Credit Ratings & Research

Credit Rating Review

Credit Union Auckland Incorporated

NZBN: 9429043039128

Credit Rating Report

Date: 22 June 2023

Prepared for: Credit Union Auckland Incorporated

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

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1. Synopsis for Comprehensive Credit Rating Report

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 Credit Ratings Australasia Pty Ltd (‘Equifax’) has downgraded NZCUA’s credit rating to ‘CCC+’ at Apr23, being a credit-watch classification with a very high level of risk. The rating has been downgraded from ‘B-‘ at Feb23, due to continued operating deficits and further deterioration in the capital ratio, placing increased pressure on NZCUA’s headroom to regulatory requirements. The outlook for the rating remains ‘Negative’ as evolving risks from the current macroeconomic environment, and one-off costs associated with management’s cost saving measures, are expected to weigh on NZCUA's operating performance in the near-term, and place its compliance with regulatory requirements and ongoing financial viability at risk. Overall, 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 an inability to realise expected benefits following the merger with NZFCU, resultant and forecast 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 competitive 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 expands and diversifies NZCUA’s existing membership base and offers some 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 1.0% of the portfolio across the rating period. Further, the merger with NZFCU, which has 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 NZFCU’s borrowers’ employment, and hence capacity to repay, is not likely to be materially impacted by macro-economic cycles.

- NZCUA’s proposed retrenchment plan designed to reduce expenses, is expected to support management’s plan to return to break-even performance. Further, over the last 12 months management has taken steps to increase NZCUA’s digital capabilities – with the majority of loan enquiries now generated on-line, thereby supporting NZCUA’s ability to enact the branch closures.

Constraints

- NZCUA’s credit rating is constrained by its weak operating profile, underlined by ongoing operating deficits, compounded by its inability to realise expected benefits post-merger with NZFCU. NZCUA reported a deficit of -$462k for the 10-months to Apr23, emanating from its high cost base and limited loan book growth, while impacted by adverse weather in the region and unexpected costs in relation to the relocation of its head office and main operating branch. Moreover, although some growth in the loan book has occurred during the 10-months to Apr23, the level remains short of management’s original forecast 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 have decided to close the NZFCU branch ~12-months following the merger – which is reflective of the insufficient uptake in members and activity to date.

- NZCU’s weak financial performance presents a high degree of compliance risk regarding the regulatory 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 has reduced to 9.6% at Apr23 (Feb23: 10.3%, Jun22: 11.88%, Jun21: 14.8%), indicating limited headroom above the regulatory minimum capital ratio threshold (8.0%). Whilst we acknowledge management’s cost saving measures which should benefit performance in the medium-term, related one-off costs, together with 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, in our view. Thus, NZCUA’s capital ratio and headroom to regulatory requirements is expected to come under increasing pressure, in our view, as ongoing monthly operating deficits continue to erode its capital reserves, while its efforts to drive growth in the loan book to improve earnings burdens its risk-weighted assets.

- Macroeconomic headwinds for the industry present a significant challenge to NZCUA’s growth and return-to-profitability plans. Adoption of contractionary monetary policies by central banks across the globe, and RBNZ’s OCR increases in response to elevated house prices and inflation levels are likely to adversely impact NZCUA’s NIMs given its deposit funding’s term is shorter than its loan book’s term. Moreover, as NZ has technically entered recession, NZCUA’s asset quality could be impacted by adverse asset price movements and higher loan losses on account of increased debt-servicing costs. In addition, as the average borrower’s credit quality deteriorates NZCUA may face greater competition for quality borrowers.

- NZCUA’s liquidity profile has recently deteriorated and its headroom over minimum liquidity coverage ratio (LCR) requirements of its trust deed is thin. A decline in member deposits has seen NZCUA utilise its liquid assets (cash reserves and 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 (calculated according to its trust deed) to 1.26x at Apr23 (Jun22: 1.60x) against a minimum 1.20x. Further, NZCUA’s liquid assets as a proportion of total assets fell to 11.2% at Apr23 (Jun22: 27.1%), which is worse than the sector average. Positively, a strong relationship with its members has supported high reinvestment rates for its member deposits (10mApr23: 96.7%, FY22: 100%), underpinning NZCUA’s deposit to loan ratio which has remained consistently above 95.0%.

- 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 15.4% of its total loan book at Apr23. 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, leading to a breach of regulatory minimum capital requirement, and/or Trust Deed covenants.

Risk Rating

CCC+

Outlook: Negative

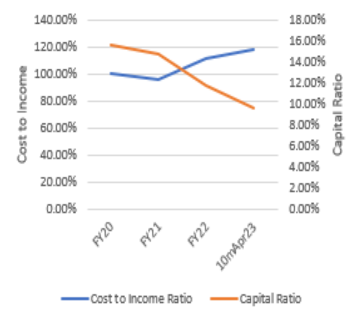
Type: Public, Monitored

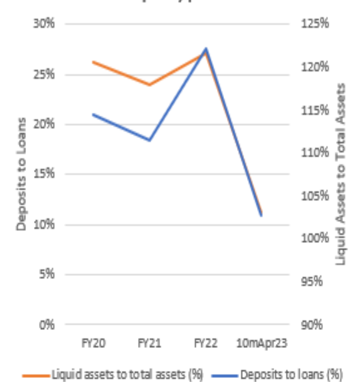
Industry Percentiles (FY22)

Scale:	Percentile*
Total Assets	24%
Gross Loans	11%
Profitability:	
NIM	94%
ROE	0%
ROA	0%
Cost to Income	0%
Capitalisation:	
Leverage (Gross loans to Equity)	1%
Capital Ratio	0%
Capital to Total Assets	21%
Funding and liquidity:	
Deposits to Loan Ratio	26%
Liquid Assets to Total Assets	14%
Asset Quality:	
Net Charge-offs	6%
Impaired Loans	27%
Provision for Loan Losses	38%

**NZCUA Apr23 results compared to the FY22 benchmark*

Key Trends





2. Scope of Report

The purpose of this report is to provide a Credit Rating Synopsis on 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	**22 June 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.

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Information Sources	
Financial Statements	**- Consolidated management accounts of NZCUA for the 10-month interim period ended 30 April 2023. - Audited Financial Statements of NZCUA for the years ended 30 June 2022, 2021, 2020 and 2019. - 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.

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APPENDICES

1. Explanation of the Equifax's credit rating

1.1 What is a rating?

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

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

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

1.2 Equifax's credit rating

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

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

Equifax's rating models have been designed to assess the proximity of an entity to defaulting on its financial commitments and obligations. Proprietary risk analytics are used to evaluate the multivariate interrelationship

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of key risk indicators using scientifically based and empirically derived risk metrics. These models evaluate the financial performance, position, and profile of an entity in the context of its industry, size, and structure. They have been validated on Australian and international data with the assistance of Professor Edward Altman, an internationally recognised leader in the field of credit risk analysis and bankruptcy prediction.

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

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

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

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

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1.3 Rating Definitions

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

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

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

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

Conditional Rating (#)

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

Provisional Rating (*)

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

Indicative Rating (^)

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

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1.4 Rating Outlooks

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

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

Credit Concepts measured

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

http://www.corporatescorecard.co.nz/services_credit_ratings.php

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

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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

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