Credit Ratings & Research

Credit Rating Report
Credit Union Auckland Incorporated

NZBN: 9429043039128

Credit Rating Report

Date: 15 December 2023

Prepared for: Credit Union Auckland Incorporated

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

Primary Analyst: Anuj Kindra, CFA

Secondary Analyst: Brock Ackerley, BCom

Job Number: 384265

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

Corporate Scorecard
From Equifax

Contents

1. Executive Summary

Credit Union Auckland Incorporated trading as NZCU Auckland ('NZCUA')

NZCUA is a New Zealand based Non-Bank Deposit Taking (NBDT) organisation licenced by the Reserve Bank of New Zealand (the RBNZ). NZCUA receives deposits from and provides consumer loans to its members.

Equifax have affirmed NZCUA's credit rating of 'CCC+' at Oct23 (and Jun23), being a credit-watch classification with a very high level of risk. The 'negative rating watch' status has been resolved as NZCUA is no longer in breach of the regulatory minimum capital ratio threshold (8.0%), with $0.3m of capital note injection from First Credit Union ('FCU') supporting capital ratio increase to 9.1% at Oct23 (Jun23: 7.8%). The outlook for the rating remains 'Negative', due to continued operating deficits, although reducing, amidst evolving risks from the current macroeconomic environment.

NZCUA's credit rating benefits from its operating history of over 50 years, established market position with its members, and healthy asset quality metrics. However, the rating is constrained by NZCUA's weak operating profile, with deficient operating earnings and high fixed cost base – compounded by inability to realise expected benefits following the merger with NZFCU, resultant pressure on capital metrics, recent deterioration in its liquidity profile, its small-scale operations which are predominantly concentrated in Auckland, and competitive threats from banks and fintech disruptors.

Strengths

- NZCUA's market position is supported by its long operating history, servicing the banking needs of its predominantly Auckland-based members since 1965. The recent merger with NZFCU (in Jun22) expanded and diversified NZCUA's membership base and offered potential for growth in the scale of operations, NZFCU itself having been providing services to its niche member base since 1976 from its Wellington branch, with members across New Zealand.

- NZCUA's asset quality is sound, indicating a prudent credit risk management function. NZCUA's loan losses have consistently remained below 1.2% of the portfolio across the rating period. Further, the merger with NZFCU, which had low delinquency levels supported by direct access to members' (firefighters') payroll for loan repayments, further supports NZCUA's asset quality. Moreover, the nature of its members' employment (offering an essential community service) means their capacity to repay, is not likely to be materially impacted by macro-economic cycles.

Constraints

- NZCUA's credit rating is constrained by its weak operating profile, underlined by ongoing operating deficits, which have decreased but not as much as originally anticipated post-merger with NZFCU. NZCUA reported a deficit of -$0.8m for FY23, and a further deficit of -$0.1m for the four months to Oct23 (4MFY24), emanating from its high-cost base and limited loan book growth, unexpected costs in relation to the relocation of its head office and main operating branch, and implementation of its new IT system. Moreover, although some growth in the loan book has occurred during the financial year ended Jun23, the level remains short of management's original expectations, as expansion opportunities presented by the merger with NZFCU have not materialised, thereby weighing on NZCUA's operating results. In particular, its ability to reach volunteer and permanent firefighters through direct marketing has been restricted by prolonged industrial action that has only recently been resolved, while management closed the NZFCU branch ~12-months following the merger – which is reflective of the insufficient uptake in members and activity to date.

- NZCUA's continued weak financial performance has placed ongoing pressure on its ability to maintain minimum capital adequacy. NZCUA's consistently deficient earnings since FY19 have eroded its retained earnings, while the merger with NZFCU placed further pressure on NZCUA's capital ratio, which had declined below minimum regulatory requirement to 7.6% at Sep23 (Jun23: 7.8%, Jun22: 11.9%, Jun21: 14.8%). Whilst management's cost saving measures are benefitting current performance, continued challenging industry conditions as described below, will likely weigh on its operating performance and constrain any meaningful improvement in operating results in the short-term. Positively, NZCUA's compliance with the regulatory capital requirements has been restored, with an increase in capital ratio to 9.1% at Oct23 supported by $0.3m of capital note injection from FCU, who have also provided an additional drawdown facility of up to $0.7m, thereby offering some protection to its capital ratio, at least in the short-term, from future periods of adverse operating performance.

- Macro-economic headwinds remain tilted downside and likely to present a challenge to NZCUA's growth and return-to-profitability plans, over the near to medium term. Together with the wider economy, the NBDT sector is likely to face the impact of inflation pressures, which remain elevated due to the evolving geo-political landscape and high energy costs. Higher interest rates are weighing on borrowers' debt servicing capacity and softening in property prices may also impact the security cover on loans. Although NZCUA's asset quality remains sound overall, early signs of pressure may be evidenced by a ~150bps increase in delinquencies rate during 4MFY24 (Oct23: ~5.1%, Jun23: ~3.6%), as members face cost of living pressures.

- NZCUA's liquidity profile has recently deteriorated and its headroom over the minimum 1.20x liquidity coverage ratio (LCR) requirement of its Trust Deed is thin. A slower than anticipated deposit growth has seen NZCUA utilise its liquid assets (cash reserves and short-term deposits held with other financial institutions) to fund the increase in member loans to improve earnings, leading to a deterioration of its LCR (calculated according to its Trust Deed) to 1.36x at Oct23 (Jun23: 1.38x, Jun22: 1.60x). Further, NZCUA's liquid assets as a proportion of total assets fell to 14.5% at Oct23 (Jun23: 15.5%, Jun22: 27.0%), which is worse than the sector average. Positively, a strong relationship with its members has supported high reinvestment rates for its member deposits, underpinning NZCUA's deposit to loan ratio which has remained consistently above 100%.

- Stiff competition from other credit unions, traditional banks, fintech companies and the Buy Now Pay Later sector represents an ongoing and increasing impediment to increase market share for NZCUA, in our view. NBDT sector's limited product offering underpins a low systemic importance and acts as a ceiling for the sector's (and by extension NZCUA's) credit rating.

- NZCUA's small scale also gives rise to moderate concentration risks in its operations. NZCUA's top six loans accounted for 15.3% of its total loan book at Oct23. Further, NZCUA's operations are exposed to geographic concentration, with the majority of NZCUA's members located in the Auckland region and its branch network largely concentrated in Auckland.

The outlook for NZCUA's credit rating is 'Negative' and a rating upgrade is unlikely in the short-term.

The rating may be revised downward in the event of continued operating deficits.

Risk Rating

CCC+

Outlook: Negative

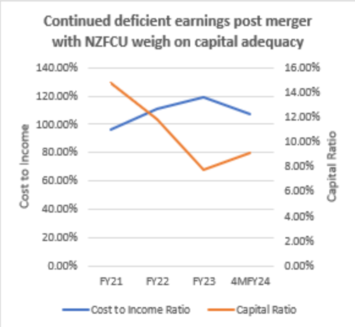
Type: Public, Monitored

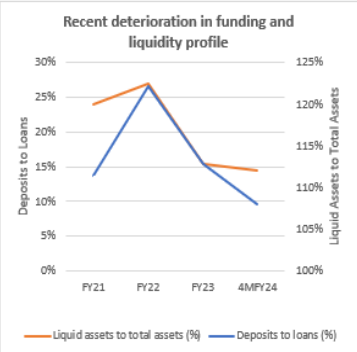
Industry Percentiles

Scale:	Percentile*
Total Assets	6%
Gross Loans	7%
Profitability:	
NIM	85%
ROE	12%
ROA	13%
Efficiency Ratio	16%
Capitalisation:	
Leverage (Gross loans to Equity)	0%
Capital Ratio	0%
Capital to Total Assets	0%
Funding and liquidity:	
Deposits to Loan Ratio	50%
Liquid Assets to Total Assets	39%
Asset Quality:	
Net Charge-offs	19%
Impaired Loans	19%
Provision for Loan Losses	24%

NZCUA Oct23 results compared to the FY23 benchmark

Key Trends





2. Scope of Report

The purpose of this report is to provide an overview of the credit rating and associated rationale of Credit Union Auckland Incorporated, trading as NZCU Auckland ('NZCUA').

We have complied with our rating services guidelines in order to derive the credit rating on Credit Union Auckland 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	**15th December 2023**
Request Type	**Issuer (Self-assessment)**
Assessment Type	**Under ongoing monitoring**
Rating Initiation	**Issuer based (solicited)**
Rating Distribution	**Public**
Report Distribution	**Unrestricted**
Purchased by	**Credit Union Auckland Incorporated**
Report Fee	**Fixed Price**
Ancillary fees	**Nil**
Issuer Name	**Credit Union Auckland 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 Credit Union Auckland Incorporated, publicly available information and from our own enquiries. We have derived a credit rating on NZCUA based on the understanding that Credit Union Auckland Incorporated has no contingent liabilities, cross guarantees or other liabilities to any other entity other than as disclosed to us or as detailed in the financial statements. Our duty does not include auditing the financial statements.

Information Sources	
Financial statements	**- Management accounts of NZCUA for the four month period ended 31 October 2023.** **- Audited Financial Statements of NZCUA for the years ended 30 June 2023, 2022 and 2021.** **- Audited Financial Statements of NZFCU for the years ended 30 June 2021, 2020 and 2019.** **- Management accounts of NZFCU for the year ended 30 June 2022.**
Name of auditor	**BDO Auckland (NZCUA – from FY22)** **PricewaterhouseCoopers (PwC), Auckland (NZCUA – to FY21)** **Grant Thornton New Zealand Audit Limited (NZFCU)**
Other Information Sources	**NZCUA's response to our Request for Information, NZCUA website, NZFCU website, industry and regulatory websites, management interviews, media articles, adverse searches and internet searches.**
Issuer Participation	**Full**
Material Financial Adjustments	**None**
Limitations of Assessment	**None noted**
Outsourced Assessment Activities	**No**
Confidentiality Agreement	**No**
Material Client	**No**
Rating Amended Post Issuer Disclosure	**No**
Potential Conflict of Interest	**None noted**
Rating Methodology	**Financial Institution Rating Criteria**

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

3. General Background of the Subject

Subject Name	Credit Union Auckland Incorporated
Type of Entity	Licensed Non-Bank Deposit Taker (NBDT)
Head Office Address	956 Great South Road, Penrose, Auckland 1061, New Zealand
Date of Incorporation	6 October 1965
Principal Activities	NZCUA provides secured and unsecured personal loans, residential mortgages, transactions and savings accounts, and term deposit services to its members.
	Credit Union Auckland Incorporated is a Non-Bank Deposit Taking (NBDT) institution licensed with the Reserve Bank of New Zealand (RBNZ). NZCUA is a not-for-profit credit union with the objective of servicing its members. Established in 1965, NZCUA primarily provides everyday transactional accounts, savings accounts, term deposits, personal loans and residential mortgages to its members who are predominantly from the greater Auckland region. On 20 June 2022, NZCUA merged with the New Zealand Firefighters Credit Union ('NZFCU'), which had previously recorded a number of regulatory breaches. NZFCU was established in 1976 as the Wellington Firefighters Credit Union, and provides a range of banking services to its members, with membership open to all New Zealand firefighters and emergency services personnel. Due to operating deficits during FY23, NZCUA breached its regulatory minimum capital ratio required as at Jun23. NZCUA's compliance with the regulatory capital requirements has since been restored, supported by capital note injection from First Credit Union ('FCU').

4. Industry Risks

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

Systemic Risk Factors

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

On Wednesday 29 November 2023, the Monetary Policy Committee (MPC) reached a consensus to maintain the official cash rate at 5.5%. MPC discussed the risks around the lagged effect of previous monetary tightening on households and businesses, and recent data showing continuing weak demand for credit, as higher interest rates and a slowing economy reduce the ability and willingness of businesses and households to borrow. It was agreed the ongoing slowdown in economic activity is not even across sectors of the economy, due to global factors and the varied impact of high domestic interest rates - pockets of stress have emerged for some in the household, commercial property, and agricultural sectors. Supply constraints in the economy continue to ease and demand growth is slowing, but to a lesser extent than expected. It was agreed that inflation remains too high and inflationary pressures continue to emerge. The Committee agreed that further slowing in spending growth is needed to reduce demand toward the economy's ability to supply goods and services, to ensure that consumer price inflation returns to its 1.0% to 3.0% target range, while supporting maximum sustainable employment.

The MPC indicated that globally, headline inflation continues to fall, but there are differences in both the timing and magnitude of these declines across countries, and central banks are expected to keep monetary policy tight for some time. While the global economy's adjustment to higher interest rates has been relatively benign so far, the full impact is still to be seen and there are several tail risk scenarios. Key global risks in the near term include the possibility that central banks need to tighten monetary policy further, unanticipated impacts from previous tightening, potential spill-overs from the current slowdown in the Chinese property market and escalation of the war in the Middle East.

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

The MPS has noted that mortgage borrowers in New Zealand are relatively more exposed to higher interest rates because of higher household debt levels and the relatively short fixed-rate periods of New Zealand mortgages. Therefore, against the backdrop of heightened cost-of-living pressures, rising debt servicing commitments have squeezed households' budgets. More borrowers are under pressure on their debt

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

obligations. Early-stage arrears have increased over the past six months and have now surpassed the levels seen at the start of the pandemic.

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

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

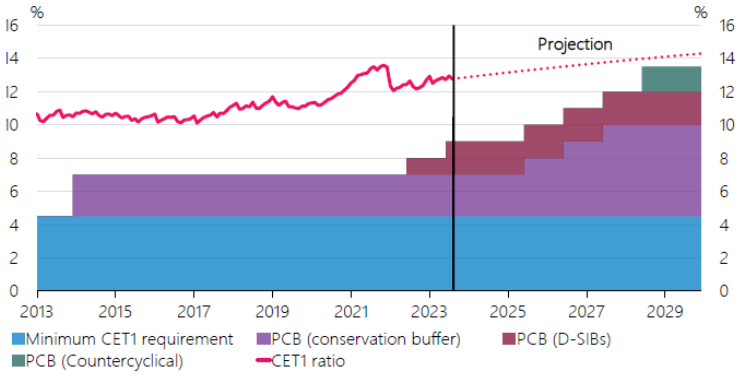
The New Zealand housing market has stabilised following a decline in prices and activity since late 2021. Recent months have seen house prices rise modestly across most regions, supported by strong net immigration, though high interest rates continue to suppress buyers' borrowing capacity. The recovery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

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

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

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

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



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

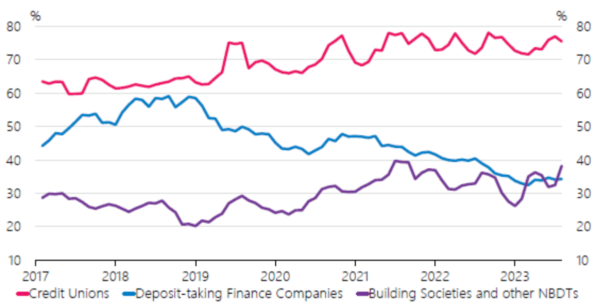
Note: CET1 is Common Equity Tier 1. PCB is the Prudential Capital Buffer.

(Source: RBNZ Financial Stability Report Nov23)

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

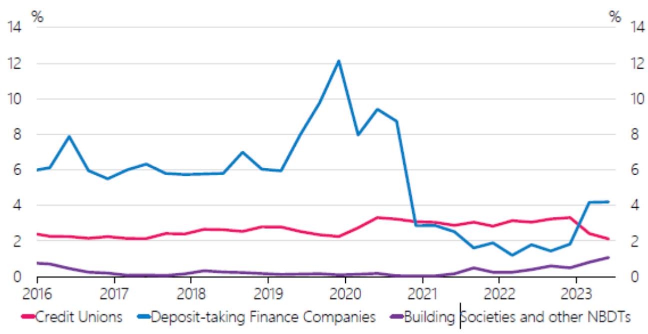
NBDT operating expenses to total income ratio

(3-month moving average)



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

NBDT non-performing loans ratio



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

(Source: RBNZ Financial Stability Report Nov23)

Cyclicality

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

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

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

Market Risk

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

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

<u>Interest rate movements</u>

In Oct23, the Monetary Policy Committee ('MPC' or 'the Committee') kept the Official Cash Rate (OCR) on hold at 5.5% (vs 5.25% at Ap23), after twelve consecutive rate hikes spanning a period of 20 months. In Nov23, the Committee affirmed its decision and agreed to maintain the OCR at 5.5%. MPC noted that inflation is still expected to decline within the target band by the second half of 2024 indicating that monetary policy will remain tight for the foreseeable future.

The above decision was taken in the light of recent data which suggests that tight monetary conditions are constraining domestic spending as expected. While GDP grew by more than expected in the June 2023 quarter, employment and headline CPI inflation in the September 2023 quarter declined by more than expected, and the latest data suggest that economic growth has slowed in the September 2023 quarter. Further, the high level of net immigration and the recovery in house prices point to capacity pressures softening less than expected. Overall, the growth outlook remains subdued amidst the restrictive monetary conditions.

Asset Price Movements

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

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

Foreign Currency Risks

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

New Zealand Exchange Rate

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

Level of Competition and Market Structure

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

<u>Overview of Competitive Landscape in New Zealand</u>

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

There are currently 14 NBDTs actively operating in New Zealand, which include building societies, credit unions, and deposit taking finance companies. They have a diverse range of business models, with credit unions having a high share of their lending in a mix of residential and consumer loans to their members, while building societies and finance companies tend to focus on a range of property lending products. At Jun23 total net lending by NBDTs was around $2.2bn, compared to $550bn in lending by banks. While small relative to the rest of the financial system, the NBDT sector covers a diverse range of organisations that support financial inclusion by serving communities that may traditionally be under-serviced by the banking system.

Consolidation in the NBDT sector continues, particularly among credit unions. Overall, since 2018, the number of credit unions operating in New Zealand has fallen from 13 to 4. Many of the profitability challenges faced by the credit union sector are due to lack of scale and high operating costs relative to income. Combined with a limited ability to raise external equity given their mutual structure, some institutions have had a limited capacity to build up the capital buffers that are needed to absorb unexpected shocks while maintaining credit growth.

Key metrics for Non-Bank Deposit Takers (NBDTs)

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

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

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

2 Other NBDT refers to Christian Savings Limited.

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

Macro Prudential Policy

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

LVR restrictions are the main tool currently used to address financial system risks related to the housing market. In Jun23, RBNZ eased LVR restrictions on lending to investors, with loans having LVR above 65% being classified as high-LVR (vs previous limit of 60%) and restricts high-LVR lending to no more than 5% of a bank's total new investor lending. In addition, the maximum share of new lending to owner-occupiers with LVRs over 80% was increased from 10% to 15% from 1 Jun 2023. RBNZ noted that the previous restrictions built resilience in the financial system, which was evident in the house prices which fell without widespread impacts to financial stability. RBNZ noted that risks to financial stability posed by high-LVR lending have reduced to a level where they believe the previous restrictions may be unnecessarily reducing efficiency.

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

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

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

<u>Regulatory developments in New Zealand</u>

The enactment of the Deposit Takers Act (DTA) in July 2023 was a major milestone and lays the groundwork for modern regulation and supervision of the deposit taking sector. The DTA creates a single regulatory framework for banks and non-bank deposit takers. Included within the DTA are proposals for a Depositor Compensation Scheme (DCS) to cover bank depositors in the event of bank, or non-bank deposit taker such as a building society, failing. Depositors will be covered for a total of $0.1m per institution per depositor.

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

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

5. Prudential Framework

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

Credit Rating	Licensed NBDTs are required to have a local currency (New Zealand dollar), long-term, issuer rating given by approved rating agencies, unless an approved exemption applies.
Governance	Licensed NBDTs that are companies or building societies must have a chairperson who is not an employee of either the licensed NBDT or a related party and must have at least two independent directors. Licensed NBDTs that are subsidiaries of another person are prohibited from including provisions in their constitutions that would allow directors to act otherwise than in the best interests of the NBDT.
Risk Management	Licensed NBDTs are required to have a risk management programme that outlines how the licensed NBDT identifies and manages its credit, liquidity, market, and operational risks. This programme is to be submitted to, and approved by, the licensed NBDT's trustee.
Capital Ratio	A minimum capital ratio (the level of capital in relation to the credit exposures and other risks of the NBDT or its borrowing group) is required to be included in licensed NBDTs' trust deeds. This ratio must be at least 8% for licensed NBDTs with a credit rating from an approved credit rating agency. For licensed NBDTs without a credit rating from an approved rating agency, the minimum capital ratio specified in the trust deed must be at least 10%, or 12% under the Non-bank Deposit Takers (Credit Ratings Minimum Threshold) Exemption Notice 2016.
Related party exposure limits	The exposures to related party, as defined in the Act, shall not exceed a maximum limit of 15% of capital.
Liquidity	Liquidity regulations require every licensed NBDT and its trustee to ensure that the licensed NBDT's trust deed include one or more quantitative liquidity requirements that are appropriate to the characteristics of the licensed NBDT's business, and that take into account the liquidity of the licensed NBDT and the liquidity of any borrowing group.
Suitability assessment of certain directors and senior officers	Licensed NBDTs must notify the RBNZ when one of its directors or senior officers (or a person who is proposed to be appointed as a director or senior officer) raises a "suitability concern".
Change in ownership	An application must be made to the RBNZ to approve a transaction that will result in a person: 1. having the direct or indirect ability to appoint 25% or more of a licensed NBDT's governing body; or 2. having a qualifying interest in 20% or more of the voting securities issued by the licensed NBDT.

6. Business Risks

6.1 Market Risk Exposures and Controls

Interest Rate Risk

NZCUA's exposure to market risk is mainly in form of interest rate risk. NZCUA currently has no exposure to foreign currencies or to equity investments.

NZCUA's loan portfolio substantially consists of floating interest rate personal loans, however, we note that in practice the interest rate on personal loans does not change during the life of the loan unless a review event is triggered. NZCUA's home loans are only offered at floating rates and are secured by residential properties.

All member deposits (shares) have fixed interest rates for their terms, and as such, NZCUA has minimal interest rate risk on these items until maturity.

In our view, NZCUA's interest rate duration risk is considered low in light of the above, however, its operations are exposed to the systemic risk of interest rate changes and their impact on earnings.

Repricing Gap Analysis at Oct23 (Undiscounted Cashflows)

000's	Total	Up to 1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	5+ years
Assets								
Cash on hand	-183	-183	-	-	-	-	-	-
Bank account	1,746	1,746	-	-	-	-	-	-
Accounts receivable	426	337	-	-	-	-	36	54
Call deposits	1,703	1,703	-	-	-	-	-	-
Term deposits	1,264	450	400	415	-	-	-	-
Overdraft	45	45	-	-	-	-	-	-
Loans to members	22,517	1,215	1,100	1,509	2,869	4,730	5,567	5,527
Total Assets	**27,519**	**5,313**	**1,500**	**1,923**	**2,869**	**4,730**	**5,603**	**5,581**
Liabilities								
On call shares	13,087	13,087	-	-	-	-	-	-
Term shares	11,285	519	1,349	3,709	3,657	2,051	-	-
Provision for dividend	179	179	-	-	-	-	-	-
Accounts payable	415	415	-	-	-	-	-	-
Total Liabilities	**24,966**	**14,200**	**1,349**	**3,709**	**3,657**	**2,051**	**-**	**-**
Difference	**2,553**	**-8,887**	**151**	**-1,786**	**-789**	**2,679**	**5,603**	**5,581**

The unfavourable balance in the near-term maturity buckets indicates that NZCUA's liabilities mature earlier and are repriced more frequently relative to its assets. In other words, NZCUA is using shorter-duration funding to underwrite longer-duration loans. In a rising interest rate environment, the above is negative as interest income from loans grows faster than cost of deposits.

Whilst the RBNZ is confident that the current level of the OCR is restricting demand, ongoing excess demand and inflationary pressures remain of concern, given the elevated level of core inflation. If inflationary pressures were to be stronger than anticipated, the OCR would likely increase interest rates further, going forward, which could present downward pressure on NZCUA's net interest margins. However, we take some comfort in a majority proportion of member deposits being at call (53.7% of total deposits), which attract a low rate of interest payable by NZCUA partially offsetting the impact to NIMs.

Liquidity Risk

Liquidity risk is the risk that NZCUA will encounter difficulty in meeting payment obligations associated with its financial liabilities when they fall due. It includes the risk that NZCUA 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.

NZCUA's membership comprises of personal members with employment and age diversification. This diversification ensures a steady and reliable flow of funds to the Credit Union. With deposits from payroll deductions and a relatively loyal term deposit base, the Credit Union has been able to maintain a regular and stable source of retail funds at reasonable cost.

As per the Trust Deed, NZCUA must at all times maintain a liquidity cover ratio (LCR) of not less than 1.2 times[1] (Actual LCR at Oct23: 1.36 times). Additionally, NZCUA's risk management policy states that liquid assets (cash and term deposits maturing within three months) must not be less than 10.0% of total tangible assets (Oct23: 14.7%). Liquidity is monitored daily by the accountant and reviewed weekly by the CEO.

NZCUA's primary funding source is term deposits from customers. The management monitors and reports on maturing deposits, reinvestment rates and new funding inflows monthly. The directors regularly review and adjust interest rates with reference to market rates and funding requirements while depositors are contacted by a member services officer in the month preceding the maturity of their deposit.

[1] Calculated as (Existing liquid assets + Expected loan receivables within one month + Expected gross deposit contributions within one month)/Expected gross deposit redemptions within one month

In our view, NZCUA's liquidity profile has deteriorated in the recent 12-18months and its headroom over minimum liquidity coverage ratio (LCR) requirements of its Trust Deed is thin. A decline in the rate of growth in member deposits has seen NZCUA utilise its liquid assets (cash reserves and short-term deposits held with other financial institutions) to fund the increase in member loans which support its earnings, leading to a deterioration of its LCR (Oct23: 1.36x, Jun23: 1.38x, Jun23: 1.60x) against the beforementioned minimum of 1.20x. Positively, a strong relationship with its members has supported high reinvestment rates for its member deposits, underpinning NZCUA's deposit to loan ratio which has remained consistently above 100%.

6.2 Credit Risk Exposures and Controls

Credit risk is the risk that the counterparty will be unable to meet obligations to NZCUA under the terms of any loan or deposits (with banks). NZCUA is exposed to credit risk on both cash deposits held with NZ registered banks and loans granted to customers. With regard to its cash and cash equivalents, NZCUA faces low credit risk given the majority of its cash holdings are held with Tier I banks – Westpac New Zealand, Bank of New Zealand ('BNZ') and Heartland Bank. With regard to the loan portfolio, NZCUA manages counterparty risks on its loan portfolio through adherence to its credit policy and management of concentration risks and loan asset quality.

<u>Credit Approval Process</u>

NZCUA has a documented credit policy and approval process that includes conducting credit checks, obtaining security in the form of charges on residential property, motor vehicles, caravans, boats and specified industrial superannuation schemes. NZCUA also ensures its loans adhere to the following LVR limits as outlined in its credit policy.

Particulars	
Maximum Unsecured Personal Loan	$50,000
Maximum Secured Personal Loan	$100,000
Maximum LVR Limits for Asset Classes:	
• Motor Vehicles, Caravans, and Boats	100.0%
• Residential Property Construction	80.0%
• Residential Property Purchase	95.0%
• Residential Property Refinance	95.0%
• Bare Land	70.0%
• Residential Property – Leasehold	65.0%

The maximum tenor for personal loans is 5 years, while standard home loans are offered over a maximum of 25 years. The interest only repayment period on home loans is offered for a maximum of 5 years.

Concentration Risks

NZCUA's loan portfolio faces moderate concentration risks. At Oct23, NZCUA's exposure to a single borrower was 4.1% and its top 6 borrowers represented ~15.3% of the gross loan book. As such, NZCUA's financial performance is somewhat susceptible to a deterioration in credit profile of a few borrowers.

Asset Quality

NZCUA has a low proportion of unsecured loans, representing ~2.0% of its total loan book at Oct23. Further, at Oct23, NZCUA reported that ~59.5% of its total residential mortgages had an LVR of less than 70.0%, with the remainder between 70.0% and 80.0% LVR.

We note that 20.4% (Jun22: 24.5%) of loans at Jun23 were to individuals employed in the fire and emergency industry.

NZCUA's asset quality remains sound, in our view, however is possibly showing early signs of pressure, likely reflected by a ~150bps increase in delinquencies rate during 4MFY24 (Oct23: ~5.1%, Jun23: ~3.6%), as members face cost of living pressures during the current inflationary environment.

Loan losses have increased at Jun23, however remained low at 1.1% (Jun22: 0.2%) and decreased to 0.3% at Oct23, while the level of impaired loans, although worse than the sector, remain fairly low (Oct23: 2.2%, Jun23: 1.2%, Jun22: 2.0%), with management's forecast for FY24 showing a similar level is expected for the current financial year.

6.3 Structure and Service Delivery Platform

Structure

In order to accept term deposits, NZCUA entered into a Trust Deed with Covenant Trustee Services Limited ("the Supervisor") on 5 April 2001, which has been amended and restated on 7 October 2016 and further amended upon incorporation on 1 January 2020 (the "Trust Deed"). Under the terms of the Trust Deed, term deposits are secured by a security interest over all of NZCUA's present and future assets and undertakings, to Covenant Trustee Services Limited, as the Supervisor. The security interest secures all amounts payable by NZCUA on the term deposits and all other moneys payable under the terms of the Trust Deed.

The Supervisor reviews, on a monthly basis, the management accounts of NZCUA to determine whether the total value of the assets subject to the security interest are in excess of the amount of the liability secured by the security interest. NZCUA is also required to provide the Supervisor, on a monthly basis, with an attestation document accompanied by a Trust Deed financial ratio compliance report.

Service Delivery Platform

NZCUA uses the 'Sovereign' solution provided by Finzsoft Solutions Limited, which is the main operating system for operation of its core banking system. The Credit Union transitioned to the Finzsoft platform in late Oct23, replacing its legacy Oracle Flexcube software previously utilised through an agency agreement with Banzpay. This implementation of a new IT platform reflects a conscious focus by management to increase NZCUA's digital capabilities – with the majority of loan enquiries now generated on-line, as part of NZCUA's strategy to improve efficiencies, downsize its branch network, and realise cost-savings.

6.4 Strategic Vision

NZCUA's main strategic vision is to help its members in achieving their financial goals, growing its membership as well as remaining relevant to its current membership base.

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

6.5 Execution of Strategy

NZCUA's relatively simple business model fundamentally revolves around the provision of personal and home loans to its members, funded by call and term deposits. Personal loans, secured by motor vehicles and other assets, made up the largest portion (~58%) of NZCUA's loan book at Oct23, followed by loans secured by first mortgage over real estate (~33%). NZCUA's personal loan rates are generally higher than those available from a bank and its home loan rates are generally 25bps higher than the rates available at Tier 1 banks.

Member deposits are either at call (53.6% of total deposits), which attract a low rate of interest payable by NZCUA, or member term deposits, comprising 46.3% of total deposits, and offered for periods up to 24 months.

In addition to the business of accepting deposits and extending loans to members, NZCUA offers a school scholarship program which supports the children or grandchildren of members by contributing toward education costs.

6.6 Management

Board Member	Position	Year Appointed
Greg Carll MBA	Chairman, Chair of Risk & Compliance Committee	1987
Lionel Pereira	Director, Treasurer	2010

Boyd Raines	Independent Director, Former Board Member NZFCU	2022
Barbara Olah	Member Board Director	2023
Lisa Amoa MBA	Member Board Director	2021

NZCUA is governed by a five-member board, including one former board member of NZFCU, Boyd Raines, who joined the NZCUA board following the merger. In addition, NZCUA has an Advisor to the Board – Morris Anderson, with ~43 years of banking experience primarily with BNZ.

NZCUA's Chief Executive, Rudolf Laumatia, joined NZCUA in September 2021. Prior to joining NZCUA, Rudolf was the South Auckland Regional Manager for Westpac New Zealand for 16 years. Rudolf has extensive experience in the financial services industry, and moreover has knowledge and understanding of the region which forms the majority of NZCUA's member base.

6.7 Governance and Oversight

Internal

NZCUA's risk management system includes the maintenance of a risk register, policy documents and procedure manuals, including the Credit Risk Policy, Lending and Investment Policies and Procedures. Any changes to NZCUA's policies require the Supervisor's approval.

NZCUA's risk register records the following:

- The risks across the business, linked to risk categories;
- Linkage of risks to processes and people (risk owners);
- Assessment of inherent risks;
- Controls in place;
- Assessment of residual risk;
- Treatment of risks; and
- Monitoring of risks.

The Board of Directors is responsible for the overall risk oversight, monitoring NZCUA's capital management, strategic, environmental and cyber risks. The CEO is responsible for operational risk oversight including credit, liquidity and market risk management, AML/CFT compliance, and reporting to the Board of Directors.

NZCUA's internal Credit Risk Policy governs the approval parameters for the loans to members. The policy defines the credit approval process, policies for each credit product, security requirements, delegation limits, and remedial management policies and procedures for non-performing loans.

NZCUA's liquidity, market and AML-CFT policies are also developed on similar lines detailed above and include additional policies and procedure to manage special aspects associated with each of the above risks.

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

External

PricewaterhouseCoopers (PwC) acted as NZCUA's external auditor until 2021, after which, the function has been performed by BDO Auckland. NZCUA engages in annual external audits as a part of its ongoing commitment to compliance and governance.

The Trust deed and the prudential norms prescribed by the RBNZ are the key source of external governance measures with which NZCUA must comply. The details of the RBNZ's prudential requirements are mentioned in Section 5 and the table below summarises NZCUA's compliance with select requirements of the trust deed and the RBNZ's prudential norms. The table also highlights NZCUA's breach of capital adequacy requirements, which occurred from Jun23 to Sep23 – refer to Section 3 for further detail.

Following the merger, NZCUA's capital ratio decreased to 11.8% at Jun22, and driven by the substantial trading deficit in FY23, fell further to 7.8% at Jun23, which was below the minimum 8.0% regulatory requirement. Positively, NZCU's compliance with the regulatory capital requirements has since been restored, with an increase in capital ratio to 9.1% at Oct23 supported by $0.3m of capital note injection from FCU, who have also provided an additional drawdown facility of up to $0.7m, thereby offering some protection to its capital ratio, at least in the short-term, from future periods of adverse operating performance.

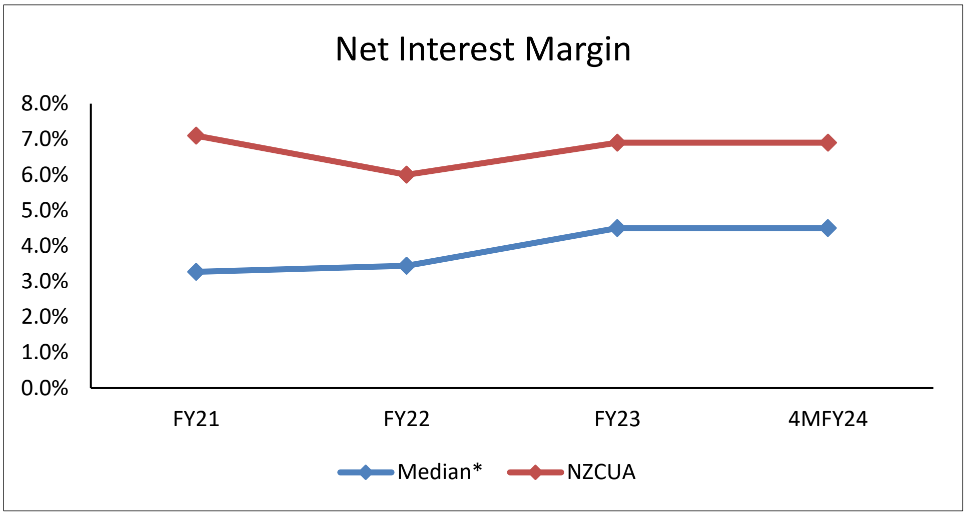
Ratio	Calculation	Oct23	Jun23	Jun22*	Trust deed	Regulatory
Risk weighted capital ratio	Tier 1 capital as a percentage of risk weighted assets	9.1%	7.8%	11.8%	8.0% or more if rated 10.0% or more if unrated	8.0% or more if rated 10.0% or more if unrated
Liquidity ratio	Liquidity + Expected loan receivables within the relevant quarterly period divided by Expected gross deposit redemptions within the relevant quarterly period.	1.4 times	1.4 times	1.6 times	>1.2 times	As appropriate
Related party ratio	Aggregate credit exposures to all the related parties as a percentage of tier 1 capital	4.3%	3.5%	2.1%	<15%	<15%

* Subsequent to Jun22, the 8.0% minimum capital requirement applies, pursuant to NZCUA obtaining a credit rating.

7. Financial Indicators

7.1 Profitability

<u>Net interest Margin</u>



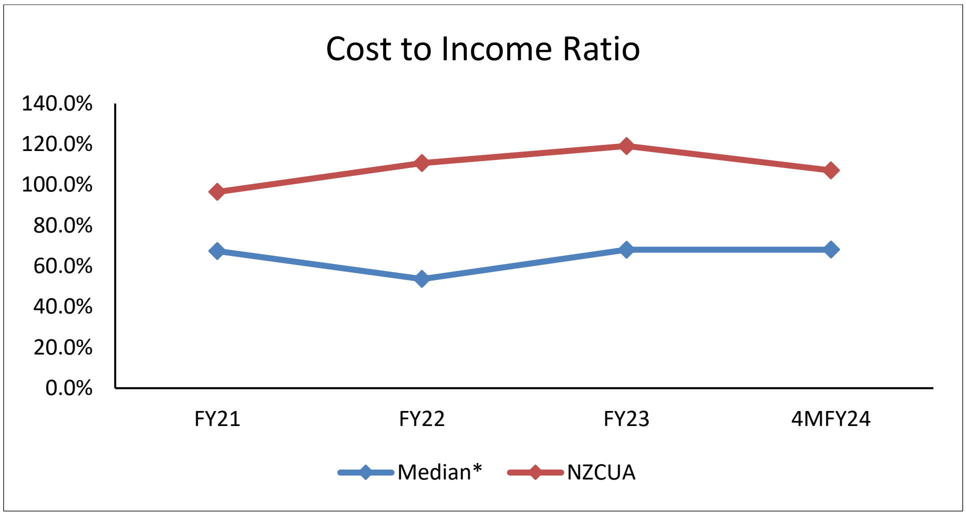
**Source: Reported financial statements of Peer Group from FY21 – FY23.*

During the year ended Jun23, NZCUA's net interest margin (NIM) improved to 6.9% (FY22: 6.0%), driven by 12.7% growth in loan book. The NIM is supported by healthy margins on its personal loans, which make up the majority of its total loan book, together with the rising interest rate environment – enabling NZCUA to increase its yield on home loans. At the same time, the interest cost on member deposits remained low, supported by a majority portion of NZCUA's member deposits comprising of call deposits (~53.7% of total deposits at Jun23), which attract minimal interest, compared to term deposits (~46.3% of total deposits at Jun23). Rising rates are likely to have also underpinned the improvement in net interest margins of its peers' for FY23.

During FY21, while interest rates were falling, NZCUA's NIM increased, as opposed to the contracted interest margin of its peers for the same period. This was primarily attributable to its negative ALM profile, whereby the effectively fixed-term nature of its longer maturity personal loans maintained higher interest rates, while short-term deposits were repriced at lower rates. In the ongoing inflationary environment, these same characteristics have the potential to place pressure on NZCUA's NIM going forward.

For the four months ended Oct23 (4MFY24), NZCUA's NIM remained stable at 6.9%.

Operating Efficiency



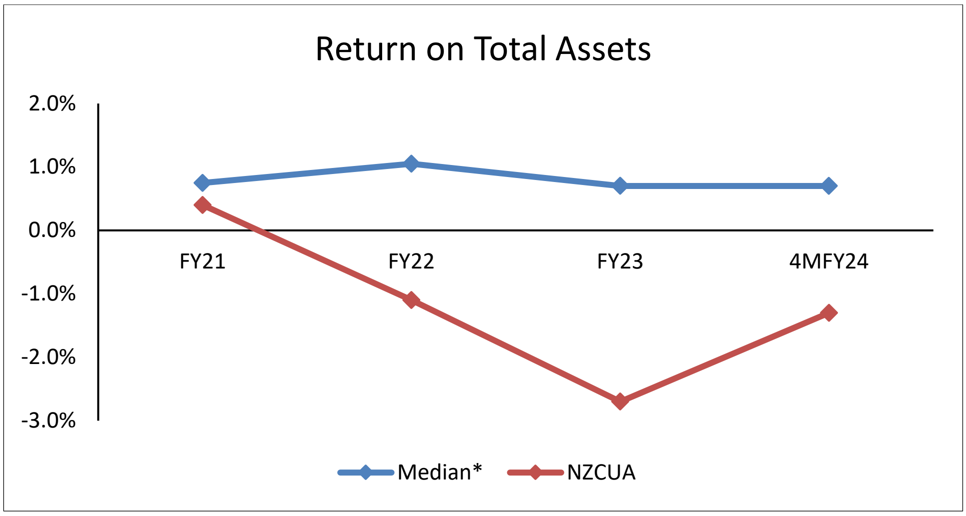
**Source: Reported financial statements of Peer Group from FY21 – FY23.*

NZCUA's small scale and high-cost base weigh on its profitability. NZCUA's cost to income ratio has remained at or above 95.0%, with persistent operating deficits reported across the review period. As part of management's strategic plan to improve efficiency and achieve cost savings, NZCUA has changed its IT system, moved into a new premises for its Penrose branch and head office, and also enacted closure of the Wellington (NZFCU) branch. However, particularly in FY23, the Credit Union's performance was impacted by unexpected costs in relation to the implementation of the new IT system – which could not be capitalised as originally expected, and substantial upfront costs associated with relocation of its head office and main operating branch, together with costs and operational disruptions from the NZFCU integration process.

Whilst we acknowledge management's cost saving measures, including the recent Penrose branch sharing arrangement with FCU, should benefit performance in the medium-term, continued challenging industry conditions as beforementioned, will likely weigh on its operating performance.

We also note that efforts to increase net interest income by raising interest rates for home loans may be challenging due to ongoing intense competition in the current market environment, while efforts to drive growth in the loan book to improve earnings burdens its risk-weighted assets, which in turn, may apply pressure on its capital ratio.

Return on Assets (ROA)



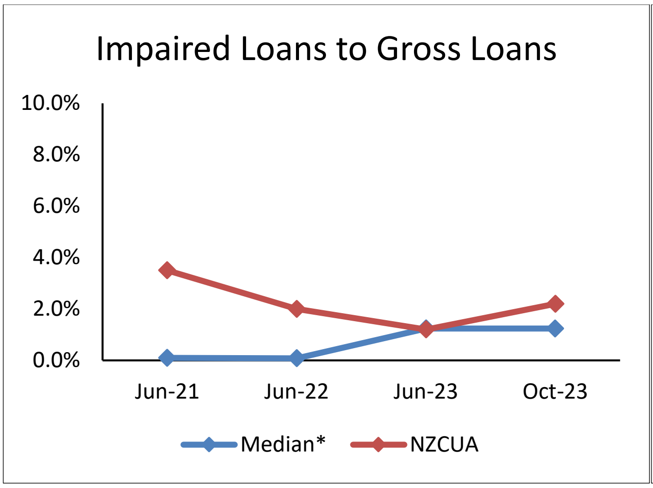
**Source: Reported financial statements of Peer Group from FY21 – FY23.*

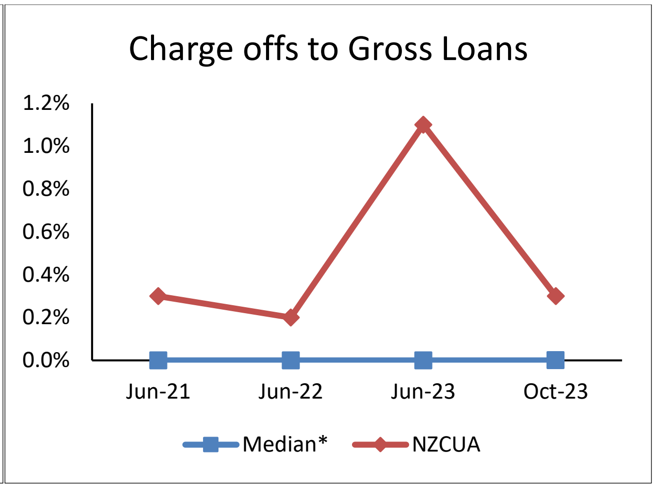
NZCUA's return on assets (ROA) declined in FY22 and FY23, due to increased operating deficits, together with a higher asset base as a result of the merger with NZFCU in FY22, and modest organic growth.

For the interim period to Oct23, NZCUA's ROA improved on account of a reduction in annualised operating deficit (vs FY23) and some contraction in total asset base, although remained negative and worse than the sector median.

7.2 Asset Quality

Impaired Loans



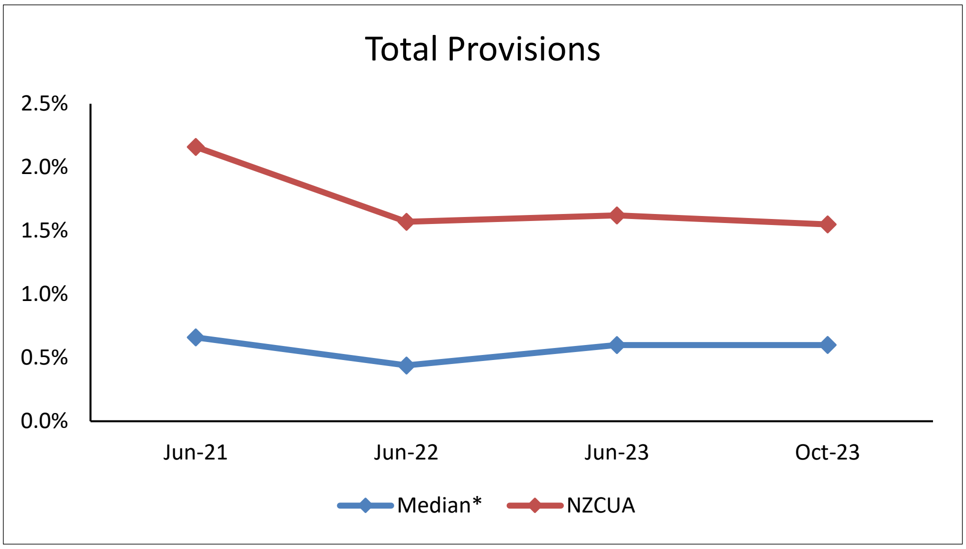


**Source: Reported financial statements of Peer Group from FY21 – FY23.*

Although worse than the sector average at Oct23, NZCUA's loan portfolio has exhibited relatively low delinquency levels and high recovery rates. The level of impaired loans decreased during the year ended Jun23, and although increasing, loan losses remained low at 1.1%.

While NZCUA's asset quality remains sound, benefitting from direct access to members' firefighters' payroll for loan repayments, there is possibly early signs of pressure, likely reflected by a ~150bps increase in delinquencies rate during 4MFY24 (Oct23: ~5.1%, Jun23: ~3.6%), as members face cost of living pressures during the current inflationary environment.

Provisioning

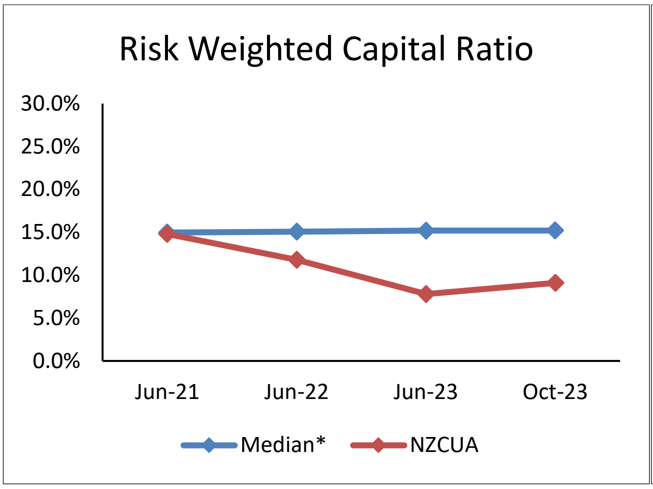


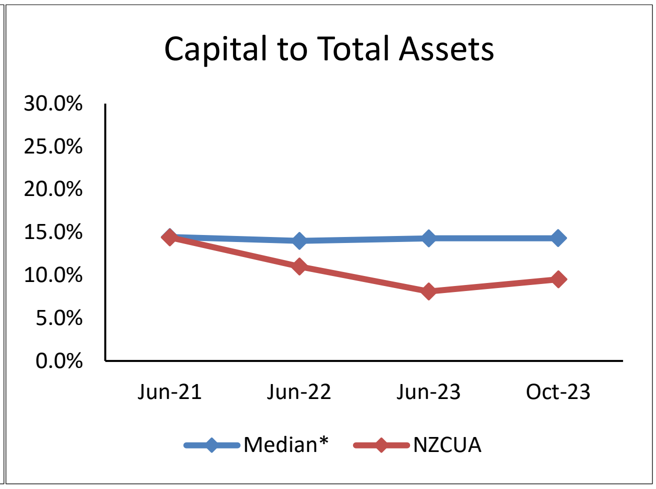
**Source: Reported financial statements of Peer Group from FY21 – FY23.*

NZCUA's loan provisioning has historically represented an average of ~1.5 – 2.5% of its total loans, and ~86.0% of its impaired loans. Given its historical write-offs have remained relatively low across the periods reviewed, NZCUA's level of provisioning appears adequate.

Overall, NZCUA's sound asset quality is evidenced by its low levels of delinquency and minimal loan losses across the rating period. Further, the merger with NZFCU has provided NZCUA with the benefit of NZFCU's niche client base, which comprises government employees who provide an essential public service; NZFCU's borrowers' employment, and hence capacity to repay, is not materially linked to macro-economic cycles.

7.3. Capitalisation





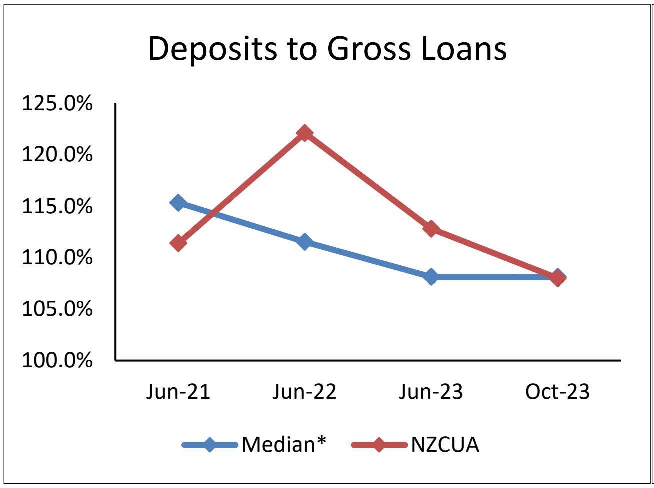
**Source: Reported financial statements of Peer Group from FY21 – FY23.*

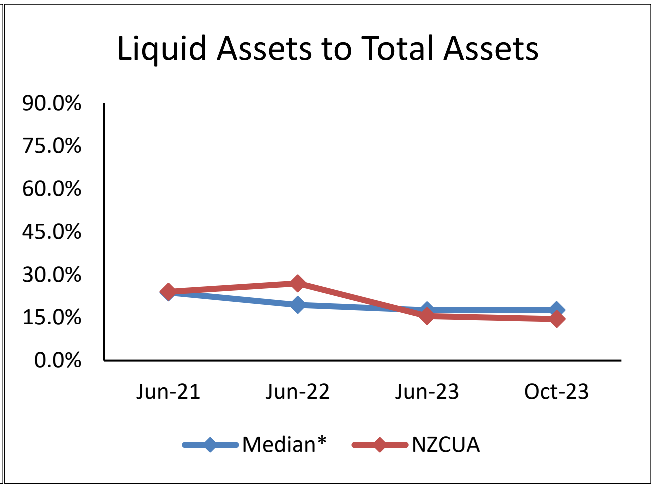
In accordance with the Non-bank Deposit Takers Act 2013 and NZ capital regulations, licensed NBDTs with a credit rating from an approved rating agency are mandated to maintain a minimum capital ratio of 8.0%. The capital ratio is a function of gross capital to NZCUA's aggregated risk-weighted asset (RWA) portfolio which has .been adjusted for credit, market, and operational risk. Since 2019, NZCUA's capital ratio has declined, underpinned by ongoing operating deficits, and the graph above highlights the impact of the merger with NZFCU with NZCUA's capital ratio falling to 11.8% at Jun22 (Jun21: 14.8%).

NZCUA reported a substantial operating deficit (~-$0.8m) in FY23, which further depleted its retained earnings, leading to a decrease in the capital ratio to 7.8% at Jun23, and was in breach of the regulatory minimum capital ratio threshold (8.0%).

Notwithstanding continued, albeit reducing, operating deficits for 4MFY24, NZCU's compliance with the regulatory capital requirements has been restored, with an increase in capital ratio to 9.1% at Oct23 supported by $0.3m of capital note injection from FCU, who have also provided an additional drawdown facility of up to $0.7m, thereby offering some protection to its capital ratio, at least in the short-term, from future periods of adverse operating performance. Going forward, in the absence of additional third-party support, any failure to execute its planned strategy and realise forecast cost savings, will place increased pressure on NZCUA's headroom to regulatory minimum capital requirements, and on its credit risk profile.

7.4. Funding and Liquidity





**Source: Reported financial statements of Peer Group from FY21 – FY23.*

NZCUA lacks access to wholesale funding. Member deposits, at call and fixed term, constitute more than 85.0% of the total funding for NZCUA, the balance comprises retained earnings. A potential funding risk, posed by NZCUA's constitutional prohibition on the use of wholesale funds, has been mitigated by its healthy deposit to loan ratio, which has remained above 100% across the rating period. There was notable increase in the ratio at Jun22 following the merger with NZFCU, which had consistently maintained a high deposit to loan ratio >170%.

NZCUA's deposit to loan ratio contracted to 108% at Oct23 (Jun23: 112.8%, Jun22: 122.1%), due to slower than anticipated deposit growth, and drew in line with the sector median. NZCUA utilised its liquid assets (cash reserves and short-term deposits held with other financial institutions) to fund the increase in member loans, and as such, NZCUA's liquid assets as a proportion of total assets fell to 14.5% at Oct23 (Jun23: 15.5%, Jun22: 27.0%), which is worse than the sector average.

Additionally, NZCUA's liquidity cover ratio (LCR) calculated according to its trust deed decreased to 1.36x at Oct23 (Jun23: 1.38x, Jun23: 1.60x) against the stipulated minimum LCR of >1.20 times, indicating minimal headroom within above metrics to enable it to withstand some level of funding volatility. Positively, NZCUA's members' deposits have a consistently healthy reinvestment rate. As of Jun23, the average monthly reinvestment rate and the annual reinvestment rate were sound at 100% and 96.7% respectively.

8. Financial Benchmarks

Description	Percentile	Liberty Financial Limited	General Finance Limited	Mutual Credit Finance Limited	Xceda Finance Limited	GoldBand Finance Limited	Finance Direct Limited	Nelson Building Society	Unity Credit Union	First Credit Union Incorporated	Christian Savings Limited	Wairarapa Building Society	Hertaunga Building Society	Police and Families Credit Union Incorporated	Credit Union Auckland
Financial Year		FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	FY23	4MFY24
Scale:															
Operating income ($ 000s)	6%	2,859	7,555	3,954	6,410	3,281	3,492	33,322	37,054	27,276	6,187	6,634	453	3,912	1,867
Total Assets ($ 000s)	7%	67,546	128,462	60,192	89,454	50,303	19,518	1,138,268	412,215	460,964	285,805	164,135	38,918	156,777	28,295
Gross loans ($ 000s)	7%	52,542	109,611	57,621	71,819	44,453	17,311	894,577	259,058	332,326	211,169	148,429	25,360	34,404	22,563
Profitability:															
Net Interest Margin (%)	85%	4.1%	4.7%	5.9%	5.5%	5.6%	7.9%	2.9%	7.4%	4.3%	2.4%	3.8%	1.9%	2.7%	6.9%
Non Interest Income to total operating income (%)	80%	0.0%	29.1%	23.1%	37.2%	20.2%	64.1%	5.3%	18.2%	31.9%	4.9%	13.2%	-52.5%	1.8%	32.4%
ROE (%)	12%	9.5%	25.2%	18.7%	10.5%	15.7%	-0.4%	9.3%	-27.1%	3.5%	9.9%	3.1%	-4.3%	2.0%	-15.2%
Return on total assets (%)	13%	1.3%	2.8%	2.8%	1.2%	2.9%	-0.1%	0.9%	-3.3%	0.5%	1.2%	0.5%	-0.7%	0.4%	-1.3%
Cost to Income (%)	16%	25.6%	35.1%	45.3%	75.2%	36.9%	99.7%	50.4%	107.8%	87.9%	50.9%	60.9%	146.2%	101.3%	107.1%
Capitalisation:															
Leverage (Gross loans to Equity) (x)	0%	5.1	6.9	6.9	7.8	4.6	4.5	8.1	5.9	4.9	6.7	5.9	4.0	1.2	8.4
Capital ratio - risk adjusted (%)	0%	27.0%	21.8%	13.1%	15.4%	20.1%	16.5%	13.2%	10.3%	14.6%	14.2%	15.0%	20.1%	22.7%	9.1%
Capital to total assets ratio (%)	0%	15.1%	12.4%	13.9%	10.2%	19.4%	19.9%	9.7%	10.7%	14.8%	12.7%	15.4%	16.2%	18.0%	9.5%
Funding and liquidity:															
Gross loans as a % of total assets (%)	51%	77.8%	85.3%	95.7%	80.3%	88.0%	88.7%	78.6%	62.8%	72.1%	84.9%	90.4%	65.2%	21.9%	79.7%
Deposits to gross loans (%)	50%	105.9%	100.3%	86.8%	110.4%	84.6%	83.8%	113.6%	135.1%	116.3%	101.4%	91.0%	127.3%	372.1%	108.0%
Liquid assets to total assets (%)	39%	21.3%	14.3%	2.5%	18.3%	11.7%	4.8%	20.4%	32.8%	22.2%	13.1%	5.5%	25.0%	71.8%	14.5%
Asset Quality:															
Write-offs to gross loans (%)	19%	0.0%	0.0%	0.0%	0.4%	0.0%	0.0%	0.0%	4.3%	0.0%	0.1%	0.0%	0.0%	0.0%	0.3%
Impaired loans to gross loans (%)	19%	2.0%	3.7%	1.3%	6.2%	0.0%	2.0%	1.2%	2.3%	1.4%	0.0%	1.1%	0.0%	0.0%	2.2%
Total provision to gross loans (%)	24%	2.2%	0.7%	0.6%	0.5%	0.0%	2.1%	0.6%	4.4%	0.6%	0.1%	0.5%	0.0%	0.4%	1.6%

*Annualised for reported periods not equal to 12 months

9.1 Summary Financial Data

Credit Union Auckland Incorporated					
$'000s	**Trend**	**FY21**	**FY22**	**FY23**	**4MFY24**
Income Statement					
Net Interest Income		1,485	1,475	1,923	631
Non Interest Income		1,156	883	959	302
Operating Income		2,641	2,358	2,882	934
Operating Expense		2,548	2,609	3,433	1,000
Pre Provision Operating Profit		0	- 179	- 550	- 66
Credit Impairment Charge / (Reversal)		82	112	256	63
Operating Profit Before Tax		- 82	- 291	- 806	- 129
Other non Operating Income / (Expense)		-	-	-	-
Net Profit		- 82	- 291	- 806	- 129
Financial Position					
Total Assets		22,021	29,527	29,563	28,295
Customer Deposits		17,886	25,167	26,200	24,372
Gross Loans		16,058	20,619	23,234	22,563
Liquid Assets		5,287	7,980	4,588	4,116
Ratios					
Profit Before Tax to Operating Income Margin (%)		-3.1%	-12.3%	-28.0%	-13.8%
Net Interest Margin (%)		7.1%	6.0%	6.9%	6.9%
Cost to Income (%)		96%	111%	119%	107%
Return on Total Assets (%)		-0.4%	-1.1%	-2.7%	-1.3%
Return on Equity (%)		-5.2%	-9.1%	-28.5%	-15.2%
Capital Ratio - Risk weighted (%)		14.8%	12.2%	7.8%	9.1%
Capital to Total Asset Ratio (%)		14.4%	11.0%	8.1%	9.5%
Leverage Ratio - (Gross Loans / Equity) (x)		5.1	6.4	9.6	8.4
Charges-offs to Gross Loans (%)		0.3%	0.2%	1.1%	0.3%
Neither Impaired or Past Due to Gross Loans (%)		82.9%	86.7%	98.8%	95.0%
Non-Performing Loans to Gross Loans (%)		3.5%	2.0%	1.2%	2.2%
Loan Loss Provision to Gross Loans (%)		2.2%	1.6%	1.6%	1.6%
Deposits to Gross Loans (%)		111.4%	122.1%	112.8%	108.0%
Liquid Assets to Total Assets (%)		24.0%	27.0%	15.5%	14.5%

*Annualised for reported periods not equal to 12 months
**Non-performing Loans = Impaired loans

1. Explanation of the Equifax's credit rating

1.1 What is a rating?

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

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

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

1.2 Equifax's credit rating

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

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

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

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

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

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

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

1.3 Rating Definitions

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

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

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

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

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

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

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

1.4 Rating Outlooks

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

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

Credit Concepts measured

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

http://www.corporatescorecard.co.nz/services_credit_ratings.php
https://www.corporatescorecard.co.nz/docs/RatingMethodologyFinancial.pdf

2. Regulatory Disclosures and Disclaimer

Equifax Australasia Credit Ratings Pty Limited (Equifax Credit Ratings) is a credit rating agency regulated by the Reserve Bank of New Zealand. The licensing regime addresses a range of matters including the quality and integrity of the ratings process, independence, and avoidance of conflict of interest, and responsibilities to the public, clients and assessed entities. The regime also covers confidentiality, communication and disclosure, professional development, document management, and a range of governance related matters. Financial, operational and compliance audits are conducted by external, independent auditors each year.

Equifax Credit Ratings also holds an Australian Financial Services License (AFS License no. 341391) which licenses it to provide credit ratings to wholesale clients in Australia.

The credit rating issued by Equifax Credit Ratings reflects our current opinion of the relative credit risk of the institution. This opinion has been formed in accordance with Equifax's published credit ratings methodology - financial institution rating criteria (Issue 8, November 2021).

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

The credit rating and associated assessments, opinions and observations are solely statements of opinion. They are not statements of fact. They do not constitute advice or a recommendation. The credit rating does not guarantee the performance of the rated issuer or relevant security, and should not be relied on for the purposes of making an investment decision. All information used in the credit rating process is obtained by Equifax from sources believed by it to be accurate and reliable. Equifax adopts all necessary measures so the information used in assigning a credit rating is of sufficient quality and from sources believed to be reliable including, when appropriate, independent third-party sources. However, because of the existence of human or system error, or other factors, all information contained herein is provided 'as is' without warranty of any kind. Equifax is not an auditor and cannot in every instance independently verify or validate information received in the rating process. Use of information contained in this report is at the recipients own risk. To the extent permitted by law, Equifax, its directors, officers, employees and any persons associated with the preparation of the release and our full report are not liable to any person in respect of anything (or the consequences of anything) done or omitted to be done by any person in reliance on any of the contents of the release or our full report; and are not responsible for any errors or omissions in the release or our full report resulting from any inaccuracy, mis-description or incompleteness of the information provided or from assumptions made or opinions reached by the parties providing the Information. All information contained herein is protected by law, including but not limited to copyright law, and this information may not be copied or otherwise reproduced, repackaged, further transmitted, transferred, disseminated, redistributed, or resold, or stored for subsequent use for any such purpose, in whole or in part, in any form or manner or by any means whatsoever, by any person without Equifax's prior written consent.

For Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of Equifax Australasia Credit Ratings Pty Limited [AFSL #341391]. This document is intended to be provided only to 'wholesale clients' within the meaning provided by the Corporations Act 2001. By continuing to access this document from within Australia, you represent to Equifax that you are, or are accessing the document as a representative of, a 'wholesale client' and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to 'retail clients' within the meaning of the Corporations Act 2001. Equifax's credit rating is an opinion as to the creditworthiness of an issuer, not on the equity securities of the issuer or any form of security that is available to retail clients. It would be inappropriate for 'retail clients' to make any investment decision based on Equifax's credit rating, and Equifax recommends you consult with your financial or other professional adviser.

Please refer to http://corporatescorecard.com.au/services_credit_ratings.php for further information and additional regulatory disclosures, including our code of conduct, published ratings, criteria, and methodologies.