

# The Banking Sector in the New Zealand: Aggregate Banking Supervision Data

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*This article provides commentary on developments and conditions in the New Zealand banking industry, based on aggregate data provided to the Banking Supervision Department by registered banks.*

## Introduction

This article is the second in a series of commentaries on developments and conditions in the New Zealand banking industry, based on aggregate data provided to the Banking Supervision Department by registered banks<sup>1</sup>. The first article<sup>2</sup> discussed the trends in the industry over the period 1989 to 1991. Accordingly this article focuses primarily on developments and conditions in the banking industry for the year ended December 1992. However, comments on longer term trends are also made where appropriate.

An overview of changes in the ownership and structure of the New Zealand banking industry is provided. This is followed by a discussion on banks' profitability, assets, and capital adequacy. In addition, this article publishes, for the first time, aggregate data on banks' large exposures to corporate counterparties and exposures to related parties. Data on large exposures provides an indication of the concentration of banks' credit risks. Data on exposure to related parties provides an indication of the extent to which a bank is insulated from its parent and other entities controlled by the parent.

## Industry Structure

This past year has seen considerable rationalisation in the New Zealand banking industry:

- NAB (Australia) Limited purchased the BNZ (as a result it also gained a majority interest in BNZ Finance);
- National Bank purchased the Rural Bank;
- Countrywide Bank purchased United Bank;

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1 Balance sheet data are as at 31 December and income data have been calculated on a 12 month running total basis, for banks with other than December balance dates. For banks not reporting to the Reserve Bank in December, annualised data from the previous reporting date have been used. That is, some banks report data on a half yearly basis, rather than a quarterly basis. For these banks, annualised September data have been used for the purposes of this article, where necessary.

2 Refer to *Reserve Bank Bulletin*, Vol 55, No. 2, 1992.

- Bank of Scotland increased its ownership stake in Countrywide - Countrywide is now a wholly owned subsidiary of Bank of Scotland;
- ANZ (New Zealand) purchased Postbank from ANZ (Australia) - this constituted a restructuring of an existing banking group; and
- NZI Bank relinquished its registration.

As a result of bank acquisitions and the withdrawal of NZI Bank, the number of banking groups in New Zealand fell from 18 to 15 over the 1992 calendar year. However, as at December 1992, the number of registered banks totalled 20, only one less than the previous year, because the banks which were acquired by other New Zealand banks in 1992 continue to conduct their activities using their existing names and registration. Appendix 1 outlines the structure of the New Zealand banking industry at year end 1992.

The number of registered banks per capita in New Zealand is still relatively high by international standards. New Zealand has just over six banks per million people compared with, for example, Australia which has less than one bank per million people.<sup>3</sup> This suggests that there is scope for further rationalisation in the medium term. This rationalisation will take the form of a reduction in the number of banks within existing banking groups and could also involve a reduction in the number of banking groups.

Restructuring has been taking place in the banking industry for some time. This has resulted in changes in the number of banking groups. In 1987 there were four banking groups in New Zealand. As a result of financial sector deregulation in the 1980s, the number of banking groups increased significantly. This increase was partly due to an influx of foreign banks and partly due to a number of non-bank financial institutions obtaining registered bank status. By August 1990, New Zealand had 21 banking groups. Since then, the number of banking groups has decreased as banks have either withdrawn from the industry or been acquired by other banks.

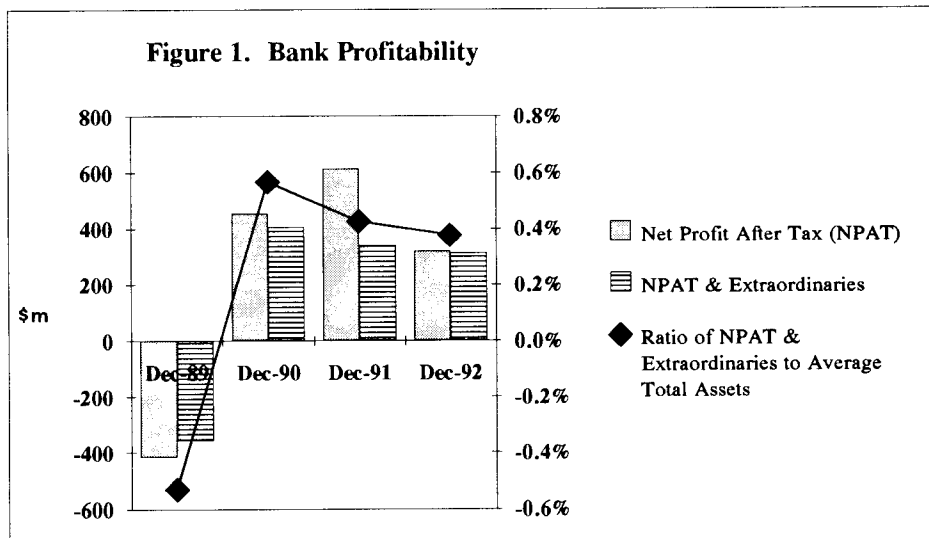
Another feature of the restructuring taking place in the New Zealand banking industry is the increasing degree of foreign ownership of New Zealand banks and, in particular, Australian ownership. As at August 1990, foreign owned banks accounted for approximately 65 percent of bank assets, with Australian owned banks accounting for around 45 percent. By December 1992, foreign owned banks accounted for more than 90 percent of the industry, with Australian owned banks accounting for approximately 65 percent. The major influences on these figures were the purchase of Postbank by Australia and New Zealand Banking Group Limited and the purchase of the BNZ banking group by National Australia Bank Limited.

## Profitability

Bank profitability declined slightly in the year to December 1992. Over this period, banks' net profit after tax and extraordinary items in dollar terms, and as a percentage of average total assets, decreased (refer to Figure 1). However, the profitability results

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<sup>3</sup> Note however that Australia has more non-bank financial institutions than New Zealand.



were not uniform across the three sectors<sup>4</sup> of the banking industry. Profitability of 'multi-purpose' and 'mainly retail' banks decreased slightly, but profitability of 'wholesale' banks increased significantly - the wholesale banking group made an aggregate profit for the first time (refer to Table 1).

**Table 1. Bank Profits After Tax and Extraordinaries By Sector**

Year	All Banks		Multi Purpose		Wholesale		Retail	
	\$m	%	\$m	%	\$m	%	\$m	%
Dec-89	(395.9)	(0.59)	(505.6)	(1.14)	(164.2)	(1.76)	273.9	1.95
Dec-90	406.1	0.57	276.3	0.59	(17.7)	(0.21)	147.5	0.91
Dec-91	340.1	0.43	297.2	0.59	(207.4)	(2.04)	268.1	1.34
Dec-92	313.3	0.37	188.6	0.35	41.5	0.43	137.4	0.62

Profits are shown as a percentage of Average Total Assets.

( ) denotes a negative figure

Variations in the performance of the different sectors of the New Zealand industry indicate that the factors affecting banks' profitability are not having a uniform impact on the various types of banks. First, banks' profit margins are adversely affected by intensity of competition in the banking industry and the general decline in interest rates. The general decline in interest rates has an adverse effect on banks' profits because it reduces the margins on banks' non-interest bearing funding. Specifically banks obtain non-interest bearing funds (principally shareholders' funds and non-interest bearing deposits, eg, customer cheque accounts) and lend these funds at market rates of interest. Therefore, when interest rates decline, banks' margins on non-interest bearing funding decline, ie, interest income reduces when interest rates fall, but the 'cost' of non-interest bearing funding does not decrease to compensate. The profit margins of banks which have a greater proportion of their funding in non-interest bearing instruments are more adversely affected by a general decline in interest rates.

<sup>4</sup> Appendix I lists the banks contained in each of the three sectors, multi-purpose, wholesale and mainly retail.

Secondly, notwithstanding the decrease in the number of banks, banks' margins have been under pressure from an increase in the intensity of competition, primarily from other banks but also from sources outside the industry. The corporate sector has contracted since the sharemarket crash, reducing the amount of business available to banks in this sector. Banks are competing aggressively amongst themselves to lend to higher quality, relatively low risk sectors of the economy. For example, over recent years most banks have been attempting to expand their market share in retail banking. This reduces the return on retail assets as banks offer lower interest rates on their retail (mainly mortgage) lending to attract customers. At the same time, banks have to maintain competitive interest rates on deposit accounts in order to attract the funds to expand their lending.

Banks are also competing with other sectors of the economy for funds, eg, the Government (Government Stock, Kiwi Bonds and Treasury Bills) and the corporate sector (a number of corporates are raising funds directly from the public by issuing their own debt, eg, capital notes). However, the major influence on bank margins seems to be the competition between banks for funds as retail deposits are reportedly sensitive to even very small reductions in interest rates.

Table 2 shows that the decline in banks' margins on interest, and non-interest, bearing funds has resulted in a decline in banks' net interest income as a percentage of average total assets over the last two years. The decline in net interest income is more acute in the multi-purpose and mainly retail sectors of the banking industry primarily because banks in these sectors were most affected by the intensity of competition in the retail mortgage market over this period.

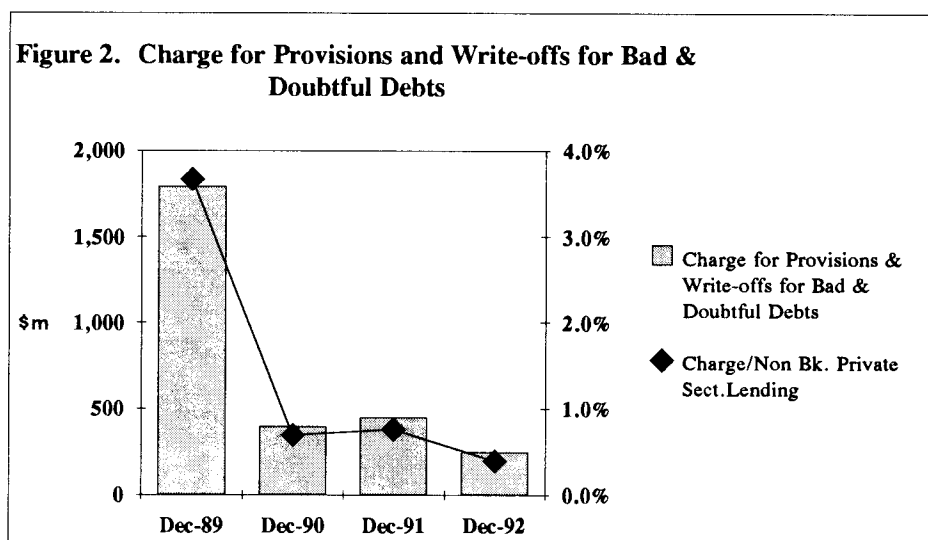
<b>Table 2. Net Interest Income</b>	<b>Dec-89</b>	<b>Dec-90</b>	<b>Dec-91</b>	<b>Dec-92</b>
Net Interest Income	\$1,993.0m	\$2,270.3m	\$2,361.0m	\$2,465.9m
Net Interest/ Ave. Total Assets	3.0%	3.2%	3.0%	2.9%

Bank profitability was also adversely affected by an industry-wide deterioration in other operating income as a percentage of average total assets in 1992 (refer to Table 3). The decrease in this ratio in the year to December 1992 compared with the previous year, mainly reflects lower trading income as a result of a smaller decrease in interest rates (or smaller increases in the price of bonds) in 1992.

<b>Table 3. Other Operating Income</b>	<b>Dec-90</b>	<b>Dec-91</b>	<b>Dec-92</b>
Other Operating Income.	\$1,315.1m	\$1,561.2m	\$1,334.3m
Oth Op Income/ Ave. Total Assets	1.8%	2.0%	1.6%

There have been some factors which have had a positive effect on bank profitability. The most significant of these has been the steady decline in the charge to banks' profit and loss accounts for provisions and write-offs of bad and doubtful debts (see Figure 2). Table 4 shows that, in aggregate, banks' charge for provisions and write-offs as a percentage of non-bank private sector lending decreased in the four years to 1992. There was a significant reduction in this ratio over the 12 months to December 1992. It appears that the bulk of the adverse effects on bank profitability arising from problem loans following the 1987 sharemarket crash and the related downturn in commercial property prices are now behind the industry.

Table 4. Charges for Provisions & Write-offs		Dec-89	Dec-90	Dec-91	Dec-92
Charge for Provisions and Write-offs		\$1,792.9m	\$393.2m	\$447.8m	\$245.6m
Charge/Non Bk. Private Sect. Lending		3.7%	0.7%	0.8%	0.4%



The decrease in the charge for provisions and write-offs occurred across all categories of banks. However, the improvement in this area was most significant for wholesale banks because their exposure to the commercial sector as a proportion of total assets is greater than that of the multi-purpose and mainly retail banks. The reduction in wholesale banks' charges for provisions and write-offs in the year to December 1992 was a major contributing factor in this sector registering a profit over this period.

Another positive factor underlying banks' profitability has been the improvement in operating efficiency each year over the four years to 1992. Banks, for some time, have been focusing on reducing operating costs as a means to improve profitability. Internal structures have been streamlined to gain efficiencies, branch numbers have been reduced, staff numbers have been lowered and some banks have invested in new technology. Banks' purchases of other banks in the past few years, and in particular in 1992, are another facet of banks' efforts to increase efficiency. Banks can improve

efficiency by acquiring other banks, if they are able to create economies of scale, ie, reduce operating costs as a proportion of total assets. Table 5 shows that the ratio of operating costs to average total assets has declined slowly but consistently for some time. However, the decrease in this ratio over the year to December 1992 was greater than in previous years.

<b>Table 5. Operating Expenses</b>	<b>Dec-89</b>	<b>Dec-90</b>	<b>Dec-91</b>	<b>Dec-92</b>
Operating Expenses/Ave. Total Assets	3.8%	3.6%	3.4%	3.0%

## Asset Growth and Composition

Banks' assets increased by 3.5 percent in the year to December 1992. This was the second consecutive year of modest growth in the banking industry and represents a significant decrease on the growth rates experienced in the industry in 1989 and 1990, as shown in Table 6. This Table also shows that a number of divergent trends underlie the growth in banks' assets in the year to December 1992. Banks' investments in government stock, bank bills and other assets have decreased, but this has been offset by an increase in banks' lending to the non-bank private sector.

<b>Table 6. Assets</b>						
<b>Date</b>	<b>Government</b>	<b>Banks</b>	<b>Non-Bank Private Sector</b>	<b>Other Assets</b>	<b>Less Provisions</b>	<b>Total Assets</b>
Dec-89	N/A	N/A	N/A	N/A	N/A	\$66,915.1m
Dec-90	\$8,666.5m	\$9,482.1m	\$57,819.1m	\$4,015.8m	\$1,978.3m	\$78,005.1m
Dec-91	\$9,988.5m	\$9,497.3m	\$58,582.2m	\$4,970.5m	\$2,597.0m	\$80,441.4m
Dec-92	\$9,787.8m	\$8,916.0m	\$62,688.8m	\$3,403.9m	\$1,517.6m	\$83,278.7m

Banks' lending to the non-bank private sector increased by around 7 percent in the year to December 1992, compared with 1 percent growth over the previous year. Table 7 shows that banks' residential mortgage lending is the principal force behind the increase in bank lending to the non-bank private sector and, more generally, the growth in banks' assets in 1992 and previous years. Over the three years to 1992, banks' residential mortgage lending has expanded at a considerably faster rate than total assets. At year-end 1992, mortgages represented 27.8 percent of total bank assets, compared with 20.4 percent at year-end 1990.

Banks are generally willing to meet demands for additional mortgage finance because the loan loss rate on this type of lending historically has been low. However, the growth in bank lending in the residential mortgage market appears to be greater than the improvement in demand conditions in this market. This may be explained by the fact that bank mortgage lending data also includes lending for other purposes: for example, some banks lend to small businesses and secure the loans over the homes of the owners of those businesses.

Date	Mortgages	Other	Total Non-Bank Private Sector
Dec-90	\$15,943.0m	\$41,876.1m	\$57,819.1m
Dec-91	\$19,851.2m	\$38,731.0m	\$58,582.2m
Dec-92	\$23,112.8m	\$39,575.9m	\$62,688.8m

Data on banks' other non-bank private sector lending also indicates that banks increased their lending to other sectors of the economy in 1992. Lending other than by way of mortgages grew by 2.2 percent over the year to December 1992 compared with an 8 percent decline in 1991.

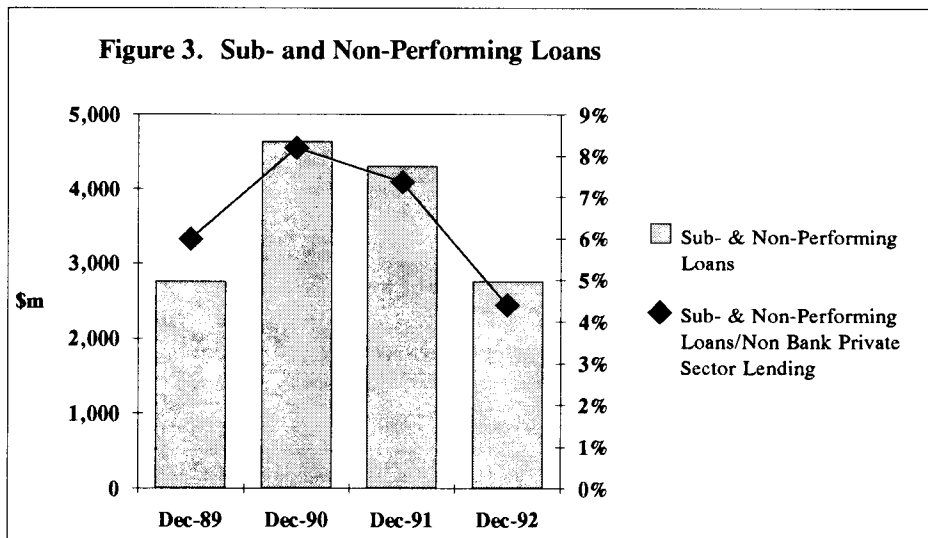
In sum, banks' non-bank private sector lending increased significantly in 1992. This was primarily a result of a continuation of the growth in banks' residential mortgage lending which has occurred over recent years, although banks' lending to other private non bank sectors of the economy also increased in 1992.

Another important development in the banking industry which has emerged over recent years is an expansion into non-traditional areas of business. Specifically banks are increasingly providing customers with a broader range of financial services like insurance, superannuation and other funds management services<sup>5</sup>. In 1992 several banks set up superannuation schemes for the first time. In view of the degree of competition in activities traditionally carried out by banks, it seems likely that funds management activities will become an increasingly important part of banks' business over the next few years.

## Asset Quality

The quality of banks' assets improved significantly in 1992. Table 8 shows that banks' sub- and non-performing loans decreased in dollar terms, and as a percentage of non-bank private sector lending, over the 12 months to December 1992 (see also Figure 3). The decrease in sub, and non-performing loans over this period was particularly significant because it occurred at a time when some banks reviewed their asset portfolios

<sup>5</sup> Banks' funds management activities are not included in asset data because these funds are owned by the investors or unit holders - banks only manage the funds.



on a more conservative basis which resulted in an increase in the number, and value, of those banks' sub- and non-performing loans.

The improvement in the quality of banks' assets in 1992 reflects banks' more cautious approach to lending over recent years, and large write-offs of bad loans in 1992.

The prospects for further improvement in the quality of banks' assets look good with forecasts of an upturn in economic conditions and a general decline in interest rates. However, the future quality of banks' assets ultimately depends on banks continuing to apply prudent credit lending criteria.

	Dec-89	Dec-90	Dec-91	Dec-92
Sub- and Non-Performing Loans	\$2,760.0m	\$4,634.6m	\$4,304.5m	\$2,764.2m
Sub- and Non-Perf. Loans/ Non Bk. Private Sect. Lending	6.0%	8.2%	7.3%	4.4%

## Exposure Concentration

Banks report to the Reserve Bank data on their large credit exposures (eg, loans, credit risk on foreign exchange transactions, etc.) to individual customers. This data provides an indication of the concentration of banks' credit risk. As at December 1992, the Banking Supervision Department had received consistent data on banks' concentration of credit risk for a 12 month period. Table 9 shows the number of exposures to the non-bank private sector advanced by New Zealand incorporated banks (excluding guaranteed subsidiaries of overseas banks) which exceeded a level equivalent to 10 percent of the individual lending banks' capital.

This data shows that the number of exposures greater than 10 percent of individual banks' capital decreased from 84 to 64 over the 12 months to December 1992. This indicates that banks' concentration of credit risk to individual customers has decreased significantly. This is consistent with the expansion of bank lending to the retail sector, noted earlier. Customers in the retail sector comprise a relatively large number of customers with small individual borrowing requirements. On the other hand, banks' wholesale customer base comprises a smaller number of customers with relatively large borrowing requirements. Accordingly, as banks expand into the retail sector, the numbers of large exposures to individual customers should decline.

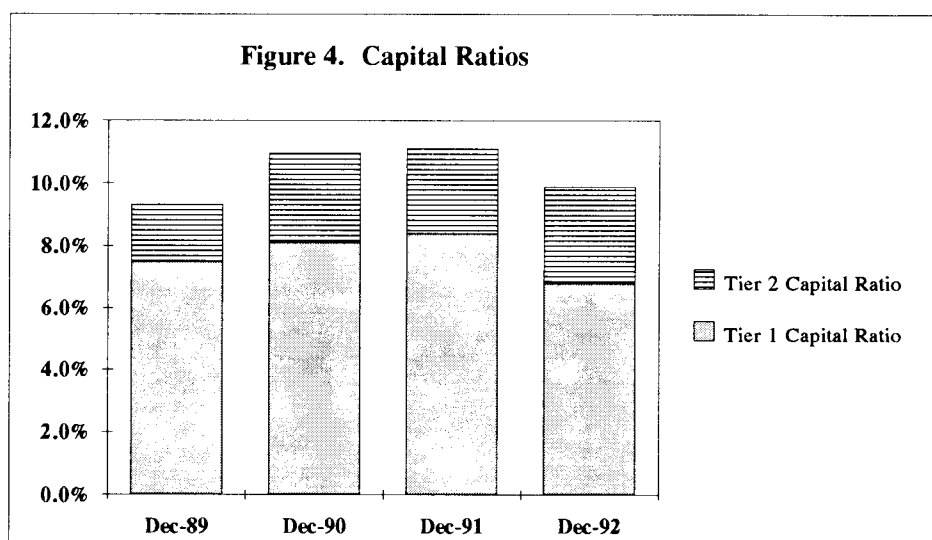
<b>Table 9. Distribution of Non Branch Large Exposures As A Proportion of Capital</b>	<b>Number of Exposures</b>	
	<b>Dec-91</b>	<b>Dec-92</b>
10% to 20%	56	40
Over 20% to 30%	13	7
Over 30%	15	17

The decrease in exposure concentration was, in part, a result of the Reserve Bank establishing a policy on banks' large credit exposures. Under this policy, the credit exposures of New Zealand incorporated banks to single customers in the non-bank private sector are limited to an amount equivalent to 35 percent of banks' capital. A few banks required a transition period before this policy took full effect.

The Bank also receives data on the magnitude of New Zealand incorporated banks' credit exposure to counterparties which are connected to the bank. Table 10 shows that the number of exposures to connected counterparties between 10 and 30 percent of individual banks' capital increased from three to four over the year to December 1992. The number of exposures to connected counterparties over 30 percent of individual banks' capital remained at six over this period.

<b>Table 10. Distribution of Non Branch Connected Lending As A Proportion of Capital</b>	<b>Number of Exposures</b>	
	<b>Dec-91</b>	<b>Dec-92</b>
10% to 20%	2	3
Over 20% to 30%	1	1
Over 30%	6	6

## Capital Adequacy



In 1989, the Reserve Bank adopted the Basle Committee's framework for measuring the adequacy of banks' capital. Under this framework banks' capital is measured as a proportion of their risk weighted exposures. The Bank also applied the Basle Committee's minimum capital standards: New Zealand incorporated banks were required to have a total capital ratio of at least 8 percent, and a Tier 1, or core, capital ratio of at least 4 percent, by year-end 1992. All New Zealand incorporated banks complied with these minimum capital standards as at the end of 1992, as shown in Table 11.

Non Branch Banks	Dec-89	Dec-90	Dec-91	Dec-92
Tier One Capital	\$3,265.8m	\$3,842.1m	\$3,891.5m	\$2,964.9m
Tier One Capital Ratio	7.5%	8.1%	8.4%	6.8%
Tier Two Capital	\$799.5m	\$1,361.9m	\$1,265.0m	\$1,353.6m
Tier Two Capital Ratio	1.8%	2.9%	2.7%	3.1%
Total Capital	\$4,065.3m	\$5,204.0m	\$5,156.4m	\$4,318.5m
Overall Capital Ratio	9.3%	11.0%	11.1%	9.9%

The amount of total capital in the New Zealand banking industry (ie, capital held by New Zealand incorporated banks) decreased, both in dollar terms and as a percentage of aggregate risk weighted exposures, over the 12 months to December 1992 (refer to Figure 4). The decrease in aggregate capital was a result of a decrease in Tier 1 capital which was partially off-set by an increase in Tier 2 capital (ie, banks issuing subordinated debt).

The decrease in the level of capital in the banking industry and the change in the composition of capital resulted directly from the restructuring which occurred in 1992. Banks' purchases of other New Zealand registered banks and New ZealandI Bank's withdrawal from the banking industry resulted in a reduction of Tier 1 capital of around \$900 million. Aggregate Tier 1 capital was also adversely affected by some banks incurring losses, primarily as a result of a more conservative assessment of asset values and corresponding additional charges for provisions and write-offs of bad loans, following changes in the ownership of those banks.

The effects of restructuring on banks' Tier 1 capital noted above, resulted in some banks having to raise more capital in order to meet the minimum capital standards. Banks which found themselves in this situation raised (Tier 2) capital by issuing subordinated debt. In aggregate, new issues of subordinated debt in the year to December 1992 totalled approximately \$380 million.

Thus, the decrease in total capital in the banking industry over the year to December 1992 should be considered in light of the transitional capital positions of individual banks following recent acquisitions and a more conservative valuation of banks' assets. Also most New Zealand banks are now owned by large overseas banks which provides a source of strength for the New Zealand industry. Based on these considerations, the capital adequacy of the banking industry remains good, notwithstanding the reduction in aggregate capital as a percentage of the industry's risk weighted assets.

## Conclusions

Conditions and developments in the New Zealand banking industry over the 12 months to December 1992 were characteristic of a competitive industry. A number of acquisitions occurred, one bank withdrew from the industry and profit margins decreased in the presence of modest industry growth.

A number of positive developments are emerging in the industry. Banks increased their operating efficiency, asset quality improved and there was a reduction in the concentration of credit exposure to individual customers.

The capital adequacy of the banking industry remains good, notwithstanding the adverse effects of the restructuring process on banks' capital. All banks exceed the Basle minimum capital requirements and the worst of the bad loan problem appears to be behind the industry.

# Appendix 1

## Registered Banks as at December 1992 Banking Group

### Multi-purpose Banks

ANZ Banking Group (New Zealand) Limited	Australia and New Zealand Banking Group Limited
Bank of New Zealand	National Australia Bank Limited
National Australia Bank (New Zealand) Limited	National Australia Bank Limited
The National Bank of New Zealand Limited	Lloyds Bank Plc
Westpac Banking Corporation	Westpac Banking Corporation

### Wholesale Banks

Bankers Trust New Zealand Limited	Bankers Trust New York Corporation
Banque Indosuez	Banque Indosuez
Barclays Bank Plc	Barclays Bank Plc
BNZ Finance Limited	National Australia Bank Limited
Citibank NA	Citibank NA
Primary Industry Bank of Australia	R&I Bank of Western Australia Limited
State Bank of South Australia	State Bank of South Australia
The Hongkong and Shanghai Banking Corporation	The Hongkong and Shanghai Banking Corporation

### Mainly Retail Banks

ASB Bank Limited	Commonwealth Bank of Australia
Countrywide Banking Corporation Limited	Bank of Scotland
Post Office Bank Limited	Australia and New Zealand Banking Group Limited
The Rural Bank Limited	Lloyds Bank Plc
Trust Bank New Zealand Limited	Trust Bank New Zealand Limited
TSB Bank Limited	TSB Bank Limited
United Bank Limited	Bank of Scotland

## **Glossary of Terms**

### **Risk Weighted Exposures**

Assets and off-balance sheet exposures are weighted according to broad categories of credit risk as determined by the risk weighting framework. For example, Government exposures of less than one year are weighted at zero, while commercial lending is weighted at 100 percent. Banks are required to hold capital against their risk adjusted credit exposures.

### **Capital**

The residual claims of owners on the assets of the bank once all claims of depositors and other commitments have been satisfied. Under the Basle framework capital is divided into Tier One and Tier Two capital.

### **Tier One Capital**

Tier One Capital is shareholders' funds or net worth (primarily issued share capital and retained earnings). It represents that part of a bank's funding which is available to absorb unanticipated losses without the bank being obliged to cease trading and which is free from any fixed servicing obligations.

### **Tier Two Capital**

Tier Two Capital comprises items which are not equity but which have some of the same characteristics as equity, for example, revaluation reserves, hybrid capital instruments such as subordinated debt and general provisions.

### **Capital Ratio**

The Capital Ratio is total capital (the sum of Tier One and Tier Two) divided by total risk weighted exposures.

