- having the direct or indirect ability to appoint 25.0% or more of a licensed NBDT's governing body; or
- having a qualifying interest in 20.0% or more of the voting securities issued by the licensed NBDT.

A transaction having this effect can only proceed with the RBNZ's approval. The RBNZ must also approve if a person proposes to increase their influence above their currently permitted level.

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 FY20 revealed no significant or material weakness.

PFCU tracks its capital adequacy and liquidity related ratios on an ongoing basis to comply with above regulations. The following table details PFCU's performance in respect of the above-mentioned parameters vis-a-vis the regulatory requirements and the trust deed.

Ratio	Calculation	Sep20	Jun20	Jun19	Trust deed	Regulatory
Risk weighted capital ratio	Tier 1 capital as a percentage of risk weighted assets	23.5%	23.3%	25.9%	>10%	>8%
Liquidity ratio	Cash equivalents and short-term deposits (<183 days[2]) as a percentage of total assets	30.5%	30.3%	36.3%	>10%	As appropriate
One-month mismatch ratio	Adequacy of liquid assets and next month's cash flows to total funding (or member deposits)	30.9%	31.3%	39.7%	>0%	As appropriate
One-year funding ratio	Estimated funding that is expected to stay in place at least one year to total assets.	83.8%	84.0%	84.1%	>70%	As appropriate
Related party ratio	Aggregate credit exposures to all the related parties as a percentage of tier 1 capital	<1%	<1%	<1%	<15%	<15%

[2]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.

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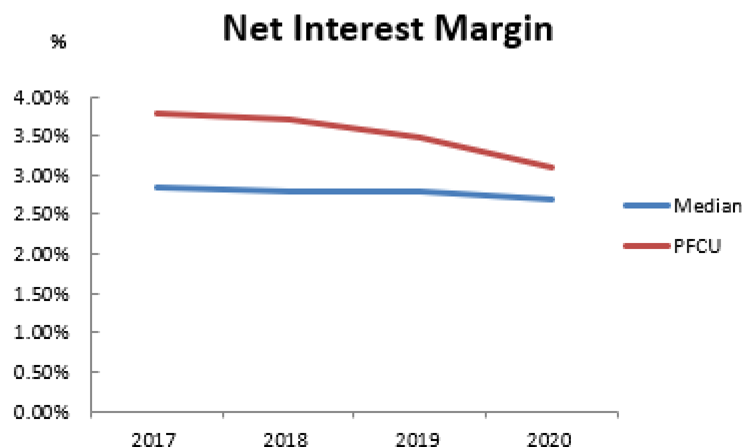
15. Profitability

Net Interest Margin



PFCU's net interest margin is better than the benchmark peers. 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 fixed interest rate mortgages.

PFCU has faced a sustained contraction in NIMs since FY15. The NIM was calculated at 3.0% for the three-month interim period ended Sep20 (FY20: 3.1%, FY19: 3.5%, FY18: 3.7%, FY17: 3.8%, FY16: 3.9%, FY15: 4.1%). PFCU has placed higher deposits with banks (Sep20: $107.6m, Jun20: $97.8m, Jun19: $82.6m, Jun 18: $73.5m, Jun 15: $43.6m), as loans to members have steadily decreased since FY15 (Sep20: $41.4m, Jun 20: $42.4m, Jun 19: $48.3m, Jun 18: $53.7m, Jun 15: $64.3m), in addition to a steady increase in deposits from members (Sep20: $125.9m, Jun 20: $117.6m, Jun 19: $106.0m, Jun 18: $103.2m, Jun 15: $89.2m). The interest rate on term deposits placed with banks (effective rate of 2.9% during FY20) covers the cost of funds on member deposits (effective rate of 1.8% during FY20) but is significantly lower than the interest charged on loans advanced to members (effective rate of 9.4% during FY20).

The gap between loan contraction and deposit growth (calculated as the sum of % decline in loan book and % increase in members' deposits) increased to 23.2% in FY20 from 12.7% in FY19 and 10.3% in FY18. While PFCU seeks to manage this gap with an increased focus on improving its loan book (slowing the rate of contraction initially, followed by an increase in the loan book) by targeting underutilised marketing channels and increasing customer value propositions, the results of the same are yet to materialise and are expected to evolve over the next 6-12 months.

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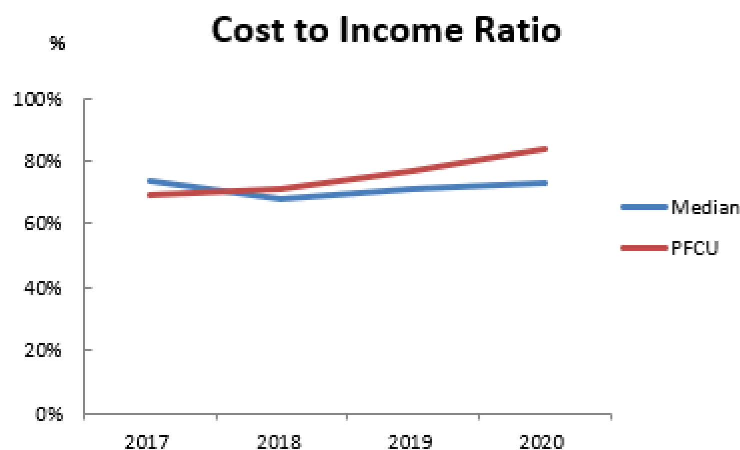
Our calculations reveal, at the current level of interest rates, total asset base (~$153.0m at Sep20) and operating costs (FY20: ~$4.2m), PFCU can operate profitably as long as the loan book remains above ~$36.5m. After a continued faster than expected contraction (reflecting a sustained competitive pressure), the proximity of PFCU's current loan book (at $41.4m as of Sep20) to breakeven level of operations (~$36.5m) has increased beyond our threshold to sustain the earlier 'BBB' credit rating.

In addition to the above-mentioned contraction in loan book, the pressure on PFCU's profitability is likely to be further exacerbated by the prolonged low interest rate environment (forecast to extend for a foreseeable period). A reduction in the RBNZ's OCR from the current levels is likely to have a disproportionate impact on PFCU's net interest income as there is limited headroom to reduce interest rates on member deposits (some of which are already nearing 0%) any more, in response to any further reduction in interest rates on cash and investments.

Favourably, we note PFCU's strong capitalisation and funding profile does not threaten the liquidity and solvency of the business, and instead, provide it with ample capacity to withstand several years of adverse operating performances.

Efficiency/ Cost-to-income Ratio



PFCU's efficiency (measured as cost to income ratio) was worse than its peers since FY18.

Historically, PFCU's efficiency was better than its peers. However, owing to steady deterioration in NIMs and increasing overheads in recent years, PFCU's efficiency has steadily worsened (since FY15) and become worse than its peers (since FY18).

During FY20, PFCU's cost-to-income ratio deteriorated by approximately 671 bps to 83.8% (FY19: 77.1%). The deterioration of PFCU's cost-to-income ratio in FY20 was primarily contributed by NIM contraction. This was further compounded by a 4.0% increase in overall operating expenses. PFCU's efficiency is expected to remain under pressure and may deteriorate further due to its weakening NIMs and increasing operating costs.

We understand PFCU spends ~$150-200k p.a. on the financial capability programme, scholarships, and the shadow board programme for its members' benefits. Favourably, we note that members' welfare expenses are

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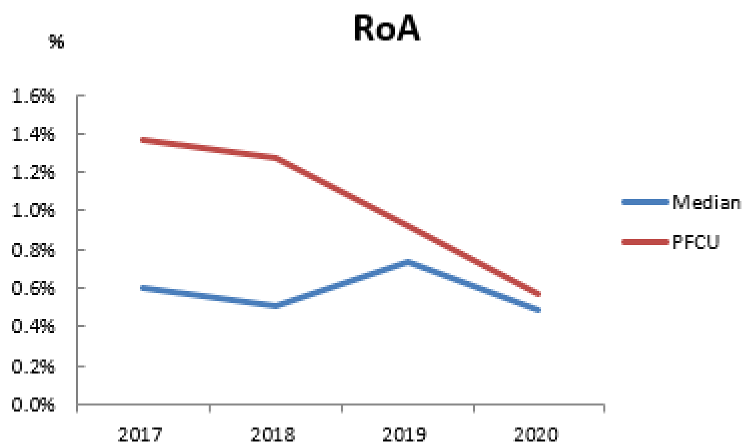
discretionary by nature and PFCU can look to cut down these spends, in case of a further material deterioration in its core operating income.

Return on Assets



PFCU's return on average assets has been on a declining trend (FY20: 0.6%, FY19: 0.9%, FY18: 1.3%, FY17: 1.4%, FY16: 1.6%). Though the return on average assets is still better than the sector average, the gap between PFCU's return on average assets and that of the sector average has been constantly narrowing over the last 5 years. The decline stems from the compounding effect of a decline in earnings and an increase in average assets – which are both primarily driven by an increase in lower yielding bank deposits.

During FY20, there was a 33.9% decline in earnings and a 6.3% increase in average assets.

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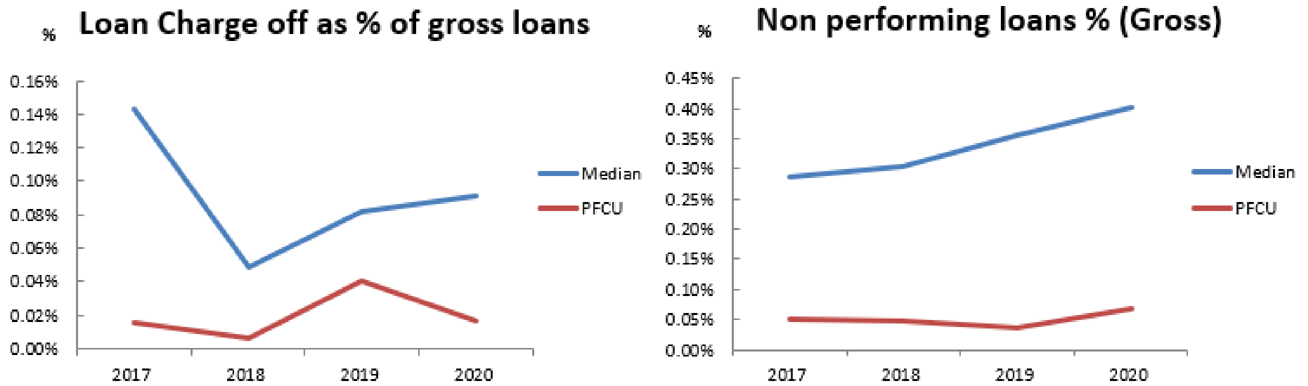
16. Asset Quality

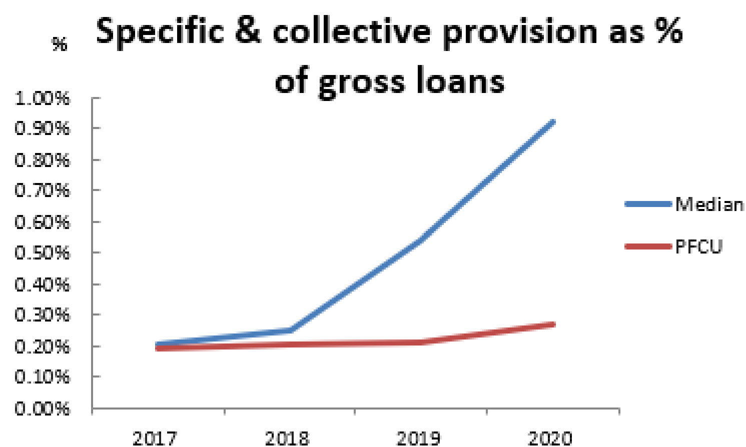
Non-Performing Loans



PFCU's portfolio exhibits low delinquency levels which reflects its extremely high asset quality. PFCU's asset quality benefits from its low exposure to residential mortgages (Sep20: 9.6% of total loan book, Jun20: 8.7%), low levels of unsecured loans in its portfolio (Sep20: 0.4% of total loan book, Jun20: 0.7%), and exclusive access to member's police payroll for loan repayments.

Though non-performing loans (as a percentage of gross loans, 'NPLs') marginally deteriorated to 6.8bps at Jun20 (from 3.6bps at Jun19), it remained better than the sector average. The marginal increase in NPLs was as a result of a $12k (70.6%) increase in impaired loans and the $5.9m (12.3%) reduction in total loans outstanding during FY20. Loans amounting to $48k were past due over 90 days but not impaired as at Jun20 (Jun19: $76k).

Provisioning



PFCU's specific/ individual loan provisioning has remained stable at 100% of the gross impaired loans as at Jun20 (and Jun19 and Jun18). The total provisions (specific and collective) have increased marginally to 27.3 bps (21.5 bps at Jun19).

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.

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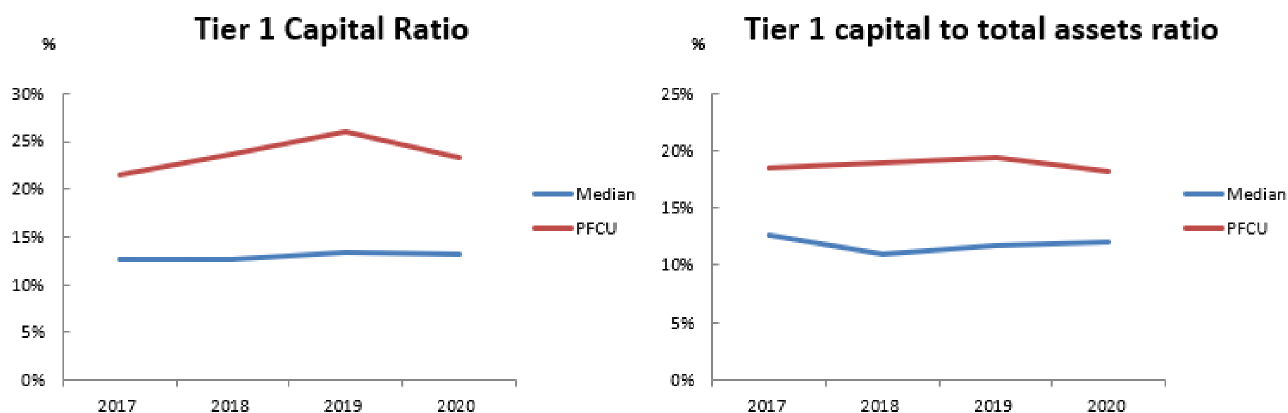
17. Capitalisation



PFCU's 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 has been consistently improving since until FY19 (Jun19: 25.9%, Jun18: 23.7%). This steady improvement was on account of an increase in retained earnings accompanied by a reduction in Risk Weighted Assets (RWA). The RWA reduced despite a growth in total assets due to a reduction in loans to members – which carry a relatively higher risk-weighted charge – accompanied by an increase in term deposits with registered banks – which carry a relatively lower risk-weighted charge.

However, this trend reversed slightly in FY20, when PFCU reported a tier 1 capital to risk weighted assets ratio of 23.3% at Jun20. While PFCU reported an increase in retained earnings and a contraction in its loan book as earlier, its $3.0m investment to acquire 29.6% in Finzsoft Solutions Ltd carried a relatively higher risk-weighted charge (at 600%), causing the overall risk weighted assets to increase at a rate greater than the increase in its tier 1 capital. That said, this slight decrease in PFCU's tier 1 capital to risk weighted assets ratio during FY20 is considered insignificant in the context of its headroom above the regulatory/trust deed requirements. We also note PFCU's tier 1 capital to risk weighted assets ratio as at Sep20 was 23.5%.

Significant headroom above the regulatory and trust deed requirements enable PFCU to adapt, in case regulatory changes require it to hold higher capital. In addition, PFCU's strong capitalisation provides it with sufficient cushion to withstand a significant contraction in its loan portfolio and consequently, its profitability.

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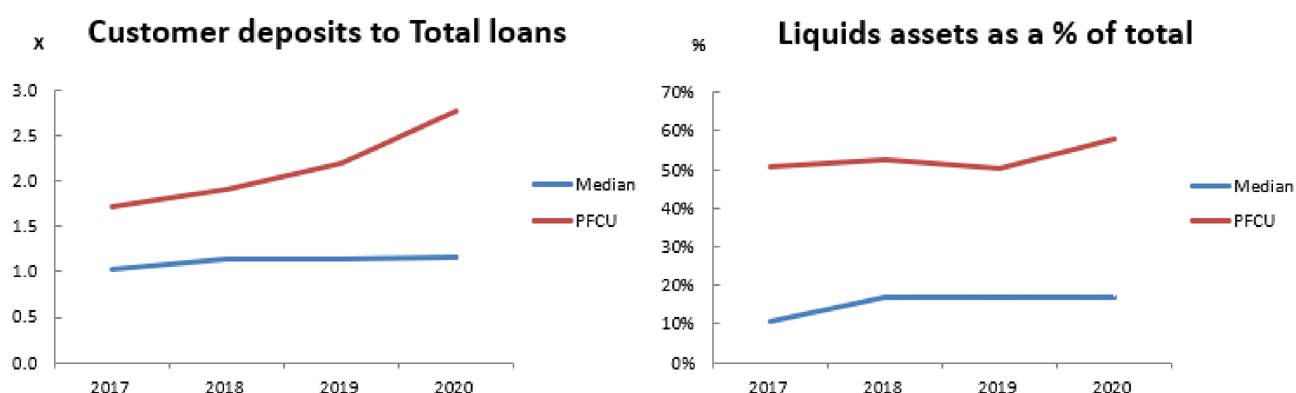
18. Funding and Liquidity



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 liquidity ratio, when calculated as cash equivalents and short-term deposits (<12 months) as a percentage of total assets, was 53.2% as at Sep20 (57.8% as at Jun20 and 50.2% as at Jun19). Equifax deems this to be extremely conservative, relative to peers' average liquidity.

Moreover, PFCU's calculation of this ratio as per its trust deed is more conservative than the industry standard. PFCU only included (from Jul17) deposits maturing within 183 days in its computation of internal liquidity. Liquidity based on deposits maturing within 183 days was computed at 30.5% as at Sep20[3] (30.3% as at Jun20[3] and 36.3% as at Jun19[3]).

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 Sep20, the monthly reinvestment rate and the annual reinvestment rate were sound at ~89% and ~87% respectively.

[3]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.

Financial Benchmarks

Description	Percentile	Credit Union Baywide*	Wairarapa Building Society	Southland Building Society	Heartland Bank	The Cooperative Bank	First Credit Union	Nelson Building Society	Police and Families Credit Union
Country		NZ	NZ	NZ	NZ	NZ	NZ	NZ	NZ
Scale:									
Operating income ($ 000s)	14%	38,226	4,493	155,159	233,249	79,246	20,387	23,338	5,001
Total Assets ($ 000s)	0%	516,928	167,785	4,992,940	5,318,136	2,979,577	402,852	869,737	144,441
Gross loans ($ 000s)	0%	344,473	126,544	4,189,806	4,583,780	2,558,692	225,158	680,022	42,517
Profitability:									
Net Interest Margin (%)	57%	6.0%	1.8%	2.3%	3.9%	2.0%	3.2%	2.3%	3.1%
Non Interest Income to total operating income (%)	0%	18.0%	22.3%	23.2%	7.1%	22.0%	35.9%	7.5%	2.9%
ROE (%)	29%	-0.7%	10.1%	5.9%	10.6%	3.5%	1.3%	9.4%	3.1%
Return on assets (%)	57%	-0.1%	1.2%	0.4%	1.5%	0.2%	0.2%	0.7%	0.6%
Efficiency Ratio (%)	71%	89.4%	66.0%	62.4%	45.8%	79.8%	87.3%	48.4%	83.8%
Capitalisation:									
Leverage (Gross loans to Equity) (x)	100%	5.99	5.76	12.49	6.55	12.64	3.70	9.27	1.61
Tier 1 common equity ratio - risk adjusted (%)	100%	10.4%	14.3%	9.8%	13.1%	13.4%	15.7%	11.8%	23.3%
Tier 1 capital to total assets ratio (%)	100%	11.1%	13.0%	6.6%	13.2%	6.8%	15.0%	8.4%	18.3%
Funding and liquidity:									
Gross loans as a % of total assets (%)	100%	66.6%	75.4%	83.9%	86.2%	85.9%	55.9%	78.2%	29.4%
Customer deposits to gross loans (%)	100%	129.3%	114.7%	3.2%	71.2%	94.0%	149.8%	116.0%	276.6%
Liquid assets to total assets (%)	100%	26.9%	17.6%	1.2%	4.9%	1.4%	37.9%	16.3%	58.6%
Asset Quality:									
Net Charge-offs to gross loans (%)	72%	2.53%	0.10%	0.00%	0.61%	0.00%	0.63%	0.08%	0.02%
Non performing loans to gross loans (%)	86%	2.36%	1.96%	0.04%	0.54%	0.26%	3.98%	0.09%	0.07%
Non performing and over 90day loans to gross loans (%)	100%	2.36%	2.80%	0.31%	1.82%	0.50%	5.40%	0.24%	0.18%
Individual provision for loan losses to gross loans (%)	57%	0.90%	0.27%	0.02%	0.12%	0.04%	0.86%	0.02%	0.07%
Individual & collective provision for loan losses to gross loans (%)	100%	1.43%	0.49%	1.23%	1.37%	0.47%	1.31%	0.62%	0.27%

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Summary Financial Data

Police and Families Credit Union (PFCU)						
NZ$ 000s	Trend	FY16	FY17	FY18	FY19	FY20
Income Statement						
Net Interest Income		5,191	5,118	5,252	5,070	4,858
Non interest income		198	200	212	156	143
Operating Income		5,389	5,319	5,464	5,226	5,001
Operating Expense		3,577	3,671	3,877	4,029	4,191
Pre-Provision Operating Profit		1,812	1,647	1,587	1,197	810
Credit impairment charge		14	8	-6	7	28
Operating Profit Before Tax		1,799	1,640	1,593	1,190	782
Other non Operating Income/(Expense)		14	8	2	11	12
PBT		1,813	1,647	1,595	1,201	794
Financial Position						
Total Assets		118,945	122,812	128,126	132,031	144,441
Customer Deposits		97,244	99,589	103,235	106,041	117,605
Loans		60,591	57,517	53,706	48,333	42,401
Liquid assets		55,308	62,212	67,361	66,284	83,450
Ratios						
PBT to operating income margin (%)		34%	31%	29%	23%	16%
Net Interest Margin (%)		3.93%	3.79%	3.72%	3.47%	3.09%
Efficiency Ratio (%)		66.4%	69.0%	71.0%	77.1%	83.8%
Return On Assets (%)		1.6%	1.4%	1.3%	0.9%	0.6%
Return on Equity (%)		9.0%	7.5%	6.8%	4.8%	3.1%
Tier 1 Risk-Based Capital Ratio (%)		19.2%	21.4%	23.7%	25.9%	23.3%
Tier 1 Capital to Total Assets Ratio (%)		17.8%	18.5%	19.0%	19.4%	18.3%
Leverage Ratio - Total loans to Equity (x)		2.87	2.52	2.20	1.89	1.61
Charge-offs/Total loans (%)		0.03%	0.02%	0.01%	0.04%	0.02%
Non-Performing Loans to Gross Loans (%)		0.03%	0.05%	0.05%	0.04%	0.07%
Non-Perform Assets & 90+ Days Past to Gross loans (%)		0.03%	0.05%	0.05%	0.19%	0.18%
Loan Loss Provision/Loans (%)		0.18%	0.19%	0.21%	0.22%	0.27%
Deposits to loans (%)		160%	173%	192%	219%	277%
Liquid assets to total assets (%)		47%	52%	53%	51%	59%

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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.

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 6, Oct19).

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

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