Credit Ratings & Research

Credit Rating Report

Police and Families Credit Union

Credit Rating Report

Date: 1 April 2019

Prepared for: Police and Families Credit Union

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

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Job Number: 264378

Currency used in this report:

This report is presented in New Zealand Dollars unless otherwise noted

From Equifax

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1. Executive Summary

Police and Families Credit Union ("PFCU")

Equifax has affirmed PFCU's credit rating at 'BBB'. The Outlook for the rating is Stable.

PFCU is a not-for-profit, Non-Bank Deposit Taking (NBDT) organisation that is licenced and domiciled in New Zealand. PFCU receives deposits from and provides consumer loans to current and retired police personnel and their family members.

PFCU's credit rating reflects its strong capitalisation and funding profile, its preferred security position over NZ Police retirement accounts and access to NZ Police payroll, its conservative credit management policies, and its limited exposure to residential mortgages. PFCU's rating is constrained by the increasing gap in its loan-book relative to its deposit-base - a headwind to its net interest margin (NIM), its small scale of operations and the competitive threat posed by both large traditional competitors as well as new disruptive business models.

Strengths

- PFCU's 25.1% Common Equity Tier 1 ratio (at Jan19) is greater than 3 times the minimum regulatory requirement (8.0%). This buffer provides PFCU ample capacity to withstand the adverse impact of a future economic downturn.
- PFCU's funding profile is stable, which provides it with sufficient headroom to withstand a funding shock. PFCU's consumer deposits to loans ratio at Jun18 is highest amongst peers at 191.8%.
- 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. PFCU's members include current and former employees of NZ Police, and their family members.
- The majority of PFCU's loans (Jan19: 88.1%, Jun18: 88.7%) are 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 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 risk through a cap on maximum deposits from individual customers. PFCU's low exposure to residential mortgages (9.0% compared to peer average of 54.7% at Jun18) also limits the risk of defaults in the event of a slowdown in residential real estate prices. Moreover, the highest LVR on PFCU's current top-8 mortgage loans was 66%, indicating comfortable headroom before recovery value falls below the loan amount.

Weaknesses

- PFCU has been facing a sustained contraction in NIMs since FY15. NIM declined to 3.6% for the seven-month interim period ended Jan19 (FY18: 3.7%, FY15: 4.1%). A steady decrease in loans to borrowers, while customer deposits increased, meant PFCU had to invest the excess funds in lower yielding bank term deposits, causing the NIMs to fall. RBNZ's Official Cash Rate cuts during FY16 and FY17 have put additional pressure on NIMs for the entire sector. However, PFCU has adequate headroom above breakeven operating levels and the current NIMs do not threaten PFCU's solvency and liquidity, in view of its strong capital and funding position, and above average asset quality. Nevertheless, continued deterioration in NIM is likely to cause profitability concerns and may restrict PFCU's discretionary spend on members' welfare initiatives.
- PFCU's small scale and the limited breadth of its service offering place the business at a competitive disadvantage to New Zealand's five major banks and top-tier credit unions. Moreover, PFCU's limited product and client segment diversification increases its susceptibility to potential loss of clients to larger competitors and relatively new disruptive businesses such as Harmoney and Squirrel.

The outlook for PFCU's rating is 'Stable' over the next 12 months. A rating upgrade over this time horizon is unlikely. However, PFCU's credit rating may migrate lower in the following instances on an individual or collective basis:

a) Material deterioration in net interest margin and/or efficiency ratio,

b) Significant contraction in scale or expectation of a fall in liquidity or capital adequacy ratios.

Risk Rating

BBB

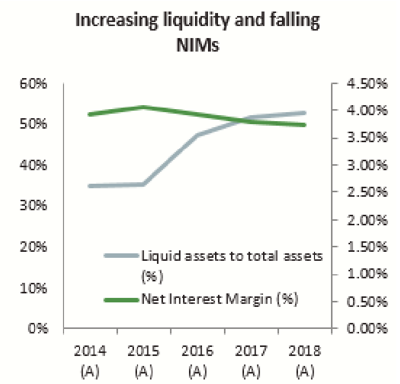
Outlook: Stable

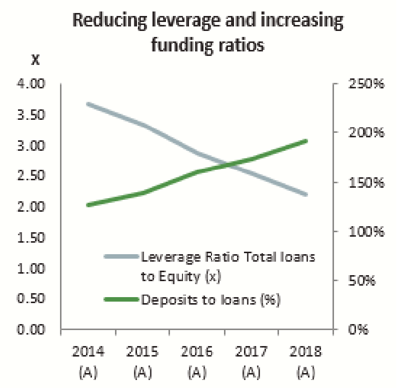
Type: Public, Monitored

Industry Percentiles

Scale:	
Total Assets	0%
Gross loans	0%
Profitability:	
NIM	75%
ROE	50%
ROA	88%
Efficiency Ratio	50%
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	75%
Non performing loans	100%
Non performing and over 90day loans	100%
Provision for loan losses	88%

Key Trends





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 (“PFCU”).

We have complied with our rating services guidelines in order to derive the credit rating on Police and Families Credit Union. 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	**1 Apr 2019**
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**
Report Fee	**Fixed Price**
Ancillary fees	**Nil**
Issuer Name	**Police and Families Credit Union**
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 (peer group listed overleaf)**
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, publicly available information and from our own enquiries. We have derived a credit rating on PFCU based on the understanding that Police and Families Credit Union 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	**Audited Financial Statements for the years ended 30 Jun 2018, 2017 and 2016, Management accounts for the seven-month interim period ended 30 Jan 2019.**
Name of Auditor	**BDO**
Other Information Sources	**PFCU's website, industry and regulatory websites, Bloomberg, management interviews, media articles, adverse searches and internet searches.**
Issuer Participation	**Yes**
Material Financial Adjustments	**None**
Limitations of Assessment	**None noted**
Outsourced Assessment Activities	**No**
Confidentiality Agreement	**Yes**
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.

3. General Background of the Subject

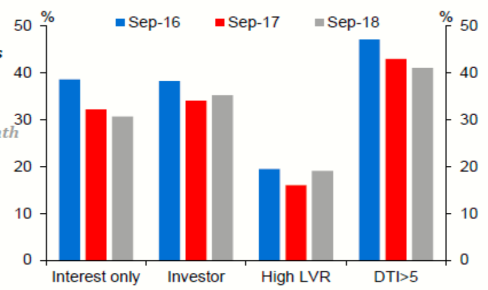
Subject Name	Police and Families Credit Union
Type of Entity	Credit union, licenced as an NBDT with the RBNZ
Head Office Address	Level 11, 57 Willis Street Wellington 6011 New Zealand
Date of Licence	12 Nov 2014
Principal Activities	PFCU provides secured and unsecured personal loans, residential mortgages, in addition to savings account and term deposit services to its members. The members can use PFCU issued Debit MasterCard to access their funds through ATMs and carrying out transactions.
History	Police and Families Credit Union 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 and their families and has evolved into a provider of a comprehensive range of banking services to meet the needs of its members.

4. Industry Risk

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.

Figure 2.3 Risk characteristics of new mortgages *(share of lending, 3-month average)*

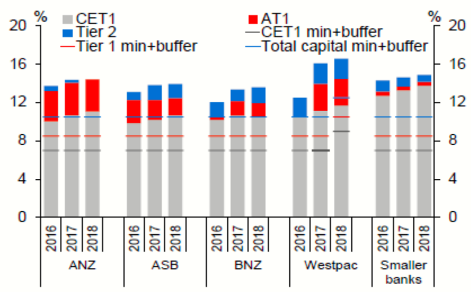


Source: RBNZ *LVR New Commitments Survey*, RBNZ DTI, private reporting.

Note: 'High LVR' is the proportion of owner-occupier mortgage loans with LVRs above 80 percent and investment mortgage loans with LVRs above 65 percent.

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 measures.

Figure 4.5 Bank regulatory capital ratios *(% of risk-weighted assets, September years)*



Source: Registered banks' disclosure statements, RBNZ *Capital Adequacy Survey*

Note: The capital ratios of individual banks and other key metrics can be found in the Bank Financial Strength Dashboard.

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.

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.

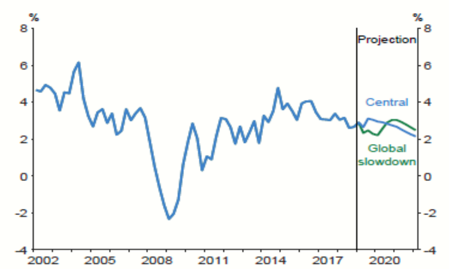
NBDTs have a lower willingness and tolerance for market risk than larger banks, but have exposure to interest rate risk due to interest rate duration mismatch between assets and liabilities.

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.

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.

NZ GDP growth has softened over the past year, despite continuing strong population growth and low interest rates. Softer growth in the housing market and reduced construction activity have resulted in weaker demand. Policy uncertainty and reduced profitability together with trade tensions impacting global growth have weighed on business confidence. Fiscal and monetary stimulus are expected to lift NZ GDP growth over 2019, offsetting softer global economic conditions.

Figure 2.9
GDP growth
(annual)



Source: Stats NZ, RBNZ estimates.

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.

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.

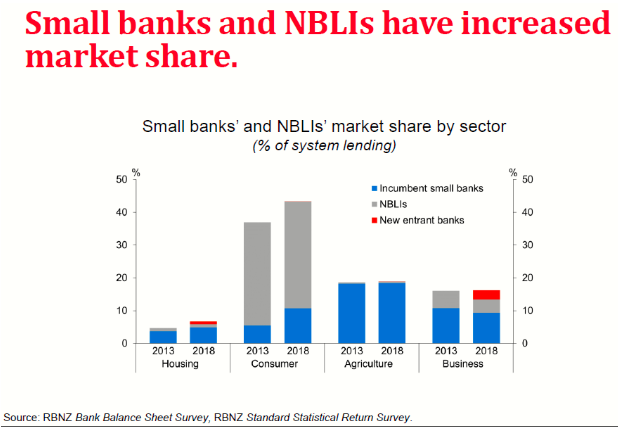
Intensity of competition would, generally, be higher in markets offering lower protection in the form of regulatory entry barriers and exhibit a higher level of fragmentation. Price based competition, rather than differentiation, would also give rise to greater intensity of competition.

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 bank. 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.



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 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 Reserve Bank'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.

The most recent example of the RBNZ's use of macro-prudential norms to promote financial stability and reduce the risk of an economic shock is stricter regulation on maximum LVRs for investment and owner-occupier mortgages. Changes implemented on 1 Oct 2016 required stricter norms on LVRs for mortgages. The RBNZ announced (on 29 Nov 2017) modest easing of restrictions on LVRs on mortgages, that came into effect on 1 Jan 2018. The restrictions required that:

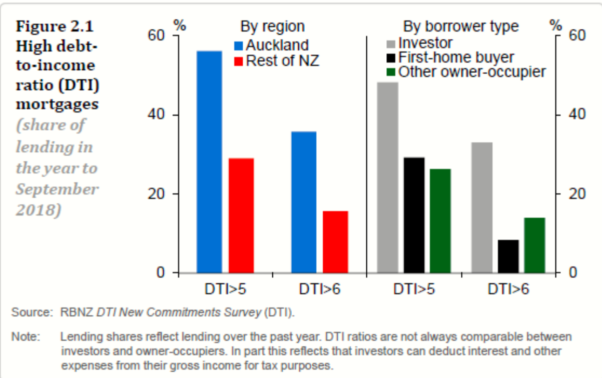
- No more than 15% (previously 10%) of each bank's new mortgage lending to owner occupiers can be at LVRs of more than 80%; and
- No more than 5% of each bank's new mortgage lending to residential property investors can be at LVRs of more than 65% (previously 60%).

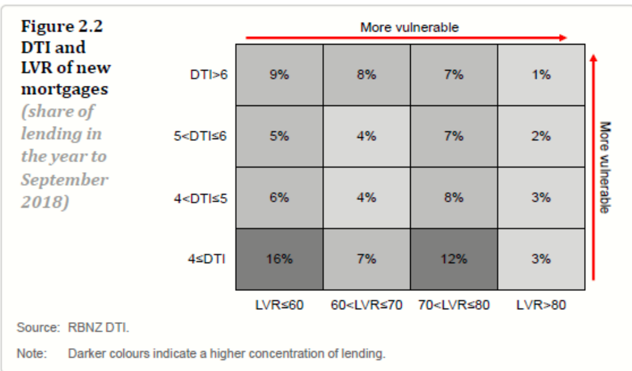
As of Nov18, house prices remained high relative to incomes and rents, and are therefore susceptible to a correction. However, momentum has waned in the housing market since early 2017 and credit growth to households has returned to more sustainable levels. This has seen a gradual reduction in the risks that the LVR restrictions were designed to mitigate. And housing market pressures are expected to remain subdued, which will further reduce risks over time.

Reflecting this, the RBNZ has eased LVR restrictions on new mortgages. From 1 Jan 2019:

- Up to 20% (increased from 15%) of new mortgage loans to owner occupiers can be at LVRs of more than 80%; and
- No more than 5% of each bank's new mortgage lending to residential property investors can be at LVRs of more than 70% (previously 65%).

The RBNZ will consider the NBDT capital requirements, post the planned review of capital requirements for banks. The bank capital review will take note of changes to international capital adequacy standards. Changes to the credit risk standard for standardised banks are likely to be particularly relevant for NBDTs, although the Reserve Bank will continue to tailor the NBDT capital requirements to the particular characteristics of the New Zealand sector.





6. Systemic Risk

NZ economic growth has slowed recently. Annual GDP growth was 2.6% in the Sep18 quarter, down from over 4% in mid-2016. This slower growth is assumed to be on account of weaker demand, partly related to the softer housing market and slower growth in construction activity. Despite slower growth, there are signs that capacity pressure in the economy has continued to build.

There are signs that growth in the global economy is starting to slow down, in part because of uncertainty around trade policies. Global growth is expected to slow over the next few years. Trading-partner growth is expected to further moderate in 2019 partly because of trade tensions and tighter financial conditions. Global commodity prices have already softened, reducing the tailwind that New Zealand economic activity has benefited from. The risk of a sharper downturn in trading-partner growth has also heightened over recent months.

Monetary and fiscal stimulus remain necessary to support growth. Monetary and fiscal stimulus are expected to lift GDP growth to 3% during 2019, contributing to higher capacity pressure and employment. As capacity pressure builds, and the dampening effect of past low headline inflation fades, inflation is projected to increase towards the target mid-point. However, the recent easing in domestic growth, together with slowing global growth, weigh on this rise in capacity pressure.

There are upside and downside risks to this outlook. A more pronounced global downturn could weigh on domestic demand, but inflation could rise faster if firms pass on cost increases to prices to a greater extent.

The RBNZ has assessed New Zealand banks as, profitable, well capitalised, sufficiently funded and liquid relative to the RBNZ's minimum guidelines. However, the RBNZ has stated the financial sector remains exposed to three key vulnerabilities: household sector indebtedness, dairy sector indebtedness, and the banking system's exposure to international risks.

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. The Company 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 of 1 year. All other loan facilities are offered on variable interest rates. Also, PFCU has made a strategic decision to reduce exposure to residential mortgages. Residential mortgages accounted for 8.4% of PFCU's total loans as at Jan19 (vs. 9.1% of total loans as at Jun17). PFCU's ALCO guidelines stipulate that a minimum of 75.0% of total term deposits held with NZ registered banks have a maturity shorter than 12 months. The interest rate risk on liabilities is minimised by limiting the duration of deposits to 24 months.

Repricing Gap Analysis ($ - 30 Jun 2018)	Total	<6 months	7-12 months	13-24 months	25-60 months	>60 months
Financial Assets	**126,175,204**	**85,797,463**	**34,267,741**	**6,110,000**	-	-
Cash & equivalents	**6,538,972**	6,538,972	-	-	-	-
Bank term deposits	**65,930,002**	26,648,002	33,172,000	6,110,000	-	-
Loans to members	**53,706,230**	52,610,489	1,095,741	-	-	-
Financial liabilities	**102,834,673**	**85,201,242**	**12,026,157**	**5,607,274**	-	-
On-call shares	**55,061,739**	55,061,739	-	-	-	-
Fixed term shares	**47,772,934**	30,139,503	12,026,157	5,607,274	-	-
Difference	**23,340,531**	**596,221**	**22,241,584**	**502,726**	-	-

Repricing Gap Analysis ($ - 31 Jan 2019)	Total	<6 months	7-12 months	13-24 months	25-60 months	>60 months
Financial Assets	**126,706,198**	**87,892,774**	**32,722,222**	**6,091,202**	-	-
Cash & equivalents	**3,119,543**	3,119,543	-	-	-	-
Bank term deposits	**72,503,202**	34,189,000	32,223,000	6,091,202	-	-
Loans to members	**51,083,453**	50,584,231	499,222	-	-	-
Financial liabilities	**103,232,489**	**84,188,731**	**13,748,137**	**5,279,605**	**16,016**	-
On-call shares	**53,573,082**	53,573,082	-	-	-	-
Fixed term shares	**49,659,407**	30,615,649	13,748,137	5,279,605	16,016	-
Difference	**23,473,709**	**3,704,043**	**18,974,085**	**811,597**	- **16,016**	-

PFCU models the sensitivity of its assets and liabilities to a 0.5% fluctuation in interest rates. Based on FY18 annual report, the impact on earnings from a 0.5% adverse movement in interest rates is not considered significant (approximately NZD 117k or 7.3% of FY18 pre-tax profits).

We have conducted a sensitivity analysis by testing the impact of a 0.5% reduction in the interest rates on cash and other liquid investments, and loans advanced to members for each of the next three years. PFCU's operations are still expected to remain profitable in each of the next three years, however, this analysis highlights a material risk to earnings from a sustained fall in NIMs.

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 53.9% as at 31 Jan 2019 (52.6% as at 30 Jun 2018 and 51.5% as at 30 Jun 2017) – 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 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 28.9% as at 31 Jan 2019[1] (25.9% as at 30 Jun 2018[1] and 24.6% as at 30 Jun 2017[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 (30.6% as at 31 Jan 2019[1], 26.6% as at 30 Jun 2018[1], and 24.6% as at 30 Jun 2017[1]). Additionally one-year stable funding ratio

[1]Calculated as per the trust deed requirements, as reported in the annual report 2018, Page 22. The calculation methodology for liquid assets has been changed to include all deposits maturing within 183 days from Jul17 onwards.

(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 (84.3% as at 31 Jan 2019[1], 84.2% as at 30 Jun 2018[1], and 83.9% as at 30 Jun 2017[1]).

Liquidity Management Policies also require that the mix of Deposits is 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 Jan19, there were 9 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.

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 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 50.0% of its total liquid assets with any individual counterparty. Only institutions that have a credit rating of A+ or better qualify as eligible counterparties for PFCU. Currently Kiwibank (holding 6.6% of PFCU's deposits) has a credit rating of A and PFCU continues to review its exposure.

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 upto 1 year, and all remaining offerings comprise of variable rate loans.
- 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, and is dependent upon the security cover provided by the assets.
- 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 unsecured loans are restricted to a maximum of $20,000 and upto 5 years.
- PFCU has a very low proportion (1.0% of total loan book as at 31 Jan 2019) of unsecured loans. Exposure to loans secured by residential mortgages is also very conservative at 8.4% of the total loan book as at 31 Jan 2019. Motor vehicle loans comprised of 2.5% of the total loan book as at 31 Jan 2019 and the minimum security cover is 20%. The balance 88.1% of the loan portfolio is secured by a charge over retirement funds in Police Superannuation Scheme (PSS) and Government Superannuation Fund (GSF) for current and ex NZ police employees and their family members.
    - PFCU's credit risk for loans secured by PSS and GSF is low since the members receive their PSS/GSF funds post repayment of loans due to PFCU. 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.
- 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 $4.3m across 37 loans, averaging approx. $117k 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 and comprises 25% of the total mortgage book by value which is commensurate with the general population concentration in the region.

9. Competition

PFCU competes with other NBDTs, NZ registered banks and P2P lenders in the domestic market for attracting deposits for funding and loans. 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.

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 disruptive business models that affect market structure through a new value offering to customers poses a threat to bank and NBDT, 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, and credit cards. In addition, it is possible for existing companies 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 PFCU's main markets and products, may lead to erosion in PFCU's market share or margins, and adversely affect the business, operations, and financial condition.

PFCU's Pricing Committee meets weekly and aims to maintain a competitive interest rate position in the market for its members. PFCU has policies for pricing frameworks that help it maintain the attractiveness of its pricing.

10. Structure and Service Delivery Platform

Structure

As of Mar19, PFCU has a simple corporate structure that is governed by a trust deed. 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. As a consequence of this limitation on sourcing capital, PFCU reinvests 100% of its surplus earnings into the business.

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 are given 6 months from the commencement date (1 Apr 2019) to apply for incorporation. An existing credit union that fails to apply for incorporation under the new provision within the 6-month period, or whose application is refused where the refusal is not overruled on appeal, loses its registration. This eliminates the need for trustees. Credit unions will be 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 accordance with the amendments, PFCU will have to apply for incorporation under the new provision before 30 Sep 2019.

We note that PFCU opposed this legislative change as it believed it will have to operate in a far more complex legislative environment. However, PFCU will now have to own itself rather than trustees owning it on behalf of the members. In order to ensure compliance with the new provisions, PFCU intends to hold a special general meeting to change the rules in Jun19.

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 members can join PFCU through completion of a web-based form on PFCU's website. The website also provides internet banking services for the members to keep track of and manage their funds. Additionally, PFCU provides access to member's accounts through a mobile application and telephone banking services. PFCU also provides web applications for loan applications via their website and their mobile banking application.

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. PFCU does not aim to generate supernormal profits or to expand into a full-service bank. 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 main objective is not to maximise profitability but to provide value to members while ensuring long-term profitability and solvency of the business.

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.

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 $142k during FY18 on this initiative (FY17: $233k, FY16: $181k, FY15: Nil). Management advised that the budget for FY19 is around $300k.

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 4 years. Scholarships were provided for activities such as beekeeping, completing a PhD, obtaining a skipper's restricted licence, speech language therapy, sporting goals, etc.

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
Richard Middleton	Chairman
Ian Harris	Vice Chairman and Trustee
Amelia Steel	Director and Trustee
Charles Ip	Director
Gail Gibson	Director
Lane Todd	Director and Trustee
Luke Shadbolt	Director
Stuart Mangnall	Director
Roly Williams	Director
Craig Tickelpenny	Director
Helen Hatchard	Chief Executive Officer
Stephen Woolley	Chief Financial Officer
Bronwyne Rozier	Manager Operations / Blue Trust
Amy Linwood	Manager Market and Products
Richard Dunn	Manager Member Services

PFCU board comprises of seven directors and three trustees, and has a strong suite of skills, experience, and expertise. It is well suited to help PFCU navigate the current competitive and regulatory challenges faced by financial sector firms worldwide. The board composition is strong with none of the ten members holding an executive position in the business.

After a service of more than 20 years to the Board, Steve Hinds and Steve Vaughan retired during FY18. They were replaced with Charles Ip and Gail Gibson.

The CEO, Helen Hatchard, has over 30 years of experience in the finance industry. Her previous experience includes leadership roles in retail lending, residential mortgages, business banking and private banking with KiwiBank, Westpac New Zealand, and the Co-operative Bank.

After 18 years of service as PFCU's CFO, Giorgio Canderle retired on 31 Dec 2018. He has been replaced with Stephen Woolley. Stephen Woolley is a member of 'Chartered Accountants Australia and New Zealand' and has over 20 years' experience in accounting and finance.

14. Governance and Oversight

Internal

PFCU's internal Credit Risk Policy governs the approval parameters for the loans to members. Post a strategic review, PFCU has reduced its exposure to mortgage lending and now 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, and changes to rates 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 deposits from members, 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 stable 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 following approved rating agencies:
   - Equifax Australasia Credit Ratings Pty Limited (formerly known as Corporate Scorecard Pty Limited (CSC);
   - Fitch Ratings;
   - Moody's Investors Service; or
   - Standard and Poor's Ratings Services.
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.

   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.
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. This programme is to be submitted to, and approved by, the licensed NBDT's trustee.
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 place a limit on the aggregate credit exposures of a licensed NBDT, or its borrowing group, to all related parties to be specified in the licensed NBDTs' trust deeds. The related party exposures should not exceed a maximum limit of 15.0% of tier one 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.

The Reserve Bank has published guidelines for NBDTs and trustees to assist with the development of the quantitative liquidity requirements.

7. Suitability assessment of directors and senior officers (in force since 1 May 2014) – Licensed NBDTs must notify the Reserve Bank 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 Reserve Bank will then carry out a suitability assessment of that person. The person must cease to act in the role (or not be appointed to the role) where the Reserve Bank has declined to issue a notice of non-objection in respect of the person.
8. Changes of ownership (in force since 1 May 2014) – An application must be made to the Reserve Bank 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 Reserve Bank's approval. The Reserve Bank 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 FY18 confirmed no significant or material weakness.

PFCU tracks its capital adequacy and liquidity related ratios on an ongoing basis to comply with above regulations.

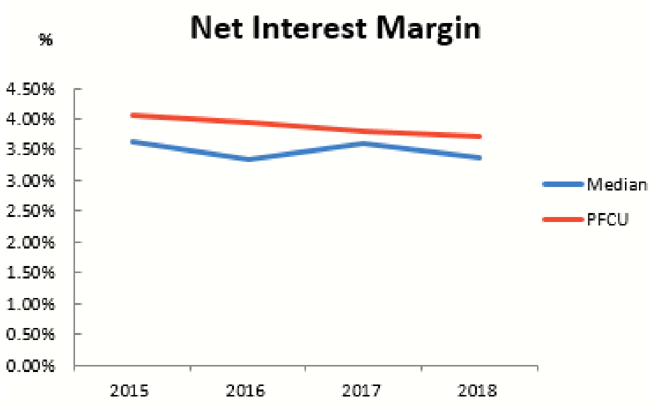
The following table details PFCU's performance in respect of the above-mentioned parameters vis-a-vis the regulatory requirements and the trust deed.

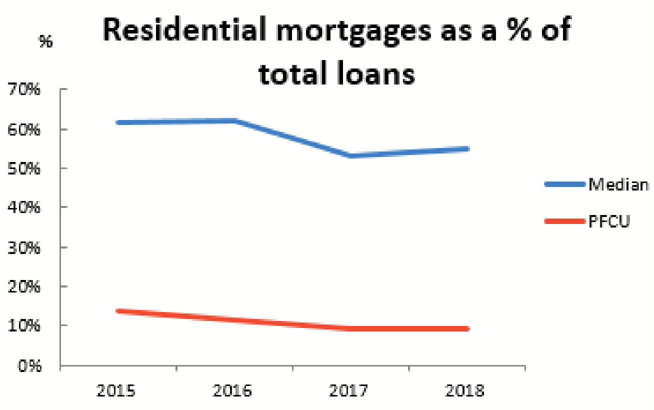
Ratio	Calculation	Jan 2019	Jun 2018	Jun 2017	Trust deed	Regulatory
Risk weighted capital ratio	Tier 1 capital as a percentage of risk weighted assets	25.1%	23.7%	21.4%	>10%	>8%
Liquidity ratio	Cash equivalents and short-term deposits (<183 days[2]) as a percentage of total assets	28.9%	25.9%	24.6%	>10%	As appropriate
One-month mismatch ratio	Adequacy of liquid assets and next month's cash flows to total funding (or member deposits)	30.6%	26.6%	24.6%	>0%	As appropriate
One-year funding ratio	Estimated funding that is expected to stay in place at least one year to total assets.	84.3%	84.2%	83.9%	>70%	As appropriate
Related party ratio	Aggregate credit exposures to all the related parties as a percentage of tier 1 capital	0%	0%	0%	<15%	<15%

[2]Calculated as per the trust deed requirements, as reported in the annual report 2018, Page 22. The calculation methodology for liquid assets has been changed to include all deposits maturing within 183 days from Jul17 onwards.

15. Profitability

Net Interest Margin





PFCU's net interest margin is slightly above the benchmark peers. Most credit unions and NBDTs are largely dependent on retail deposits for funding, 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, like Credit Union South, 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.

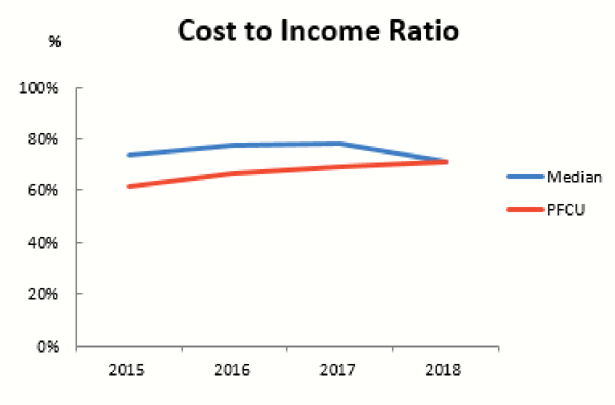
Loans to members (by PFCU) are extended in the form of personal loans secured by a charge on PSS/GSF, motor vehicle loans, unsecured loans, and residential mortgages. PFCU does not write low equity property loans and only offers one-year fixed interest rate mortgages.

PFCU has faced a sustained contraction in NIMs since FY15. The NIM was reported at 3.6% for the seven-month interim period ended Jan19 (FY18: 3.7%, FY17: 3.8%, FY16: 3.9%, FY15: 4.1%). PFCU's has placed higher deposits with banks (Jan19: $77.0m, FY18: $73.5m, FY15: $43.6m), as loans to members have decreased since FY15 (Jan19: $51.1m, FY18: $53.7m, FY15: $64.3m) in addition to a steady increase in deposits from members (Jan19: $103.7m, FY18: $103.2m, FY15: $89.2m). The interest rate on term deposits placed with banks (effective rate of 3.3% during FY18) covers the cost of funds on member deposits (effective rate of 2.2% during FY18), but is significantly lower than the interest charged on loans advanced to members (effective rate of 9.3% during FY18). The fall in NIM was also aggravated by the RBNZ's cuts to the Official Cash Rate during FY16 and FY17.

The gap between loan and deposit growth increased to 10.3% in FY18 from 7.5% in FY17. PFCU seeks to manage this gap by taking steps to increase members' loan uptake by offering new products. PFCU also aims to increase the member base on the back of planned addition to police personnel. We, also, note that the gap fell during the seven-month interim period ended Jan19 to 5.3%.

We understand that PFCU's main objective is to provide value and remain relevant to its members while ensuring long-term profitability and solvency of the business. Although the NIMs have declined since FY15, given adequate headroom from breakeven operating levels at present, the current NIM does not threaten the long-term profitability and solvency of the business in Equifax's view.

Efficiency/ Cost-to-income Ratio



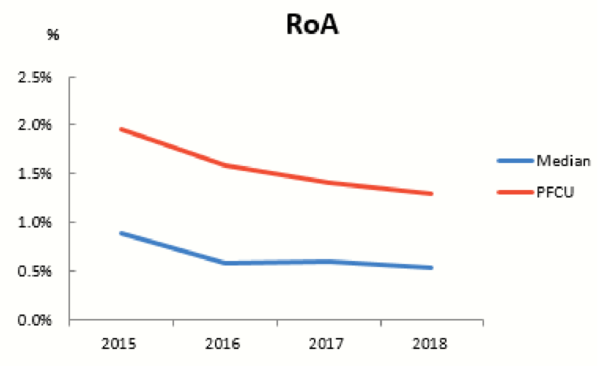
PFCU's efficiency (measured as cost to income ratio) was in line with its peers during FY18. PFCU's efficiency was supported by its captive customer base, which means its requisite spend on promotional activities is lower than its peers, and its exclusive access to NZ Police payroll for repayments – requiring lesser time and costs for loan recovery related activities.

Historically, PFCU's efficiency was better than its peers mainly due to its operating simplicity. However, owing to steady deterioration in NIMs and increasing overheads in recent years, PFCU's efficiency has worsened and come in line with its peers.

During FY18, PFCU's cost-to-income ratio deteriorated by approximately 192 bps to 71.0% (FY17: 69.0%) to be in line with the benchmark average. NIM contraction and a $110k/39.5% increase in cash machine and ATM card related costs contributed to the deterioration of PFCU's cost-to-income ratio in FY18. Overall, total operating expense growth of 5.6% outpaced the 2.7% growth in operating income. PFCU spent approximately $202k during FY18 on the financial capability programme, scholarships and the shadow board programme for its members' benefit. Excluding the impact of these, the cost-to-income ratio during FY18 was 67.3%. We understand that members' welfare expenses are discretionary by nature and PFCU can look to cut down these spends, in case of a material deterioration in its core operating income.

PFCU's efficiency is expected to remain under pressure and may deteriorate due to its weakening NIMs and increasing overheads. PFCU's cost-to-income ratio deteriorated to 77.5% during the seven-month interim period ended Jan19. However, this could potentially be unfavourably impacted due to advance recognition of some welfare and other expenses in the interim period financials.

Return on Assets



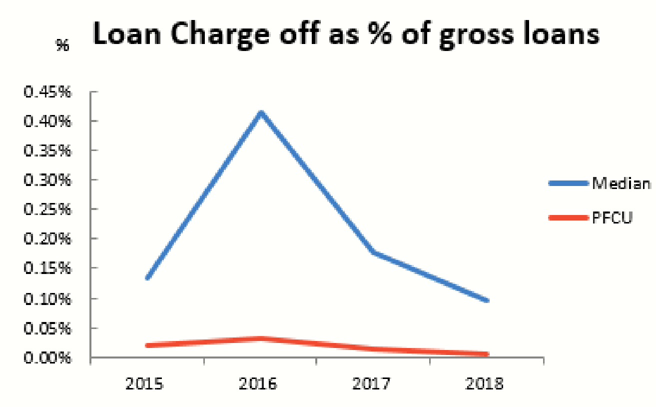
A low cost-to-income ratio and high asset quality (details below) have allowed PFCU to operate at a higher RoA than its peers historically.

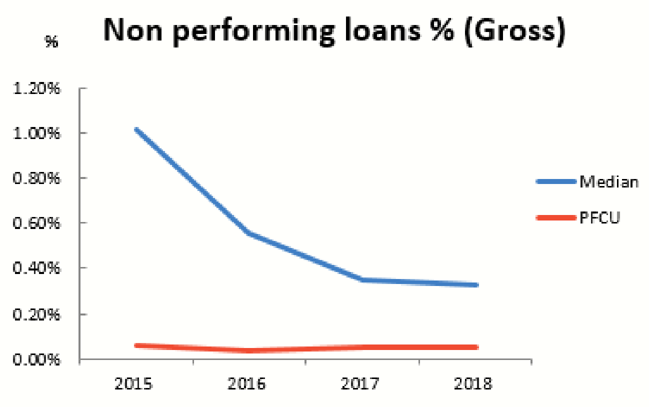
Return on average assets, though still better than the sector average, has been on a declining trend since FY15 (FY18: 1.3%, FY17: 1.4%, FY16: 1.6%, FY15: 2.0%). The decline stems from the compounding effect of a decline in earnings and an increase in average assets – which are both primarily driven by an increase in lower yielding bank deposits. During FY18, there was a 3.2% decline in earnings and a 5.5% increase in average assets. Earnings decreased mainly due to a lower NIM and higher cash machine and ATM card related expenses. Average assets increased as a result of an increase in members' deposits, which are invested in bank term deposits.

During the seven-month interim period ended Jan19, return on average assets declined further to 0.95%. The deterioration during this period was on account of an annualised 24.3% decline in earnings and a 2.7% increase in average assets.

16. Asset Quality

Non-Performing Loans

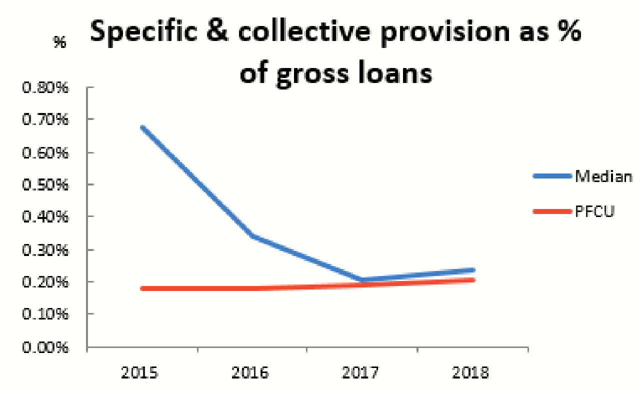




PFCU's portfolio exhibits low delinquency levels which reflects its extremely high asset quality. PFCU's asset quality benefits from its low exposure to residential mortgages (8.4% of total loan book as at Jan19, FY18: 9.0%), limited number of unsecured loans in its portfolio (1.0% of total loan book as at Jan19, FY18: 1.3%), and exclusive access to member's police payroll for loan repayments.

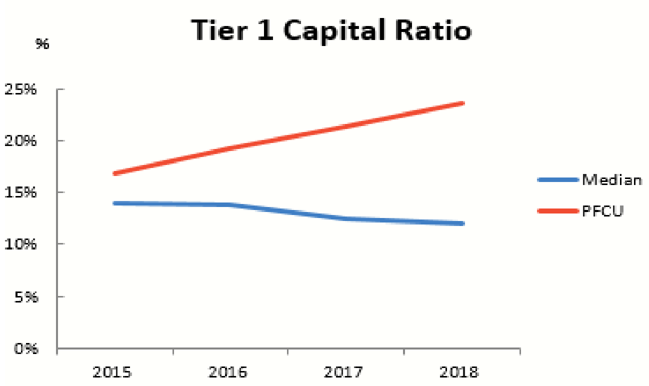
Non-performing loans (as a percentage of gross loans, 'NPLs') marginally improved to 4.8bps in FY18 (from 5.1bps in FY17) and remained better than the sector average. The marginal decrease in NPLs was as a result of a 11.7% reduction in impaired loans, partially offset by the 6.6% reduction in total loans outstanding. Loans amounting to $3k were past due over 90 days but not impaired as at Jun18 (Jun17: Nil).

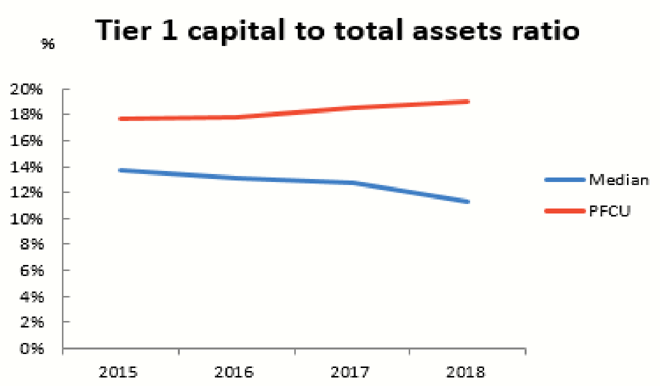
Provisioning



PFCU's specific/ individual loan provisioning has remained stable at 100% of the gross impaired loans as at Jun18 (and Jun17). The total provisions (specific and collective) have increased marginally to 20.6 bps (19.2 bps at Jun17).

17. Capitalisation



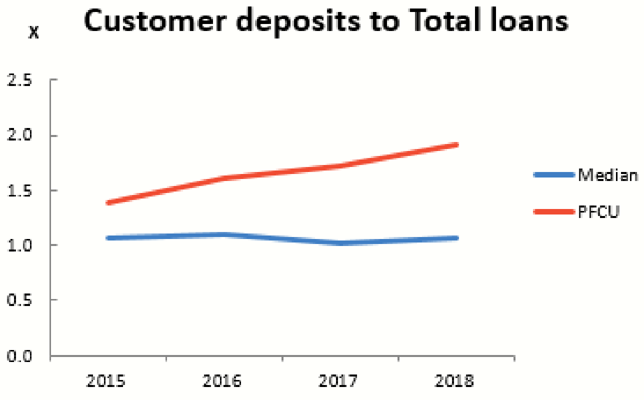


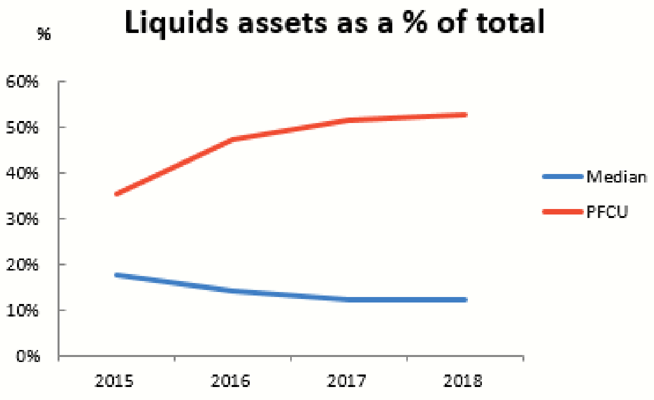
PFCU's Tier 1 capital to risk weighted assets ratio is better than benchmark average as a result of its conservative financing (as its trust deed disallows raising of debt) and business strategy. The regulatory capital requirement for PFCU under the RBNZ guidelines is 8% (relates to credit unions that are rated by an RBNZ licenced credit rating agency). PFCU's Tier 1 capital requirement under its trust deed is 10%. Management aims to maintain the capital ratio at above 12% at all times as per its internal target.

PFCU's tier 1 capital to risk weighted assets ratio has been improving since FY15 and was 23.7% as at 31 Jan 2019 (FY18: 23.7%, FY17: 21.4%). This steady improvement was on account of 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 higher risk-weighted charge of >100% - accompanied by an increase in assets with a lower risk-weighted charge (term deposits with registered banks).

Significant headroom above the regulatory and trust deed requirements enable PFCU to adapt, in case regulatory changes require it to hold higher capital, without having to sacrifice profitability.

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 53.9% as at 31 Jan 2019 (52.6% as at 30 Jun 2018 and 51.5% as at 30 Jun 2017). Equifax deems this to be extremely conservative, relative to peers' average liquidity.

Moreover, PFCU's calculation of this ratio 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 28.9% as at 31 Jan 2019[3] (25.9% as at 30 Jun 2018[3] and 24.6% as at 30 Jun 2017[3])

PFCU was assessed as having sufficient headroom to trust deed requirements for above-mentioned metrics, which supports PFCU's capacity to withstand a funding shock. Moreover, PFCU's members' deposits have a consistently healthy reinvestment rate. As of Jan19, the monthly reinvestment rate was 81% and the annual reinvestment rate was 89%.

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[3]Calculated as per the trust deed requirements, as reported in the annual report 2018, Page 22. 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	Credit Union South	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	NZ
Scale:										
Operating income ($ 000s)	13%	16,072	13,125	3,960	139,453	196,794	76,140	19,531	16,393	5,464
Total Assets ($ 000s)	0%	381,380	130,716	159,809	4,455,210	4,525,597	2,628,754	359,315	724,403	128,126
Gross loans ($ 000s)	0%	274,876	106,047	132,047	3,796,045	4,014,612	2,292,497	198,519	558,356	53,817
Profitability:										
Net Interest Margin (%)	75%	3.4%	6.9%	1.7%	2.2%	3.8%	2.0%	3.6%	1.9%	3.7%
Non Interest Income to total operating income (%)	0%	13.5%	27.4%	20.8%	24.0%	6.6%	26.6%	32.6%	7.5%	3.9%
ROE (%)	50%	2.5%	-4.4%	3.9%	11.9%	11.7%	7.4%	1.3%	8.7%	7.0%
Return on assets (%)	88%	0.3%	-0.7%	0.5%	0.8%	1.7%	0.5%	0.2%	0.6%	1.3%
Efficiency Ratio (%)	50%	93.1%	81.1%	65.3%	64.0%	40.9%	76.1%	92.0%	60.9%	71.0%
Capitalisation:										
Leverage (Gross loans to Equity) (x)	100%	6.71	5.11	7.30	12.40	6.00	12.63	3.49	11.38	2.20
Tier 1 common equity ratio - risk adjusted (%)	100%	10.8%	12.0%	11.7%	10.9%	13.7%	13.6%	14.9%	10.1%	23.7%
Tier 1 capital to total assets ratio (%)	100%	10.7%	15.9%	11.3%	6.7%	14.7%	6.9%	15.7%	6.8%	19.0%
Funding and liquidity:										
Gross loans as a % of total assets (%)	100%	72.0%	81.1%	82.6%	85.2%	88.7%	87.2%	55.2%	77.1%	42.0%
Customer deposits to gross loans (%)	100%	122.7%	87.5%	106.5%	3.8%	71.8%	96.0%	150.2%	120.3%	191.8%
Liquid assets to total assets (%)	100%	25.9%	12.4%	10.5%	1.4%	4.4%	1.8%	37.6%	23.0%	52.6%
Asset Quality:										
Net Charge-offs to gross loans (%)	75%	0.18%	0.33%	0.10%	0.00%	0.48%	0.00%	0.23%	0.06%	0.01%
Non performing loans to gross loans (%)	100%	0.32%	0.94%	2.21%	0.05%	1.13%	0.09%	4.33%	0.28%	0.05%
Non performing and over 90day loans to gross loans (%)	100%	0.32%	0.94%	4.01%	0.21%	1.84%	0.35%	4.95%	0.48%	0.05%
Individual provision for loan losses to gross loans (%)	75%	0.14%	0.08%	0.19%	0.02%	0.23%	0.03%	0.65%	0.07%	0.05%
Individual & collective provision for loan losses to gross loans (%)	88%	0.22%	0.74%	0.27%	0.13%	0.74%	0.21%	1.34%	0.24%	0.21%

Summary Financial Data

Police and Families Credit Union (PFCU)							
NZ$ 000s	Trend	2014 (A)	2015 (A)	2016 (A)	2017 (A)	2018 (A)	2019 (F)
Income Statement							
Net Interest Income		4,290	4,930	5,191	5,118	5,252	5,167
Non interest income		256	241	198	200	212	158
Operating Income		4,546	5,171	5,389	5,319	5,464	5,324
Operating Expense		2,975	3,175	3,577	3,671	3,877	4,153
Pre-Provision Operating Profit		1,572	1,997	1,812	1,647	1,587	1,172
Credit impairment charge		-2	-18	14	8	-6	0
Operating Profit Before Tax		1,574	2,015	1,799	1,640	1,593	1,172
Other non Operating Income/(Expense)		38	21	14	8	2	7
PBT		1,612	2,036	1,813	1,647	1,595	1,179
Financial Position							
Total Assets		98,583	108,945	118,945	122,812	128,126	129,288
Customer Deposits		80,756	89,174	97,244	99,589	103,235	103,235
Loans		63,598	64,283	60,591	57,517	53,706	52,087
Liquid assets		33,776	38,470	55,308	62,212	67,361	69,985
Ratios							
PBT to operating income margin (%)		35%	39%	34%	31%	29%	22%
Net Interest Margin (%)		3.93%	4.05%	3.93%	3.79%	3.72%	3.52%
Efficiency Ratio (%)		65.4%	61.4%	66.4%	69.0%	71.0%	78.0%
Return On Assets (%)		1.7%	2.0%	1.6%	1.4%	1.3%	0.9%
Return on Equity (%)		9.8%	11.1%	9.0%	7.8%	7.0%	4.7%
Tier 1 Risk-Based Capital Ratio (%)		15.9%	16.7%	18.6%	21.4%	23.7%	27.0%
Tier 1 Capital to Total Assets Ratio (%)		17.5%	17.7%	18.6%	18.5%	19.0%	19.8%
Leverage Ratio Total loans to Equity (x)		3.68	3.33	2.87	2.52	2.20	2.04
Charge-offs/Total loans (%)		0.01%	0.02%	0.03%	0.02%	0.01%	0.01%
Non-Performing Loans to Gross Loans (%)		0.03%	0.05%	0.03%	0.05%	0.05%	0.05%
Non-Perform Assets & 90+ Days Past to Gross loans (%)		0.03%	0.23%	0.03%	0.05%	0.05%	0.05%
Loan Loss Provision/Loans (%)		0.23%	0.18%	0.18%	0.19%	0.21%	0.21%
Deposits to loans (%)		127%	138%	160%	173%	192%	199%
Liquid assets to total assets (%)		35%	35%	47%	52%	53%	54%

APPENDICES

1. Explanation of the Equifax's credit rating

1.1 What is a rating?

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

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

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

1.2 Equifax's credit rating

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

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

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

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

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

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

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

1.3 Rating Definitions

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

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

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

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

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

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

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

1.4 Rating Outlooks

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

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

Credit Concepts measured

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

http://corporatescorecard.com.au/services_credit_ratings.php

http://corporatescorecard.com.au/docs/RatingMethodologyFinancialInstitutionRatingCriteria.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 (version 5, 2018).

http://www.corporatescorecard.co.nz/docs/RatingMethodologyFinancialInstitutionRatingCriteria.pdf

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