

## Police and Families Credit Union

**Counterparty Credit Rating**

BB+/Stable/B

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### Rationale

The counterparty credit ratings on Police and Families Credit Union (PFCU) reflect the credit union's sustainable business model, which consists of serving the personal lending and deposit needs of members of the New Zealand Police and their families; its exceptional asset quality; and sound financial profile.

These strengths are moderated by the very small size of its capital base, by domestic and international standards; key person risk; and PFCU's scope for continuing development of its operational risk management policies.

While small in the context of the New Zealand financial services sector, PFCU has a good market position in its core industry segment of secured personal and housing lending and deposit-taking.

PFCU's competitive position is sound because unlike many community-based and regional credit unions PFCU is not in direct competition with banks; rather, it is a well-established supplementary banking provider to its members, who typically maintain their main borrowing relationship with a commercial bank. The lending rates for personal secured lending offered by PFCU are more competitive compared with banks, which has an enfranchising effect among members. This price advantage leverages from PFCU's mutual status that emphasizes member benefits rather than profit maximization, its low cost base and tax exempt status, brand loyalty, and predictable customer behavior. Offsetting these positive factors, however, is PFCU's lower flexibility to raise capital, compared with listed financial institutions, in the event of operational problems or other business needs because of its mutual status. Key person risk inevitably associated with its small staff of 12 is a potential concern, despite efforts by the management and Board to alleviate key person risk.

PFCU's asset quality is excellent and its balance sheet is conservatively structured.

At April 30, 2009, PFCU's ratio of nonperforming assets to gross loans was an impressive 0.03%. PFCU has a good-quality deposit base and maintains very sound liquidity, which offsets potential concerns regarding its lack of funding diversity. While PFCU's capital ratios are good, the absolute size of its capital base, being NZ\$9.95 million at April 30, 2009, is

very small by domestic and international standards. The small capital size introduces an element of vulnerability in contending with large negative operational risks or events.

### *Short-term credit factors*

The short-term rating on PFCU is 'B'.

Liquidity is very good, which ameliorates potential short-term rating concerns. This is indicated by PFCU's ratio of liquid assets to total assets of approximately 40% at April 30, 2009. Liquid asset investments by PFCU are mainly in the form of short-term deposits with New Zealand's four 'AA' rated major banks. While PFCU's liquidity is anticipated to decrease when market conditions stabilize, this should not by itself negatively impact PFCU's credit-standing, considering its track record of maintaining good liquidity in previously benign times. PFCU remains comfortably in compliance with its trust deed in terms of liquidity and other operating parameters, and has never had a breach of trust deed covenants in its 35-year operating history.

## **Outlook**

The stable outlook reflects Standard & Poor's Ratings Services' expectation that PFCU's business and financial profile will remain sound during the current economic downturn in New Zealand and the impending period of regulatory change affecting the New Zealand credit union sector.

Standard & Poor's also expects that PFCU will continue to demonstrate very good asset quality, despite the economic downturn. Increasing unemployment trends in the general economy and their adverse impact on loan serviceability are less of a threat to PFCU compared with most New Zealand financial institutions. This is because PFCU's asset quality is more highly correlated with trends affecting the police force and police wages than with the general economy. We expect PFCU's good asset quality would continue to be supported by steady or potentially increasing police employees, lower police force turnover, and higher-than-average wages for the force. In addition, police employees have more predictable wage increases and greater job security, compared with the general community.

Negative ratings momentum is mostly likely to eventuate should a major operational risk or other negative event impact PFCU's financial profile.

PFCU's small capital base affords only modest protection against a major operational risk event, even if such an event is of a low probability or difficult to predict. Deterioration in its business profile and customer franchise, or a material weakening in its asset quality, liquidity or other financial parameters could also contribute to negative ratings momentum.

Positive ratings momentum is not expected in the short-to-medium term.

In the long term, it is most likely dependant upon PFCU's ability to strengthen its financial profile after the current economic downturn and period of regulatory change, which may consequently further differentiate itself from peers. PFCU may be challenged to achieve positive ratings momentum due to its small capitalization, which is likely to maintain the ratings at the current level.

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