Developments in the banking industry

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This article reviews developments in the New Zealand banking system over 1997 against the background of international banking trends. Financial data extracted from banks' disclosure statements point to a banking system which, although less buoyant than in earlier years, is still well placed to handle adverse economic developments.

1 Introduction

Over 1997 and the first part of 1998, banks around the world faced increasing competitive pressures in international financial markets. The New Zealand financial system was also characterised by intense competition over the period and there were some common elements to the responses of major international banks and of New Zealand banks to the competitive environments they faced. This article discusses recent developments in the New Zealand banking system against the background of international banking trends.

The article also reviews the financial performance of banks in New Zealand on the basis of the financial data for 1997 published in banks' disclosure statements. The picture which emerges is of a less buoyant banking system exhibiting continuing profit growth (albeit only a more modest rate of increase than in earlier years), slower asset growth and indications that the previous steady improvement in asset quality has come to an end. Capital ratios remained above required levels and generally market risk levels were low. Banks have continued to seek greater efficiency by containing costs or by recovering them through fees.

2 Structural and policy issues

International developments/trends

There can be little doubt that financial intermediation is becoming increasingly global. Technological advances and on-going liberalisation of financial markets have contributed to the development of increasingly integrated global capital markets dominated by global financial institutions. At the same time, distinctions between different types of financial institution have been breaking down. Banks have been moving to become more involved in other areas of business such as insurance and funds management and firms which have previously specialised in these businesses have been moving to become more involved in banking. The result has been the emergence of very large financial institutions participating in a wide range of financial activities.

In part, the development of such financial conglomerates has been motivated by a view that the only way to survive in an increasingly competitive international marketplace is by seeking the economies of scale associated with size, and the ability to cross-sell from a broad range of financial products. Faced with intense competition, banks have also been looking for ways to improve their profitability, particularly by reducing their costs. One result has been banks looking for merger partners or acquisition targets which offer complementary business or which enable them to conduct banking business more efficiently. This process has been highlighted by six high profile mergers between large international banks announced since November 1997. These mergers will create very large financial conglomerates in the US, Canada and Europe, each with assets of between USD280 billion and USD960 billion.

Mergers such as these can create obvious scope for reducing costs by rationalising the provision of services. Banks have also moved to centralise functions and decision-making to make use of the best practice available to the merged organisation. While this practice has been especially evident in the data processing area, there is a tendency also to centralise management and decision-making. In particular, banks have been moving to centralise their risk management functions in order to follow a standard approach throughout the organisation and to ensure that appropriate controls are in place.

Banks have also been looking for greater efficiency by finding lower cost ways to deliver banking services. There has been a particular emphasis on the development of 'direct banking'. This form of banking is based around the delivery of services by telephone or by electronic means via the Internet. In some instances, direct banking has involved the participation of firms which are not otherwise involved in financial markets. For example, in the United Kingdom supermarket chains have been going into partnership with banks to establish direct banking operations targeting supermarket customers.

Another key area in which banks internationally are looking to improve their profitability is the more efficient use of capital. Banks need to hold capital as a buffer against losses, of course. However, the costs of raising capital can be high. Banks have therefore been exploring ways to reduce the need for capital or to raise it more cheaply. One approach to reducing the need for capital which has been growing in importance has been to securitise assets and sell them, thereby removing the associated credit exposure from the bank.

The trend towards the development of financial conglomerates is presenting new challenges to bank regulators around the world. The traditional approach to financial market regulation has been to have separate regulators for the different sectors of the industry. However, this approach encounters some difficulties when the industry is dominated by conglomerates operating in a range of different sectors. Some countries have sought to meet this challenge through efforts to co-ordinate and exchange information amongst different supervisors. Other countries, such as Australia and the United Kingdom, have moved to introduce a single 'umbrella' body to supervise all financial institutions.

The problems associated with regulating large, internationally active, financial conglomerates are also leading regulators to consider more carefully the role that can be played by market forces and improved internal governance in disciplining bank behaviour. The case for greater reliance on market forces was summed up by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, in a speech to the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition on 1 May 1997:

"As financial transactions become increasingly rapid and complex, I believe we have no choice but to harness market forces, as best we can, to reinforce our supervisory objectives. The appeal of market-led discipline lies not only in its cost effectiveness and flexibility, but also in its limited intrusiveness and its greater adaptability to changing financial environments. Measures to enhance market discipline involve providing private investors the incentives and the means to reward good bank performance and penalise poor performance. Expanded risk management disclosures by financial institutions is a significant step in this direction."

The move away from regulation based on detailed rules to an approach placing greater emphasis on the adequacy of internal risk control mechanisms is also highlighted by the steps taken by the Basle Committee on Banking Supervision to amend the Capital Accord to include market risk. That initiative gives a greater role to banks' own internal risk models in determining adequate capital levels.

Developments in Australia

With about 70 percent of bank assets in New Zealand owned by Australian-controlled banks, developments in Australia are important for the New Zealand banking system. Over the past year, developments in the Australian banking system have been heavily influenced by the Australian Government's response to the Financial System Inquiry (also known as the Wallis Inquiry). One of the key recommendations of that Inquiry was the removal of ownership restrictions on banks in Australia. However, the Australian Government has decided not to approve any mergers of the four big retail banks until competition in the Australian banking sector has increased. To date the retention of this ‘four pillars’ policy has prevented the international trend towards banking sector consolidation spreading to Australia. However, the policy would not prevent the take-over of a major Australian bank by a foreign bank.

The future structure of the New Zealand banking system will depend heavily on developments in Australia. Should the Australian Government remove the ‘four pillars’ restriction on bank mergers, or a major Australian bank be taken over by a foreign bank, there could be significant flow-on effects to New Zealand.

The Australian Government has taken steps to implement two other key recommendations in the Wallis Report. Legislation has been introduced to establish a single prudential regulator. The Australian Prudential Regulation Authority (APRA) will be responsible for the supervision of all financial institutions, including banks. APRA is expected to be operating by July 1998.

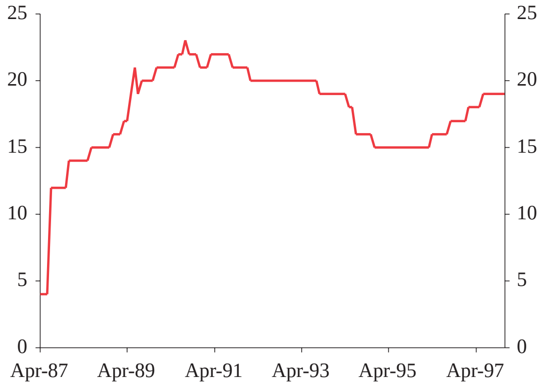
Legislation has also been introduced to formalise the role of the Reserve Bank of Australia (RBA) in overseeing the payments system. The RBA is to be given quite extensive powers to regulate payments systems to ensure that those systems are efficient, competitive and stable.

New Zealand experience

There was a further increase in the number of registered banks in New Zealand over 1997. Two more banks were registered over the year bringing the total number of registered banks to 19 at 31 December 1997. The two new banks were Banque Nationale de Paris S.A. (BNP), which was registered in March 1997, and Kookmin Bank, a major Korean Bank, which was registered in July 1997. In March 1998, the Dutch bank ABN AMRO Bank N.V. was registered after purchasing the New Zealand assets of Barclays Bank plc. Barclays subsequently relinquished its bank registration.

It is interesting that major international banks still see opportunities to establish a presence in New Zealand. The recently-registered banks have largely sought to establish themselves in specialised niche markets. In particular, several banks have looked to concentrate on the corporate market.

Figure 1
Number of banks registered in New Zealand



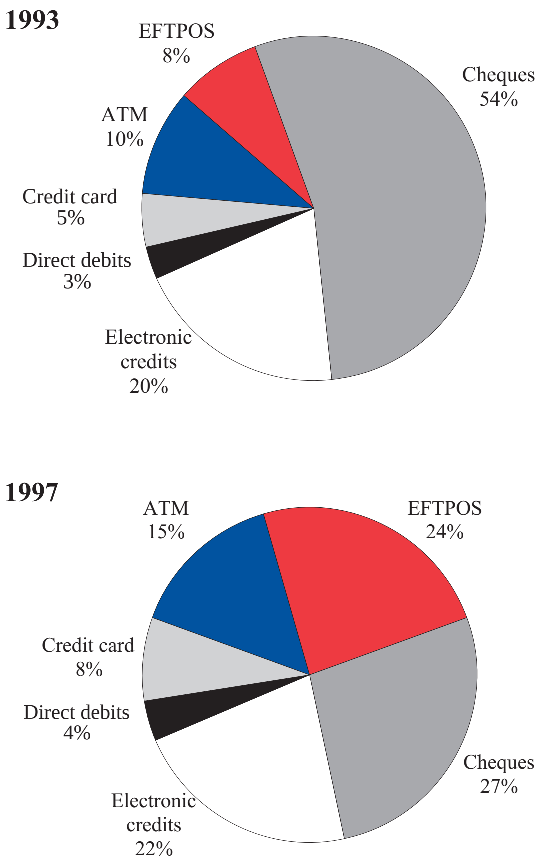
The existence of specialist institutions concentrating on a particular market niche in which they have a comparative advantage and also of some low cost non-bank operations mean that there is considerable competition in the New Zealand banking industry. This competition has prompted banks to follow the international trend towards attempting to reduce costs and centralising the management of their businesses. In particular, there has been a tendency towards effectively managing banks from Australia, even when the New Zealand operation is incorporated in this country. Australian-owned banks are also looking at centralising the provision of data processing services in Australia.

A desire to cut costs has also been a key reason for banks looking to establish direct banking operations. A number of banks have moved to offer services by telephone and over the Internet. Although it is probably too early to draw any conclusions on how successful this type of banking will be, there is some evidence to suggest that the approach is proving popular with a growing number of bank customers.

The other continuing trend in New Zealand has been the attempt by banks to recover costs through transaction fees. By setting fees which more closely reflect the costs of providing various services, banks have been looking to provide incentives for customers to make use of lower cost methods of conducting their banking business and to reduce the extent of cross-subsidisation inherent in traditional fee structures.

Generally, electronic banking will deliver services more cheaply. Data from the New Zealand Bankers' Association (see figure 2) show that there has been a definite trend towards making increased use of electronic payment methods over the last five years. Cheque use continued to decline in 1997 with cheques only used in 27 percent, by number, of non-cash transactions compared with 54 percent in 1993. Over the same period, EFTPOS use grew significantly with EFTPOS now accounting for almost a quarter of non-cash payments.

Figure 2
Payment methods



Source: New Zealand Bankers' Association

A further significant change to the operating environment for banks in New Zealand has been the introduction of real time gross settlement (RTGS) for most high value wholesale payments. The Reserve Bank's Exchange Settlement Account System (ESAS) went fully live in March 1998. The advent of RTGS means that the level of systemic risk in the financial system has been substantially reduced. The Bank is now working with the banks to find ways to reduce cross-border foreign exchange settlement risk (Herstatt risk) and will be looking at other areas of risk management in the payments system as well.

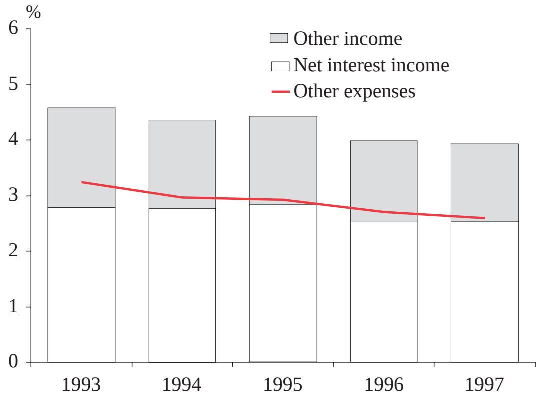
3 Financial performance of banks in New Zealand

The commentary in this section is based on data for 1997 compiled from registered bank disclosure statements. Although there were 19 registered banks as at 31 December 1997, the commentary is only based on information from 18 banks. As previously noted, Barclays Bank plc was removed from the register in March 1998 and was therefore not obliged to publish a disclosure statement for the December quarter. The data disclosed in the four quarterly disclosure statements for each bank have been aggregated for use in this article.

Profitability

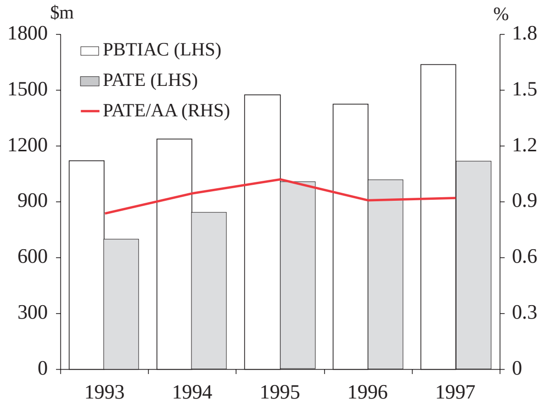
Figure 3 illustrates the impact on the costs and non-interest income of New Zealand banks of the strategies which they have adopted to boost profitability in the face of increasing competition. Cost reductions have been achieved by rationalisation of branch networks and by developing and encouraging the use of lower cost means of delivering banking services (such as telephone banking). These developments have resulted in a steady fall in operating expenses as a proportion of assets recorded over the last few years. The fall in this ratio over 1997 would probably have been more pronounced if it were not for the one-off costs incurred by banks to ensure that their computer systems are Year 2000 compliant.

Figure 3
Income and expenses as a percentage of average assets



Note: Data for the 12 months to December.

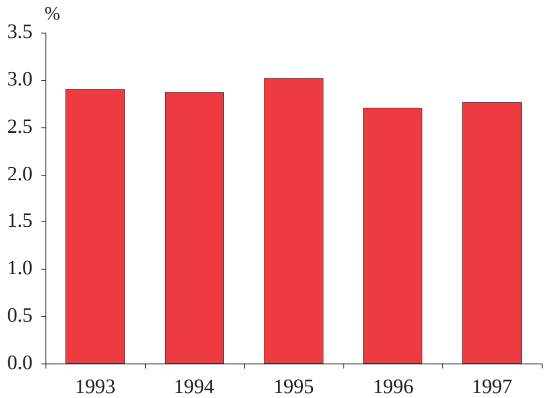
Figure 4
Profitability



Note: PBTIAC = Profit before tax and impaired asset charges. PATE = Profit after tax and extraordinary items. PATE/AA = Profit after tax and extraordinary items as a percentage of average assets. Data for the 12 months to December.

Table 1 highlights that, in spite of banks' strategies, cost reductions were not the major factor underpinning the increased profits recorded in 1997. Rather, the growth in underlying profit (profit before impaired asset costs, tax and extraordinary items) was driven largely by increased net interest income. In turn, the increase in net interest income reflected a 6 percent increase in the banks' interest earning assets (see below for a discussion of asset growth). Given that the profit growth largely reflected asset growth, net profit as a percentage of total assets remained steady at about 0.9 percent.

Figure 5
Interest rate margin



Note: Figures for the 12 months to December.

Table 1

($ million)	**1993**	**1994**	**1995**	**1996**	**1997**
Net interest income	2,336	2,462	2,794	2,827	3,090
plus					
Other income	1,499	1,409	1,557	1, 638	1,694
less					
Operating expenses	2,713	2,634	2,877	3,038	3,148
equals					
Underlying profit	**1,122**	**1,237**	**1,474**	**1,427**	**1,636**
less					
Impaired asset costs	53	-97	-8	-42	88
less					
Tax and other items	368	494	477	453	431
equals					
Net Profit	**701**	**840**	**1,005**	**1,016**	**1,117**

Table 2

($ billion)	1993	1994	1995	1996	1997
Investments	23.0	19.0	19.4	21.5	19.2
Residential mortgages	27.2	32.7	38.5	45.7	50.6
Other lending	32.2	36.2	40.1	43.9	48.3
Other assets	2.9	4.1	5.1	7.5	12.1
Total assets	**85.3**	**92.0**	**103.1**	**118.6**	**130.2**

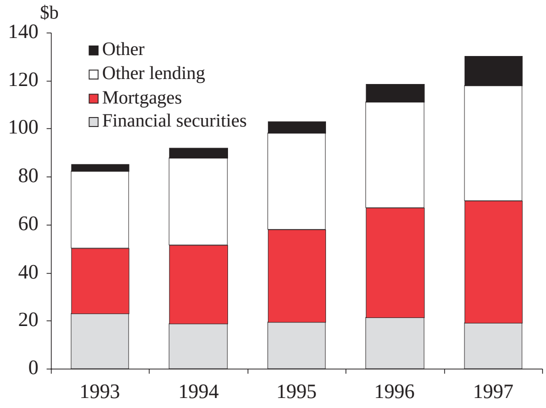
An increasingly competitive banking system is typically characterised by falling interest rate margins. Figure 5 shows that after quite strong downward pressure in 1996, margins remained at the lower levels in 1997 as banks continued to operate in a very competitive environment.

Overall profitability in 1997 was also constrained by the ending of the ability of some banks to write back impaired asset costs due to subsequent recoveries. Such write-backs made a significant contribution to profitability between 1994 and 1996, but with the favourable asset quality conditions apparently coming to an end over 1997 banks have generally been unable to continue the practice.

Balance sheet

The asset growth underlying the increased profits in 1997 was the result of a broadly based increase in lending. Both residential mortgage lending and other lending grew by about 10 percent.

Figure 6
Composition of assets



Note: As at 31 December. Other lending is net of provisions.

A significant trend in recent years has been the increasing share of bank assets represented by residential mortgages. From 1992 to 1996, the share of residential mortgages in total bank assets increased from 28 percent to 39 percent with particularly strong growth recorded in 1996. However, the growth in mortgages in 1997 was less marked, and their share of total assets remained fairly stable at around 39 percent. As a proportion of total bank lending, residential mortgages increased from 43 percent in 1992 to 51 percent in 1997.

The other assets category has also increased significantly over the last two years. This increase largely reflects the inclusion from 1996, as a result of changes to accounting policies, of the revaluation gains on off-balance sheet items.

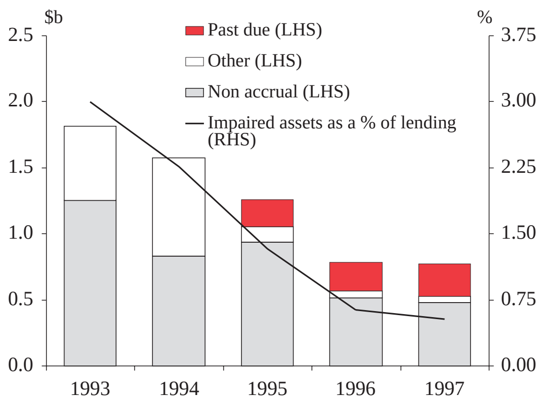
Asset quality

As shown in figure 7, the aggregate data points to a further improvement in asset quality indicators over 1997. However, these results are dominated by one bank which recorded a big fall in its impaired assets over the year. Most banks actually showed some increase in their impaired assets. This result is perhaps not surprising given the general slow-down in economic activity which has occurred. In such circumstances, some borrowers can be expected to have difficulty servicing their loans. Nevertheless, impaired assets remain at historically low levels.

The asset quality indicators reported by banks are yet to reflect the full effect of the problems facing Asian economies. The direct exposures of New Zealand banks to Asia are small. However, Asia does represent an important market for many New Zealand firms and those firms can expect an adverse impact on sales from developments in the troubled Asian countries. That adverse impact will, in turn, be reflected in banks' financial performance in the future.

The New Zealand banking system seems unlikely, however, to have to deal with the problems caused by foreign currency borrowing which have been experienced in Asia. In a number of Asian countries, firms borrowed large amounts in foreign currencies without hedging the resulting exchange rate risk. The subsequent significant depreciations of Asian currencies left many of those firms technically insolvent, unable to meet their foreign currency commitments. There is no evidence to suggest that New Zealand firms face similar foreign exchange risks. Firms in this country tend to hedge their foreign currency exposures using financial instruments, or to have natural hedges because at least some of their receipts are also in foreign currency.

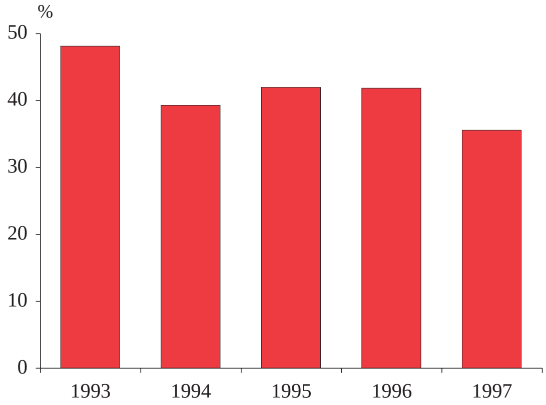
Figure 7
Asset quality



Note: As at December. Past due is not available for 1993 and 1994. Other = restructured assets and assets acquired through the enforcement of securities. Impaired assets = non accrual and other.

The recent increase in impaired assets for most banks has not yet been reflected in provisioning levels. As shown in figure 8, specific provisions fell to be about 36 percent of impaired assets at the end of 1997.

Figure 8
Specific provisions as a percentage of impaired assets



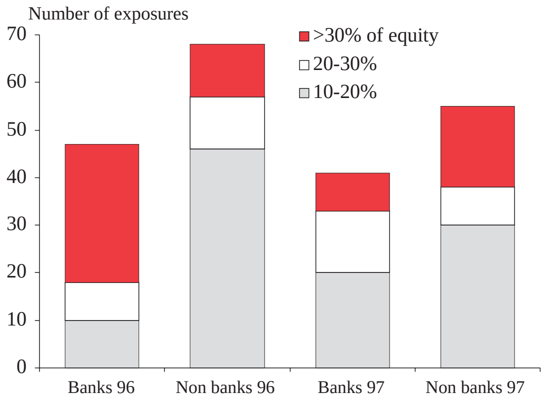
Note: As at 31 December.

Large exposures

Figure 9 summarises information on the number of exposures that banks have to individual counterparties which exceed 10 percent of the bank's equity. This measure is more relevant to New Zealand incorporated banks because branch banks seldom have exposures in New Zealand large enough to exceed 10 percent of the bank's global equity.

The available information tends to suggest that the overall level of banks' credit concentration fell in 1997. Both the total number and the size of large exposures appear to have fallen. It is difficult to put this result in a longer term context because large exposure information has only been available in this form since 1996. Before 1996 banks reported large exposures in excess of 10 percent of total capital (as measured for capital adequacy purposes). As total capital usually exceeds equity, the threshold for reporting large exposures has been lower since 1996 than in previous years. Thus the current data are not exactly comparable with the earlier data. However, it does appear that the number and size of large exposures in 1997 are below the levels experienced in the early 1990s.

Figure 9
Number of large exposures to bank and non bank counterparties



Note: As at 31 December.

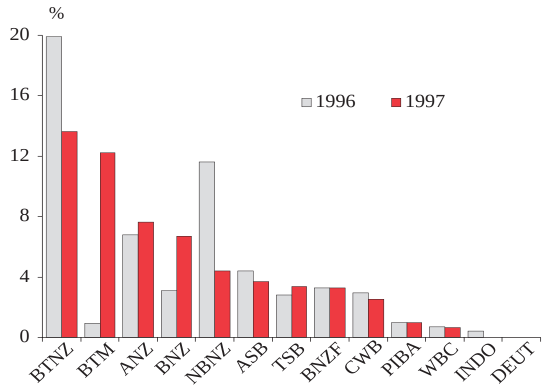
Market risk

The market risk disclosures that a bank is required to make are designed to give an indication of the change in the value of a bank's on- and off-balance sheet assets and liabilities arising from movements in market prices (interest rates, exchange rates or equity prices). Banks are required to disclose their level of market risk as an amount and as a percentage of equity.

Interest rate risk tends to be the largest component of reported market risk. Figure 10 shows details of peak interest rate risk for 1996 and 1997 (earlier information is not available). As can be seen in the graph, market risk levels tend to be reasonably small, but can show large variations over time. There are also significant differences between the levels of risk reported by different banks. These differences reflect the different natures of the business conducted by various banks. Banks which actively seek to take positions in financial markets will have larger market risks than banks which concentrate on lending.

Banks in New Zealand are not required to hold capital in excess of the minimum requirement of 8 percent of risk weighted exposures to cover market risks. Disclosure of these risks is expected to provide banks with sufficient incentives to hold additional capital to cover the risks involved. It is important when assessing reported market risks also to consider banks' capital positions.

Figure 10
Peak interest rate risk as a percentage of equity



Note: See appendix 1 for full bank names.

Operational risk

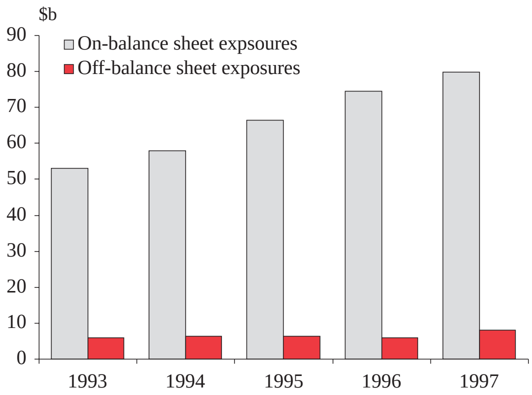
Operational risk may be caused by such things as a failure of internal control systems or interruptions to the availability of computer systems. A good test of banks' preparedness to handle such operational problems was provided by the Auckland power crisis. The crisis appeared to cause no major or insurmountable difficulties for banks, even for those banks whose head offices are located in the affected central business district.

The need to ensure the Year 2000 compliance of computer systems is a significant issue for banks. The Bank believes that there are strong incentives for banks to address the issue and all banks have projects underway to ensure compliance. These efforts are being co-ordinated by a New Zealand Bankers' Association committee. Year 2000 projects are likely to continue to impact on banks' costs in the short term.

Capital adequacy

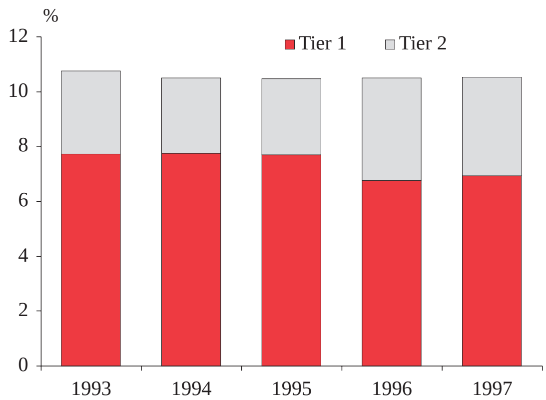
The capital position of the New Zealand banking system at 31 December 1997 was little changed from its level a year earlier. Increases in banks' on- and off-balance sheet exposures were matched by the appropriate increase in capital to allow the overall capital ratio to remain virtually unchanged. There was a small increase in banks' tier 1 capital due to increases in equity recorded by a number of banks. As a result, the aggregate tier 1 ratio increased from 6.77 percent to 6.94 percent.

Figure 11
Risk weighted exposures



Note: As at 31 December.

Figure 12
Capital adequacy



Note: As at 31 December.

The tier 1 and overall capital ratios for all banks remain comfortably above the international minimum standards of 4 percent and 8 percent respectively.

As noted above, one of the key trends in international banking is for banks to look to use their capital more efficiently and, in particular, to securitise assets. To date, there has been little in the way of securitisation in New Zealand and so there has been little impact on banks' capital requirements.

4 Conclusion and outlook

The last year has seen financial institutions world-wide seeking to improve their profitability in the face of an increasingly competitive marketplace. One result of these efforts has been a number of mergers involving large financial institutions which will create very large financial conglomerates. In the near future, the prospects for further consolidation in the New Zealand banking sector are likely to depend on developments in Australia. Should the Australian Government allow any of the four large banks to merge or should one of those banks be bought by a foreign bank, there could be significant flow-on effects for New Zealand.

As in other countries, banks in New Zealand have been seeking to reduce their costs and to put in place fee structures to cover costs and to encourage customers to use lower cost services. However, over 1997 the major factor underpinning the profit growth enjoyed by banks was increased lending.

Looking ahead, the indications are that credit growth may be subdued for a period, which suggests that banks will not be able to look towards further rapid expansion of their balance sheets as a way to maintain profit growth in the near future. Of particular relevance for banks will be developments in the housing market (given the significant proportion of total bank assets represented by residential mortgages) and in Asian countries. The direct exposures of New Zealand banks to the troubled Asian countries are very small. However, New Zealand firms can be expected to be adversely affected by developments in Asia and such adverse effects will, in turn, be reflected in banks' financial performance in coming quarters.

Nevertheless, the New Zealand banking system appears to be well placed to handle adverse developments. In spite of the apparent end to improvements in asset quality, impaired asset levels remain very low by historical standards. Furthermore, market risk levels are also low and capital ratios remain comfortably above international standards.

Appendix
Registered banks as at 31 December 1997

New Zealand Incorporated Banks		
ANZ Banking Group (New Zealand) Limited	Australia and New Zealand Banking Group Limited	ANZ
ASB Bank Limited	Commonwealth Bank of Australia (75%), ASB Community Trust (25%)	ASB
Bank of New Zealand	National Australia Bank Limited	BNZ
Bankers Trust New Zealand Limited	Bankers Trust New York Corporation	BTNZ
BNZ Finance Limited	National Australia Bank Limited	BNZF
Countrywide Banking Corporation Limited	Bank of Scotland	CWB
The National Bank of New Zealand Limited	Lloyds TSB Group plc	NBNZ
TSB Bank Limited	TSB Community Trust	TSB

Overseas Incorporated Banks	Abbreviation
Bank of Tokyo-Mitsubishi (Australia) Limited	BTM
Banque Nationale de Paris S.A.	BNP
Barclays Bank plc	BARC
Citibank N.A.	CITI
Credit Agricole Indosuez	INDO
Deutsche Bank A.G.	DEUT
Hong Kong and Shanghai Banking Corporation	HKSB
Kookmin Bank	KMIN
Primary Industry Bank of Australia Limited	PIBA
Rabobank Nederland	RABO
Westpac Banking Corporation	WBC