The banking sector in New Zealand: aggregate banking supervision data

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This article provides commentary on the financial performance of the New Zealand banking industry over 1995 based on aggregate data provided to the Banking System Department by registered banks. (A glossary of terms is contained in Appendix 1.)

I Introduction

The performance of the banking industry has improved considerably since 1993. Bank profits were adversely affected in the late 1980s and early 1990s by expenses from sub- and non- performing loans, and a general decline in the level of interest rates which eroded interest rate margins. Following several years of relatively stagnant conditions the economy subsequently expanded at a greater rate and the level of problem loans has declined dramatically.

Over 1995 the banking industry continued to achieve the strong level of financial performance of the past few years. Two key factors impacted on the performance of banks in 1995. First, the continuation of a buoyant economy provided scope for banks to expand their balance sheets and through this achieve greater profits. Secondly, intense competition was maintained within the industry - this kept interest rate margins in check and also sustained the pressure on banks to seek efficiency gains, diversify their activities and develop more innovative products and services.

This article discusses the performance of the banking industry over 1995 with regard to the structure of the banking system, profitability, the growth and composition of bank assets, asset quality, exposure concentrations, and capital adequacy. These aspects are analysed in the context of developments and trends in the industry over the last five years.

II Banking system structure

The past five years have seen significant rationalisation take place within the industry. As shown in figure 1, the number of registered banks decreased from a peak of 23 in August 1990 to 15 by the end of 1994.

The number of registered banks had grown rapidly from 1987 to 1990 due to the industry being deregulated in 1987 - the number of registrations grew from 4 to 23 in that period. During that time many overseas banks established operations in New Zealand and some non-bank financial institutions registered as banks. Then, in the early 1990s the economic downturn, declining interest rates and intense competition made conditions in the industry more difficult. In the period of rationalisation which folllowed some of the overseas banks withdrew from New Zealand and a number of mergers and acquisitions took place.

In 1995, this process of rationalisation temporarily halted. The number of registered banks and banking groups remained at 15 and 14 respectively. (Appendix 2 lists the individual banks registered in New Zealand and their banking groups as at 31 December 1995.)

There may be some scope for further rationalisation within the industry, through mergers or acquisitions, given that banks are seeking ways to streamline their operations and obtain efficiency gains. Recently, the acquisition of Trust Bank New Zealand Ltd by Westpac Banking Corporation was announced.

Another recent development is the renewed interest in New Zealand by international banks. Rabobank Nederland N.V., which owns the Primary Industry Bank of Australia, registered as a bank in New Zealand in April of this year. In addition, the Reserve Bank has received a registration application by another overseas bank. Given a continuation of economic expansion and growing trade and investment links with Asia there could be further interest in the New Zealand market by overseas banks over the next few years.

III Profitability

The profitability of New Zealand banks showed solid improvement in 1995. Aggregate bank profits after tax and extraordinaries grew by 21.6 percent to $1.02 billion in 1995 which is in line with the 20.2 percent profit growth achieved in 1994. This is the third successive year of significant growth in profitability, as is apparent from figure 2. The main factor underpinning this growth has been the existence of favourable economic conditions.

In 1993, the profitability of the banking system improved dramatically following several years of very weak profits, reflecting difficult economic conditions and the burden of problem loans. Underpinning this

Figure 1

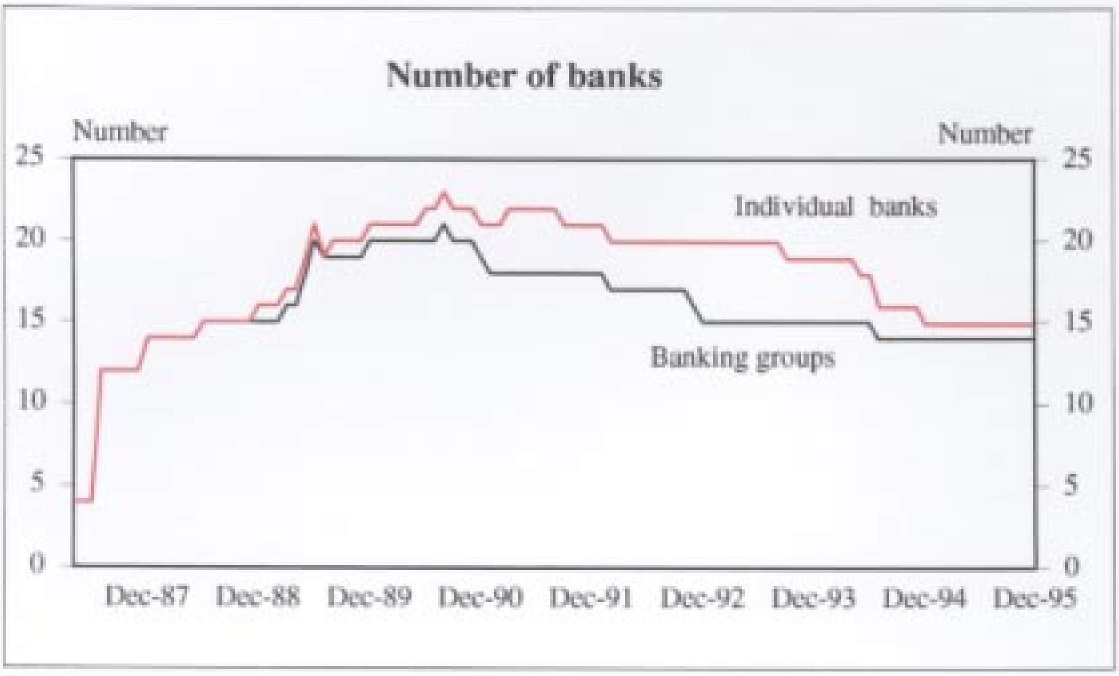
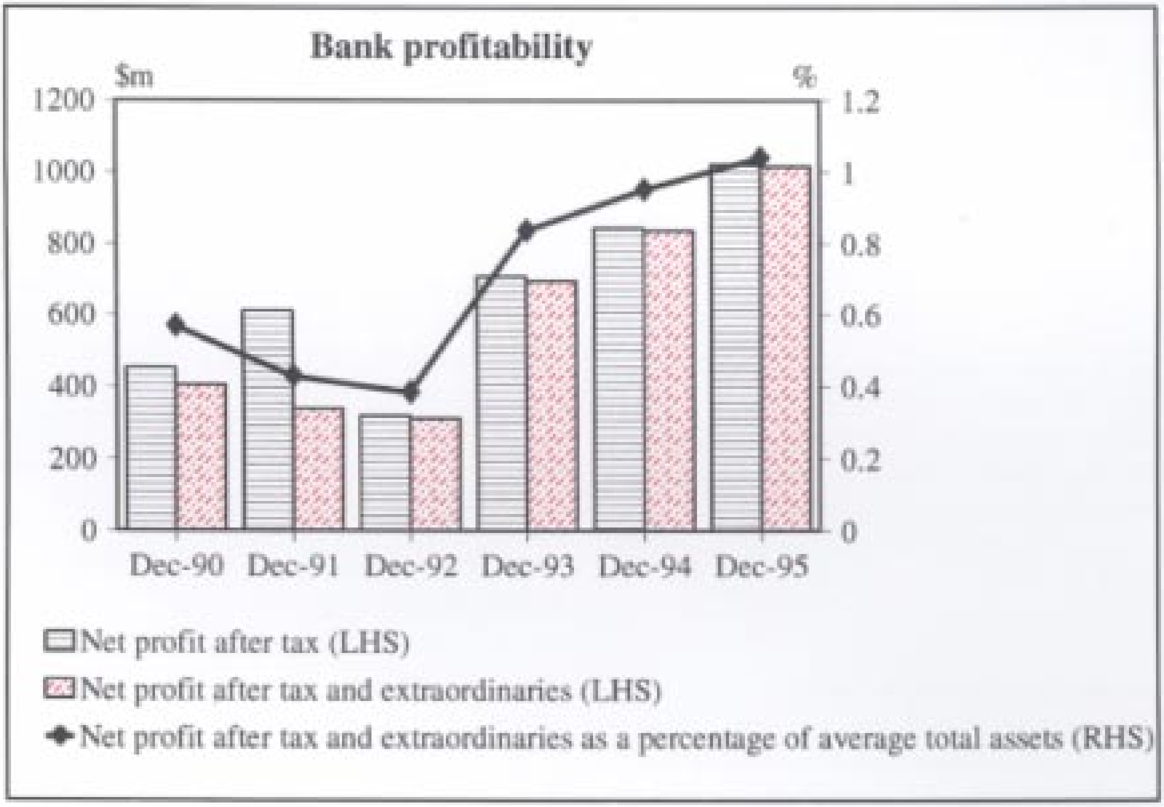


Figure 2



improvement in 1993 was a large reduction in charges for sub- and non- performing loans, which resulted in a much higher rate of profit growth than that which has been achieved over 1994 and 1995.

In line with this trend of growing aggregate profits, figure 3 indicates that banks' underlying profitability has also been steadily improving. This improvement suggests that the higher levels of profit now being earned by banks are sustainable in nature because underlying profitability excludes the one-off effects of items such as loan charges, and abnormal and extraordinary items.

As table 1 indicates, the profit increase in 1995 was derived principally from significant increases in net interest income and, to a lesser extent, other operating income. However, these gains were partially offset by a substantial rise in operating expenses. These factors are discussed in more detail below.

Figure 3

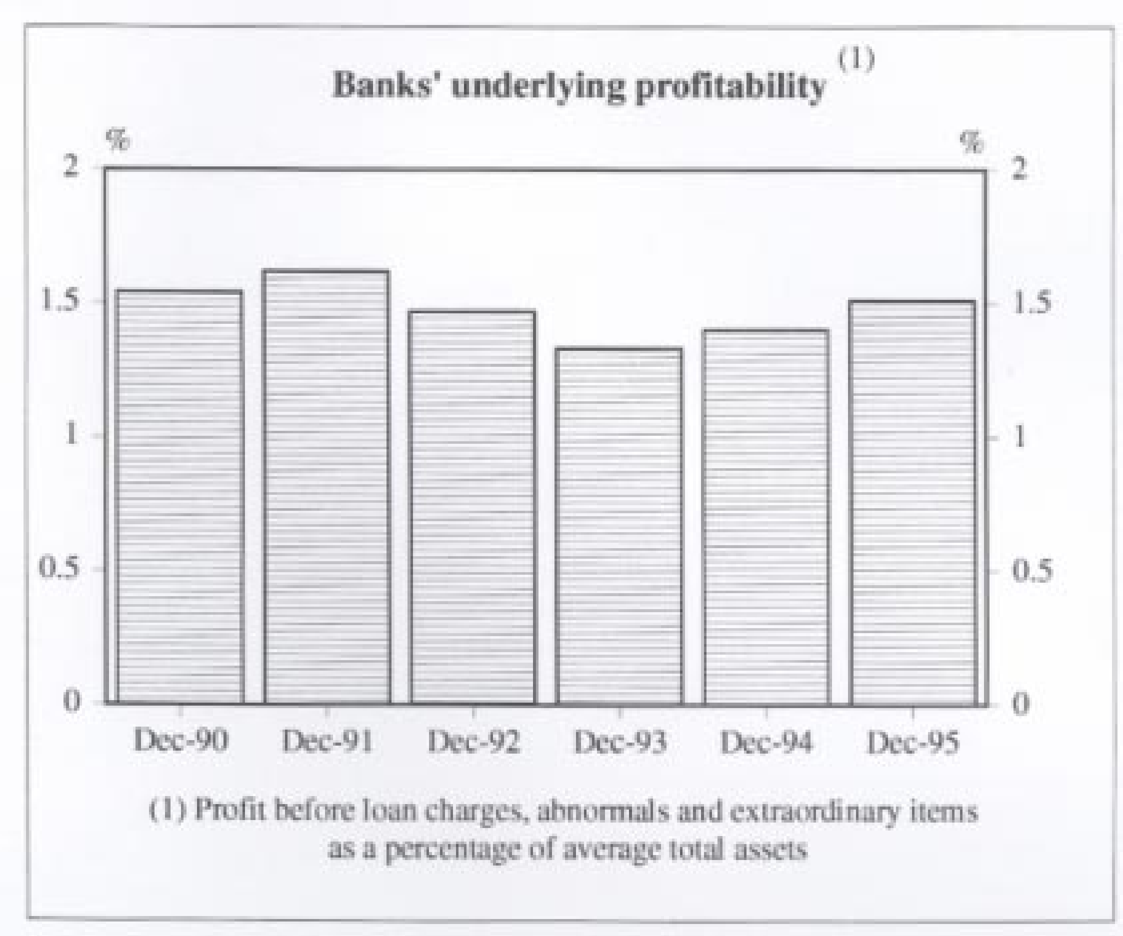


Table 1

Aggregate income statement

($ million)	**1994**	**1995**	**Change**
Net interest income	2,462.4	2,786.4	324.0
Other operating income	1,401.0	1,596.2	195.2
Operating expenses	(2,629.9)	(2,906.2)	(276.3)
Sub- & non- performing loan expenses	96.0	8.6	(87.4)
Abnormal items	(77.5)	(2.9)	74.6
Pre-tax operating profits	**1,252.0**	**1,482.2**	**230.2**
Tax	(409.8)	(461.6)	(51.8)
Extraordinary items	(7.3)	0.0	7.3
Profits after tax & extraordinaries	**834.9**	**1,015.2**	**180.3**

Net interest income

Growth in net interest income was the main contributor to the profit increase in 1995. Net interest income increased by 13.2 percent, which represents the largest rise since 1990.

The strong growth in net interest income can largely be attributed to the significant rise in bank lending which took place over 1995. This is indicated by the fact that the ratio of net interest income to average total assets improved only marginally from 2.8 percent in 1994 to 2.9 percent in 1995.

Tight competition within the banking industry has resulted in pressure being maintained on lending margins. Banks' net interest margin improved slightly over the year from 2.9 percent in 1994 to 3 percent in 1995 and the average interest rate spread of banks narrowed marginally from 2.5 percent in 1994 to 2.4 percent in 1995.

The pressure on lending margins evident in the last five years has stemmed partly from the substantial shift over this period into residential mortgages which tend to carry lower margins than other bank lending and also for which there is strong competition. In addition, the general decline in interest rates up to 1993 eroded the margins earned by banks on their low interest retail funding, such as cheque and savings accounts, and on their equity funding which is free for investment in financial assets. These two factors led to a decline in the net interest margin and the ratio of net interest income to average total assets up to 1993.

This trend was reversed in 1994, when rises in the general level of interest rates increased the benefit which banks obtain from investing low interest retail funding and "free" equity at prevailing market rates, resulting in an improvement in net interest income. This increased benefit has been maintained for banks in 1995 with the prevalence of the higher level of interest rates from 1994.

Other operating income

The other main contribution to the increase in aggregate profits in 1995 was growth in other operating income. This rose by 13.9 percent in 1995, which represents a turnaround from 1994, when other operating income declined by 6.1 percent.

Rising interest rates in 1994 resulted in banks earning lower returns from trading financial instruments and incurring losses on holdings of financial securities. In 1995, similar losses were not incurred, since the general level of interest rates did not rise to the same extent and many banks scaled back their trading activities.

Banks have sought to offset the pressure on interest rate margins by diversifying into non-lending activities to generate additional sources of income. However, the success of this strategy has so far been limited. Despite the increase in 1995, other operating income constituted only 1.6 percent of average total assets which is lower than the ratio of 2.0 percent for 1990.

Table 2

Net interest income	**Dec-90**	**Dec-91**	**Dec-92**	**Dec-93**	**Dec-94**	**Dec-95**
Net interest income ($m)	2,270.3	2,361.0	2,465.9	2,304.3	2,462.4	2,786.4
Net interest margin (%)	3.36	3.10	3.01	2.87	2.92	3.00
Net interest income/ average total assets (%)	3.18	2.98	2.92	2.77	2.80	2.85

Table 3

Other operating income	**Dec-90**	**Dec-91**	**Dec-92**	**Dec-93**	**Dec-94**	**Dec-95**
Other operating income ($m)	1,315.1	1,561.2	1,334.3	1,492.1	1,401.0	1,596.2
Other operating income/ average total assets (%)	1.84	1.97	1.58	1.79	1.59	1.63

Nevertheless, banks are continuing to expand their range of business with further development of insurance, funds management and superannuation products taking place. The most active banks in this regard have been the multipurpose and retail banks.

In an attempt to reduce cross-subsidisation of services some banks have sought to introduce "differential" pricing by increasing fees for over-the-counter and cheque transactions, which are more costly for banks, and lowering them for the cheaper electronic transactions. However, competitive pressures and resistance by customers have slowed the introduction of new fee structures and in some cases forced banks to waive existing fees. For example, banks have on occasion been forced to lower or waive loan application fees in order to obtain business.

Operating expenses

A substantial rise of 10.5 percent in banks' operating expenses over 1995 partially offset the gains achieved in net interest income and other operating income. However, the ratio of operating expenses to average total assets remained at around 3.0 percent (essentially the same as for 1994), suggesting that overall operating efficiency may not have deteriorated significantly.

The increase in the amount of banks' aggregate operating expenses over 1995 is a result of a number of factors. Many banks incurred costs in implementing methods to improve efficiency in the medium term, such as restructuring costs in centralising functions, costs of installing new accounting and service delivery systems, and costs associated with re-engineering and process improvement projects. Some banks have expanded their geographical presence or moved into new segments of the market and have therefore needed to invest in new staff and facilities.

Banks have also been actively pursuing improvements in operating efficiency, as another method of offsetting margin pressures. Efficiency gains have been sought in the following ways:

- by expanding business at a faster rate than operating expenses;
- by seeking economies of scale through an acquisition or merger;
- by rationalising branch structures;
- by centralising accounting and processing functions;
- by developing and encouraging the use of automated or electronic services.

The strategy of improving operating efficiency appears to have had some success. Table 4 shows a decline in the ratio of operating expenses to average total assets over the last five years from 3.6 percent for 1990 to 3 percent for 1995. Also, figure 4 (overleaf) indicates that banks' ratio of operating expenses to total income, which is another measure of operating efficiency, has decreased steadily in the last three years from 70.8 percent for 1993 to 66.3 percent for 1995.

As shown in figure 5 (overleaf), the retail banks' aggregate operating expenses to average total assets ratio dipped below that of the multipurpose banks for the first time in 1995. This is largely due to retail banks having grown their assets at a faster rate than other banks. Retail banks have generally been well-positioned to take advantage of the growth in recent years in the residential mortgage market. In addition, some have a strong base in Auckland and hence were able to take advantage of the rapid growth in that market.

It is notable from figure 6 (overleaf) that neither branch nor staff numbers have declined substantially in the past few years. However, signs are now emerging that banks see considerable scope to rationalise branch structures and migrate customers to non-branch delivery mechanisms, which should lead to further improvements in operating efficiency over the next few years.

Table 4

Ratio of operating expenses to average total assets

	Dec-90	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95
Operating expenses/ average total assets (%)	3.58	3.33	3.03	3.23	2.99	2.98

Figure 4

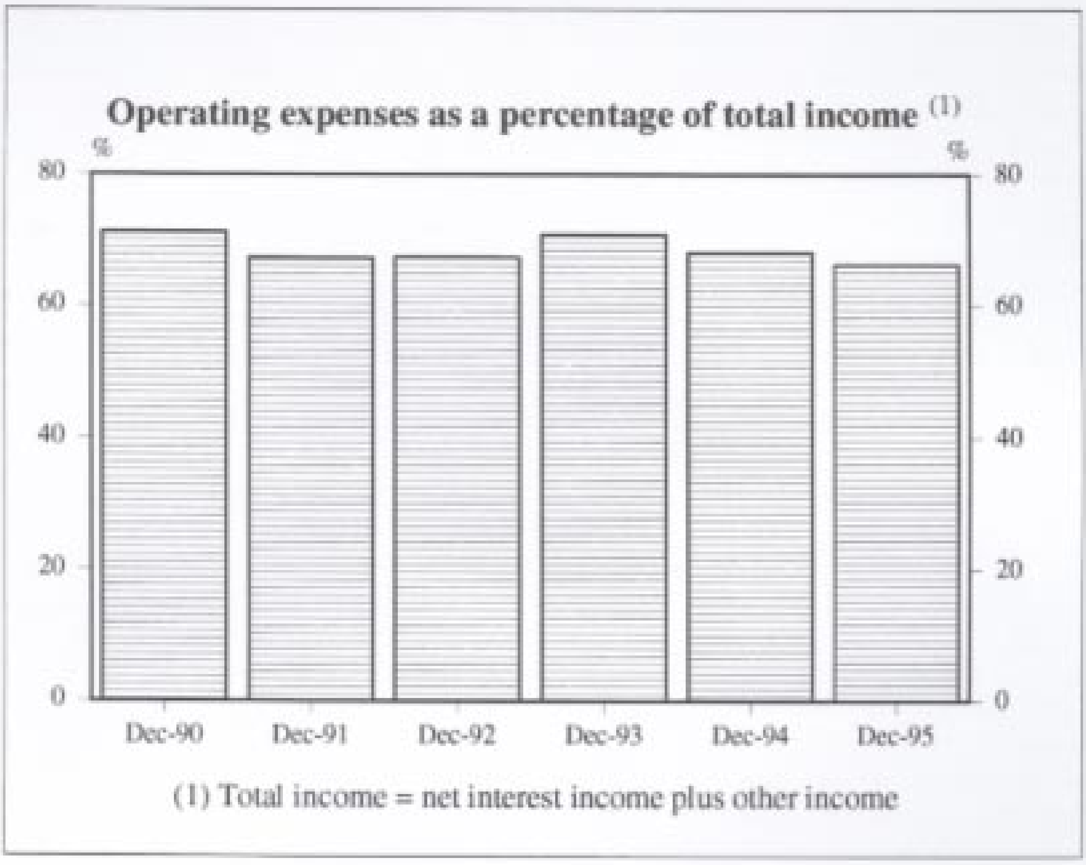


Figure 5

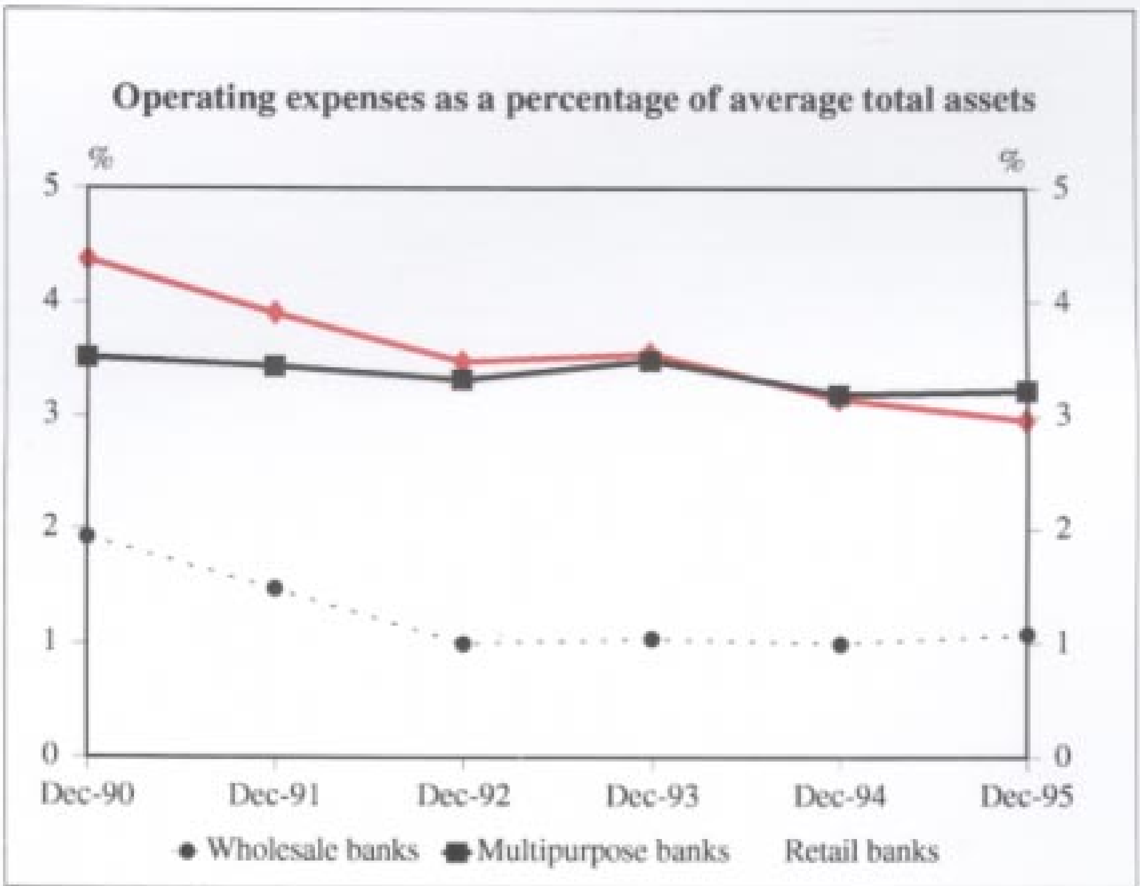
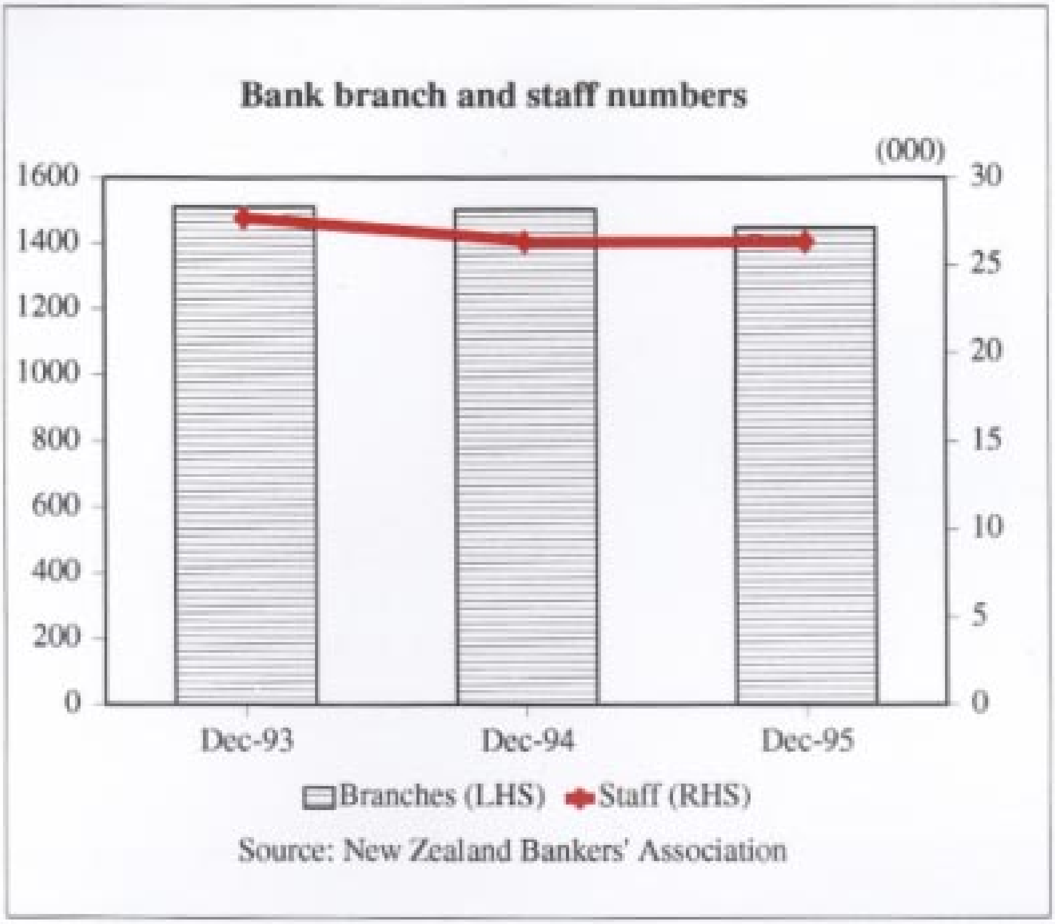


Figure 6



Sub- and non- performing loan expenses

Since 1992, there has been a strong trend of improving asset quality within the banking system, largely due to favourable economic conditions. The consequent reduction in the charges for sub- and non- performing loans in 1993 led to significant improvements in banks' profits for that year and in 1994 an aggregate credit of $96 million in respect of sub- and non- performing loans resulted.

In 1995, an aggregate credit of $8.6 million was recorded which, although considerably less than the credit for 1994, reflects further improvement in asset quality. The credits in 1994 and 1995 have resulted from substantial reductions and reversals in provisions for loans classified as sub- or non-performing and recoveries of loans previously written off.

The amount of reversals and recoveries decreased considerably in 1995. This indicates that there is unlikely to be further improvement in profitability through gains in asset quality. In fact, a net charge for provisions and write-offs can probably now be expected. Over the next few years, profitability is likely to depend much more on factors other than loan charges.

IV Asset growth and composition

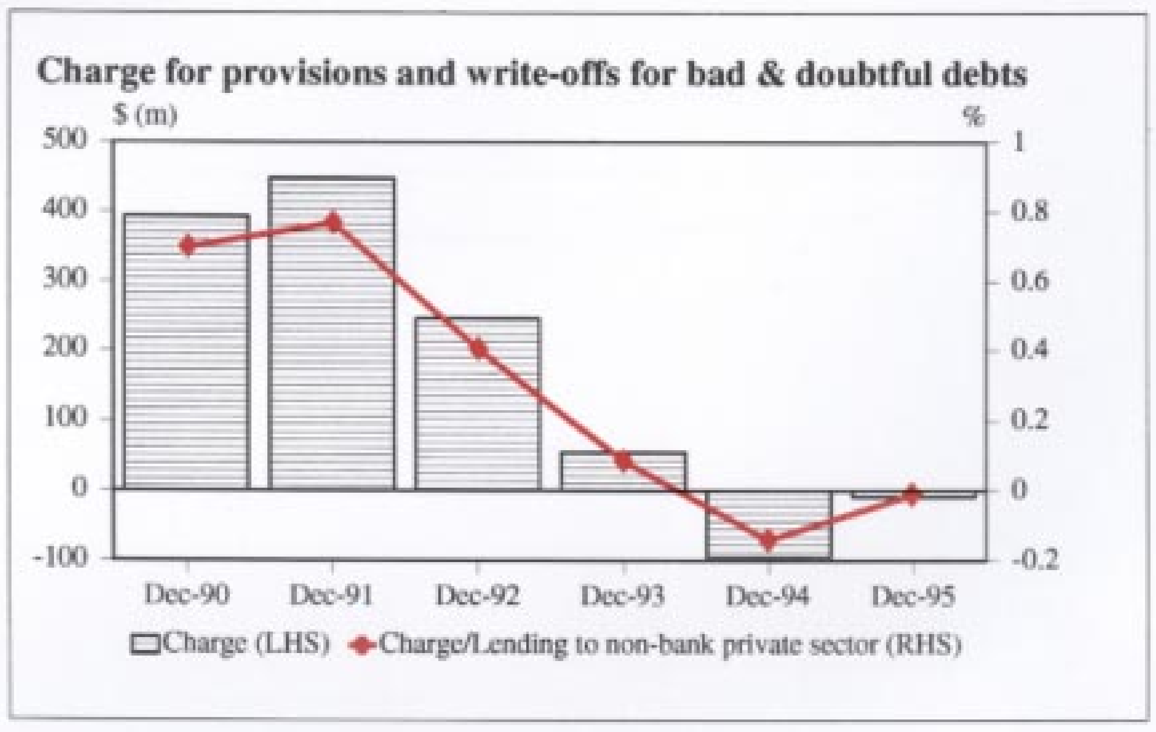
In 1995, the banking industry experienced its highest rate of growth in the past five years. Total banking system assets grew by 12.3 percent to reach $103.2 billion. In comparison, on the immediately preceding years, growth was considerably less at 7.4 percent in 1994 and at modest levels ranging from 3.1 percent to 3.5 percent during 1991 to 1993.

The rapid growth rate achieved in 1995 partly reflects a deliberate strategy by many banks to pursue asset growth as a means of boosting profits and achieving economies of scale. The type and volume of growth achieved varies across the different sectors of the banking industry.

Sector growth

Retail banks have grown more rapidly than the other two sectors of the industry in the past few years due in large measure to the rapid expansion of residential mortgage lending over this period. Growth in retail banks' assets in 1995 reached 16.3 percent. Significantly, the greatest increase for retail banks was in non-residential lending, which increased by 33.2 percent. This growth reflects a strategic move into the commercial lending market by a

Figure 7



number of retail banks which have focused on building relationships with small to medium size businesses and developing expertise through upskilling staff and gathering information on particular industries.

After being in decline over 1992 and 1993, the wholesale banking sector has grown at an increasing rate over the past two years. Some wholesale banks have moved into residential mortgage lending to take advantage of the growth in that market. This sector has also benefited from an increase in demand for credit from some parts of the business and rural sectors.

Residential mortgage lending has underpinned overall lending growth in the industry in the past five years. Consequently the proportion of mortgage lending to total bank lending (to the non-bank private sector) has increased significantly. As shown in figure 8, residential mortgage lending constituted 27.6 percent of non-bank private sector lending as at 31 December 1990. By 31 December 1995 this ratio had risen to 45.8 percent.

In the past two years a significant amount of the growth in residential mortgage lending has been in Auckland, due in part to the substantial migration into Auckland over this period. In recognition of this, a number of retail and wholesale banks have expanded their presence in the Auckland market.

Table 5

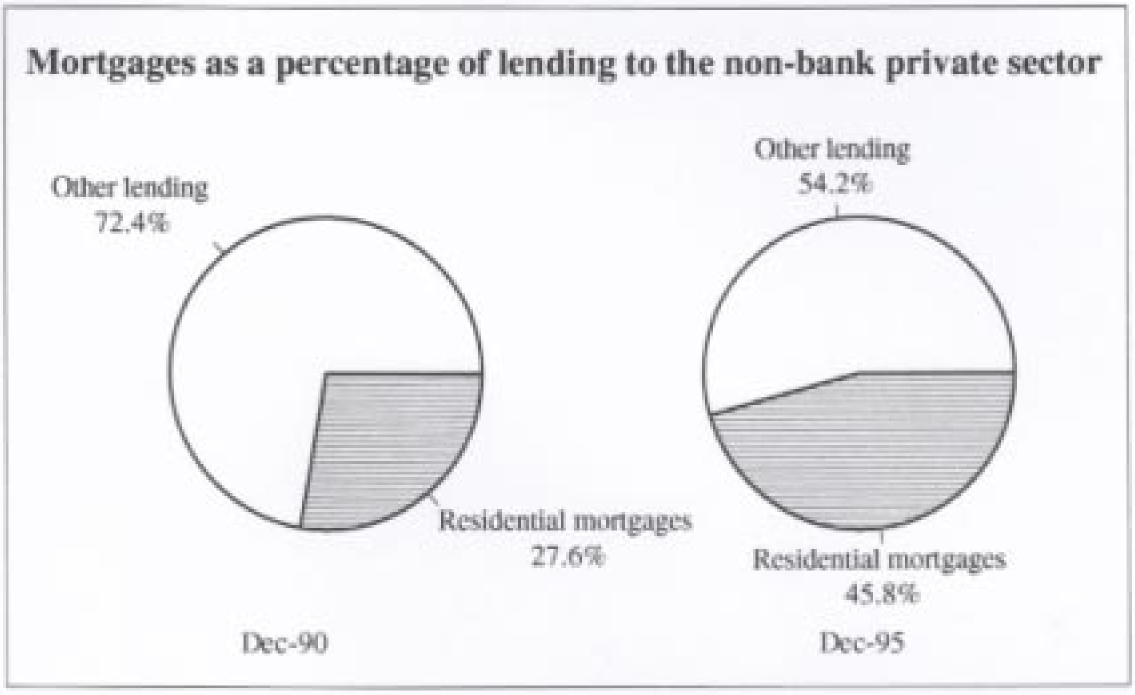
Lending to the non-bank private sector
$(million)

Date	Residental mortgages	Other	Total
Dec-90	15,943.0	41,876.1	57,819.1
Dec-91	19,851.2	38,731.0	58,582.2
Dec-92	23,112.8	39,575.9	62,688.8
Dec-93	27,237.0	37,655.0	64,892.0
Dec-94	32,734.7	40,656.2	73,390.9
Dec-95	38,464.0	45,468.5	83,932.5

However, the scope for growth in residential mortgages to continue at these high levels may be limited. If the rate of expansion in the economy slows down, the rate of growth in the size of the mortgage market may also decline. Also, much of the growth of the past two years has been based on increases in residential property prices leading to higher amounts being borrowed. A weakening in the rate of property price increases would reduce this avenue for lending growth.

Significantly, banks' other lending has increased substantially in the past two years after a number of years of modest growth and even decline. In 1995, other lending grew by 11.8 percent to reach $45.5 billion, which for the first time exceeds the 1990 level of $41.9 billion.

Figure 8



Commitments and contingencies

Banks are subject to a range of obligations and benefits under contracts which are not recognised, or only partially recognised, on their balance sheets. These are often referred to as "off-balance sheet" activities. The nature of the rights and obligations under these contracts varies considerably. Some, such as forward foreign exchange contracts, involve obligations which must be carried out on some future date while others, such as guarantees or standby letters of credit, represent contingent obligations to make payment in the future which depend upon the occurrence of some other event. However, despite their lack of recognition in banks' balance sheets, such commitments and contingencies can give rise to significant credit, liquidity, market, legal and operational risks.

As at 31 December 1995, the aggregate amount of banks' commitments and contingencies in credit equivalent terms was $11.7 billion or 11.4 percent of on-balance sheet assets. This represents an increase of 4.5 percent over the total amount of these items held at the same date in 1994, and a 0.7 per cent decrease as a proportion of balance sheet assets. The bulk of the credit equivalent amount of these items is made up of derivatives contracts which constituted 42.8 percent of off-balance sheet exposures at 31 December 1995.

Related financial services

As mentioned earlier, banks have in recent years expanded their involvement in non-traditional banking activities such as the provision of insurance, superannuation, and retail funds management services. These activities have been pursued in part to offset margin pressures, but also to retain customers who were increasingly being attracted to investment funds by the prospect of higher returns as interest rates declined.

Table 6 (overleaf) shows that the total value of funds under management rose at an annual average rate of 48 percent from 1991 to 1993. Over the same period, bank managed funds increased at an annual average rate of 102 percent.

However, since 1994 rises in the general level of interest rates have slowed the rate of growth in managed funds by making them less attractive investments relative to bank deposits. In 1995, unit trusts declined by 2.7 percent while superannuation funds grew by 16.7 percent. The weak, and in many cases negative, performance of many unit trusts in 1994 led some investors to withdraw their funds. This resulted in a net outflow of funds from unit trusts in 1995.

Bank managed unit trusts, in particular, suffered a significant decline in 1995. They decreased by 16.7 percent and also lost market share, dropping from 35.3 percent as at 31 December 1994 to 30.2 percent at the same date in 1995. In part, this may be due to some investors, who are subject to the surcharge on New Zealand

Table 6

Retail funds management and other similar activities
Net assets under management (1)
$ (million)

	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95
All surveyed funds managers					
Unlisted unit trusts (2)	1,503.0	2,073.2	3,181.5	3,665.1	3,565.7
Insurance bonds	1,349.4	1,805.0	2,327.9	2,549.9	2,409.4
Retail superannuation funds	1,059.1	1,755.7	3,057.4	3,569.1	4,165.9
Banking groups					
Unlisted unit trusts (2)	374.4	625.8	1,105.3	1,293.9	1,077.3
Insurance bonds	111.9	206.6	235.2	256.9	263.5
Retail superannuation funds	72.7	335.1	939.6	1,082.3	1,344.0
Market shares					
Unlisted unit trusts (2) (%)	24.91	30.18	34.74	35.30	30.21
Insurance bonds (%)	8.29	11.45	10.10	10.08	10.94
Retail superannuation funds (%)	6.86	19.09	30.73	30.32	32.26

(1) Source: FPG Research Ltd.
(2) Including group investment funds.

superannuation, transferring their funds from bank unit trusts into bank superannuation schemes to take advantage of the 50 percent exemption from the surcharge available for investors in registered superannuation schemes. The decline in bank managed unit trusts may also reflect a more short term outlook taken by some of the investors in those funds who have tended to regard them as direct alternatives to bank term deposits.

If interest rates remain at current levels, this will tend to moderate further growth in managed funds, since bank deposits will continue to be an attractive investment. However, many of the remaining investors probably have a longer-term outlook and hence will tend not to be influenced by short term fluctuations in returns.

V Asset quality

The trend over the last five years of improving asset quality continued in 1995. As shown in figure 9, there has been a steady downward movement in the level of banks' sub- and non- performing loans since 1990, which has coincided with improving economic conditions.

Over 1995 substantial asset quality gains were made. Banks' sub- and non- performing loans declined by $487 million to 1.3 percent of non-bank private sector lending as at 31 December 1995 from 2.1 percent at the end of 1994. More importantly, in terms of the soundness of the banking system, the ratio of sub- and non- performing loans to total capital has also declined in recent years as indicated by figure 10. A decline in this ratio indicates an increase in the ability of banks to absorb losses arising from default.

The decrease in sub- and non- performing loans in 1995 has come about mainly as a result of recoveries of loans for which provisions have been made and a decrease in the amount of new classifications of loans as being sub- or non- performing.

Favourable economic conditions have not been the only factor behind the strong gains in asset quality achieved in recent years. The problem loan difficulties experienced subsequent to the 1987 sharemarket crash and associated downturn in commercial property prices have resulted in banks applying stricter lending criteria and improving their management of problem loans. More recently, some banks

Figure 9

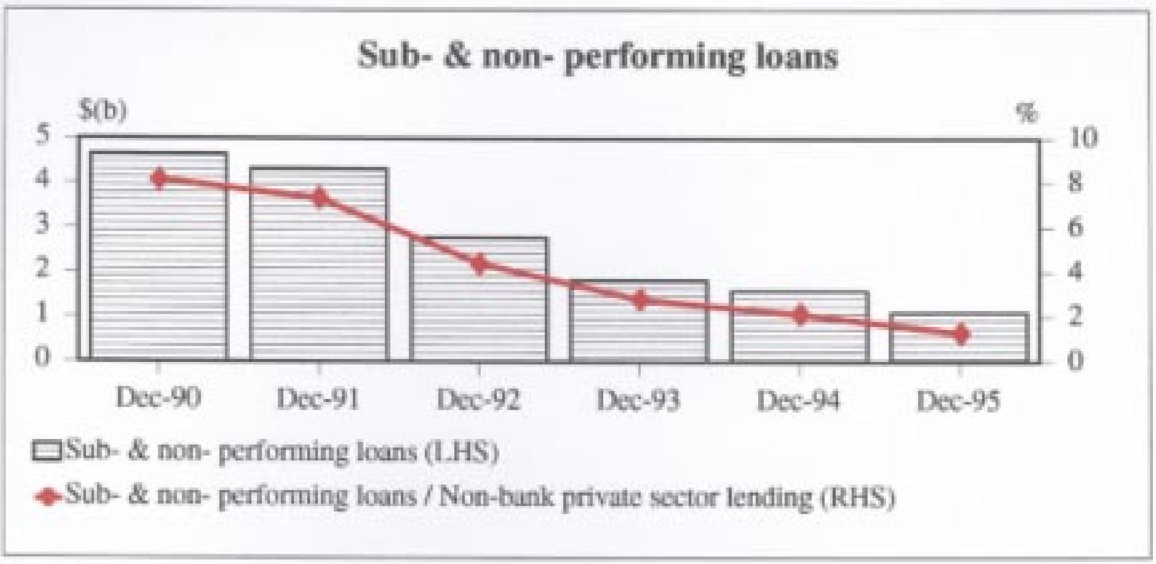
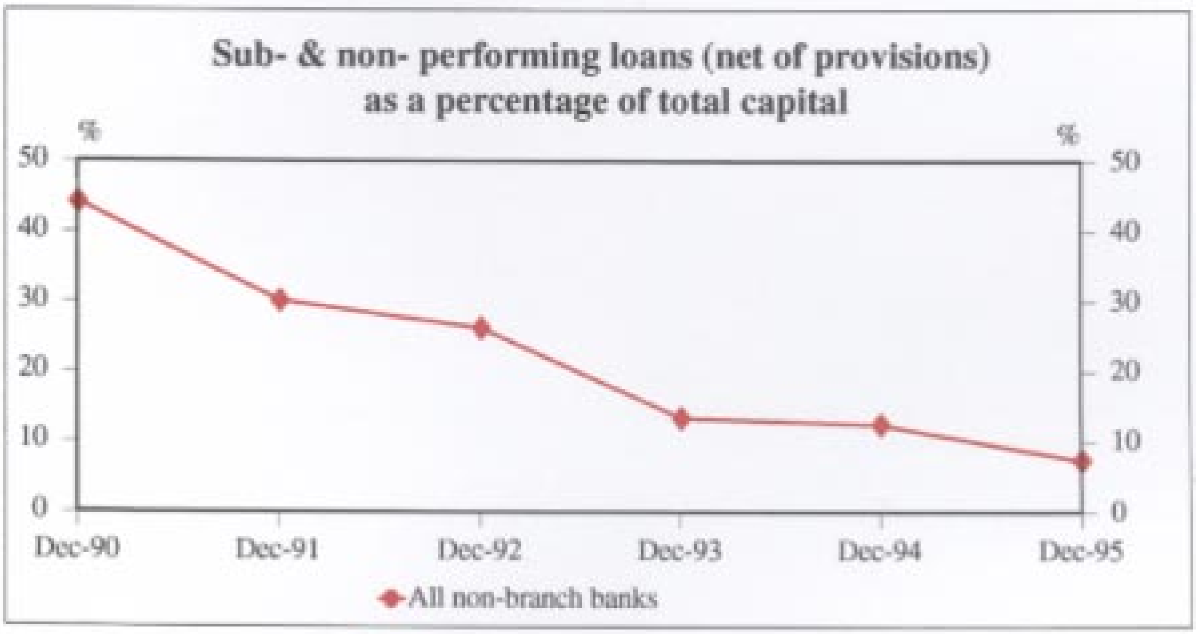


Figure 10



have been developing systems to predict and monitor asset quality problems along with databases on various industries and sectors within the economy.

Given the substantial asset quality gains achieved over the past five years, and the possibility of a reduction in the rate of economic expansion, the scope for further improvement in this area in the next few years may be limited.

VI Exposure concentrations

The concentration of credit exposures of banks to individual counterparties, or groups of closely related counterparties, are an important indication of banking system soundness. The failure of an individual counterparty, or a related group, to which a bank has a large credit exposure relative to capital, could potentially undermine the financial soundness of that bank. Accordingly, a reduction in the concentration of loan portfolios makes banks less vulnerable to potential losses arising from the failure of a single customer.

Table 7 (overleaf) shows that the number of exposures held by locally incorporated banks to individual corporate borrowers exceeding 10 percent of the lending bank's capital has reduced from 85 as at 31 December 1991 to 41 at the same date in 1995.

Banks' exposures to bank counterparties also decreased very significantly over the same period, coming down from 130 exposures greater than 10 percent of the lending bank's capital to 38, as indicated in table 8. However, the number of exposures to bank counterparties greater than 30 percent of the lending bank's capital doubled over

Table 7

Distribution of non-branch banks' exposures to corporates as a percentage of capital

Number of exposures

	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95
10% to 20%	56	47	32	27	26
Over 20% to 30%	13	9	10	11	12
Over 30%	16	15	7	4	3
Total	**85**	**71**	**49**	**42**	**41**

The table includes registered banks owned by other registered banks.

1995 from 7 to 14, suggesting that some inter-bank exposures have increased significantly. In some cases, banks have very high exposure limits, or actual exposures to other banks, which exceed the amount of their capital. Exposures to banks usually carry lower credit risk than exposures to corporates due to the generally higher credit standing of banks and the short-term nature of the exposures.

Table 8 does not include intra-day exposures arising between banks under payment settlement arrangements or exposures through correspondent banks to overseas counterparties under international settlement arrangements. These intra-day exposures between banks can reach very high levels but are also short-term in nature. The Reserve Bank is currently implementing reforms to reduce the risks to which banks are exposed in the domestic payments system. A key reform is the development of a real time gross settlement system which will significantly reduce the level of intra-day exposures between banks and give banks the ability to control these exposures.

Banks' exposures to counterparties which are connected, by ownership or effective control, and which exceed 10 percent of the lending bank's capital have reduced from a peak of 10 as at 31 December 1992 to 6 as at the same date in 1995. Connected exposures are of particular interest because of the ability of the connected counterparty to direct or influence a bank's lending policies and the terms of lending.

VII Capital adequacy

The improvement in the industry's profitability since 1993 has resulted in a considerable rise in the amount of capital held by New Zealand banks. In 1995, the aggregate

Table 8

Distribution of non-branch banks' exposures to other banks as a percentage of capital

Number of exposures

	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95
10% to 20%	13	13	8	28	6
Over 20% to 30%	49	47	28	10	18
Over 30%	68	63	20	7	14
Total	**130**	**123**	**56**	**45**	**38**

The table includes registered banks owned by other registered banks.

Table 9

Distribution of non-branch banks' connected lending as a percentage of capital

Number of exposures

	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95
10% to 20%	2	3	1	1	1
Over 20% to 30%	1	1	2	3	1
Over 30%	6	6	5	3	4
Total	**9**	**10**	**8**	**7**	**6**

The table includes registered banks owned by other registered banks.

amount of capital held by locally incorporated banks increased by 14.2 percent.

However, this has not led to an increase in the aggregate capital adequacy ratios for the industry. Table 10 shows that the total capital ratio of banks as at 31 December 1995 was 10.5 percent, the same as that recorded on 31 December 1994. Over 1994 there was actually a slight decline of 0.3 percent in the total capital ratio from 10.8 percent as at 31 December 1993.

The lack of improvement in capital ratios can be attributed to the strong asset growth of the past few years. On a risk weighted basis, banks' assets have expanded at a rate at least equal to the increases in the amount of capital over the past two years.

The quality of capital in the banking industry has been maintained from 1993 to 1995. Figure 11 (overleaf) shows that the aggregate tier 1 capital ratio of banks has remained at 7.7 percent over this period. Tier 1 capital is more robust, and hence more important, than tier 2 capital because it can be used to absorb losses while a bank continues to trade.

VIII Conclusions

The strong performance of the banking industry in 1995 reflects, to a large extent, a continuation of the positive trends established over the past few years. Interest rate rises and strong economic growth in the last few years have been the main factors behind the improvements in the financial performance of banks. More specifically, banks have been able to earn larger amounts of net interest income, despite the pressure on margins, largely through expanding their assets. In addition, improving asset quality has led to substantial reductions in the charges incurred for problem loans.

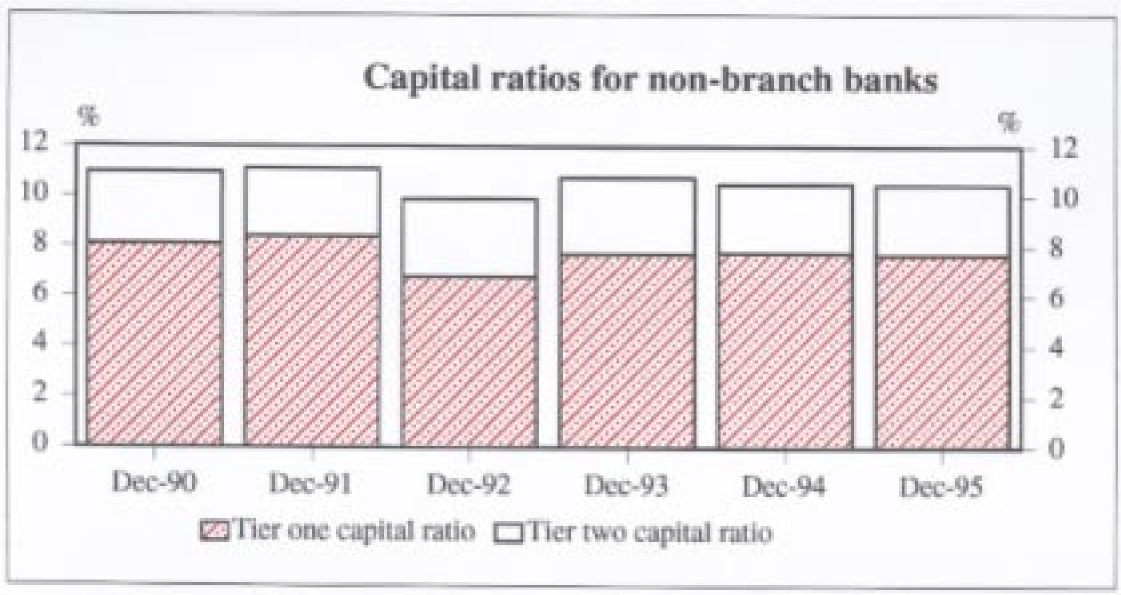
The overall soundness of the industry has also improved due to these and other factors. The development of stricter lending policies and better management of exposure levels and problem loans has, coupled with the favourable

Table 10

Capital ratios for non-branch banks

	Dec-90	Dec-91	Dec-92	Dec-93	Dec-94	Dec-95
Tier one capital ($m)	3,842.1	3,891.5	2,964.9	3,472.8	3,855.1	4,378.7
Tier one capital ratio (%)	8.10	8.39	6.79	7.72	7.75	7.69
Tier two capital ($m)	1,361.9	1,265.0	1,353.6	1,368.1	1,367.3	1,583.7
Tier two capital ratio (%)	2.87	2.73	3.10	3.04	2.75	2.78
Total capital ($m)	5,204.0	5,156.4	4,318.5	4,840.9	5,222.4	5,962.4
Total capital ratio (%)	10.97	11.12	9.89	10.76	10.50	10.47

Figure 11



economic conditions, resulted in significant reductions in the amount of sub- and non- performing loans, lower exposure concentrations and the maintenance of solid capital positions.

However, some of these trends are likely to change. A slowdown in economic growth would probably impact on the rate and composition of asset growth. Without continued growth in the size of the residential mortgage market it is unlikely that the current high level of growth will be sustainable. It is notable that non-residential lending to the business sector has picked up substantially over 1994 and 1995 after being stagnant, and at times in decline, for a number of years. This sector of the lending market may increase in importance over the next few years.

With problem loans having decreased to low levels, after several years of sharp declines, the scope for further improvements in asset quality to lead to profitability gains is now very limited.

Other factors will probably be more important in determining improvements in bank profitability over the next few years. Tight competition is likely to continue to place pressure on interest rate margins. Competitive pressures could increase if more overseas banks are attracted to New Zealand or if some non-banks, such as insurance companies, attempt to enter the lending market.

These pressures will maintain the impetus for banks to improve operating efficiency and seek non-lending sources of income. There may be significant scope for further rationalisation of branch structures, migration of customers to alternative methods of service delivery, such as telephone banking and ATMs, and imposition of “differential” fee structures. Also, banks have begun to realign their methods of service delivery to distinguish “high value” customers from the mass market. Many banks have begun to develop new and more innovative products and personally tailored services for their “high value” customers and “plain vanilla” products and services which are cost effective for the mass market. In doing this, banks are seeking to forge closer relationships with, and to retain, their “high value” customers while minimising the costs incurred in servicing customers who do not make a large contribution to earnings.

Appendix 1

Glossary of terms

Capital

The residual claims on the assets of the bank once all claims of depositors and other obligations have been satisfied. Under the Basle framework capital is divided into tier one and tier two capital.

Credit equivalent amounts

A credit equivalent is a measure of the credit risk associated with commitments and contingencies which allows a direct comparison with on-balance sheet items.

Derivatives

Derivative contracts mainly consist of foreign exchange and interest rate contracts such as currency swaps, forward interest rate agreements, forward foreign exchange contracts, and interest rate and currency options purchased. Other market related contracts such as share and gold options purchased are also included in this category.

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.

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 consists mainly of hybrid capital instruments such as subordinated debt, which have some, but not all of the characteristics of equity. In most cases they are only capable of absorbing losses in a winding-up.

Total capital ratio

The total capital ratio is the sum of tier one and tier two capital divided by risk weighted exposures.

Appendix 2

Registered banks as at December 1995

Multi-purpose banks	Banking group
ANZ Banking Group (New Zealand) Limited	Australia and New Zealand Banking Group Limited
Bank of New Zealand	National Australia Bank Limited
The National Bank of New Zealand Limited	Lloyds Bank Plc
Westpac Banking Corporation (B)	Westpac Banking Corporation

Wholesale banks	
Bankers Trust New Zealand Limited	Bankers Trust New York Corporation
Banque Indosuez (B)	Banque Indoseuz
Barclays Bank Plc (B)	Barclays Bank Plc
BNZ Finance Limited	National Australia Bank Limited
Citibank NA (B)	Citibank NA
Primary Industry Bank of Australia (B)	Rabobank Group
The Hongkong and Shanghai Banking Corporation (B)	The Hongkong and Shanghai Banking Corporation

Mainly retail banks	
ASB Bank Limited	Commonwealth Bank of Australia
Countrywide Banking Corporation Limited	Bank of Scotland
Trust Bank New Zealand Limited	Trust Bank New Zealand Limited
TSB Bank Limited	TSB Bank Limited

(B) Banks registered in New Zealand as branches of overseas incorporated banks

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