ARTICLES

Developments in the New Zealand banking industry

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This article reviews developments in the New Zealand banking system over the year to December 2000. Financial information extracted from banks' disclosure statements indicates a strong banking system with good asset quality.

1 Introduction

This article discusses recent developments in the New Zealand banking industry. It also looks at some of the current policy and structural issues affecting the industry. It then comments briefly on the financial performance of the industry, using financial data for the year 2000 published in registered banks' disclosure statements. That information shows that the New Zealand banking sector performed solidly during the year to December 2000. Profits and assets grew in a market that continues to be highly competitive. This competition led to a further narrowing of interest margins, but this narrowing was offset by growth in both interest and non-interest income. Asset quality remains very sound.

2 Policy developments

In past articles we have discussed trends in international banking, an important one of which has been the establishment of financial conglomerates that operate in all spheres of the financial system, and the challenges that this trend presents for regulators. Until recently the Reserve Bank has been able to take a permissive approach to the activities that banks can conduct, because banks have substantially restricted themselves to traditional banking business. The financial landscape in New Zealand is now changing, with the boundaries between banking and particularly insurance beginning to be blurred. A major banking group has acquired a large insurance operation, an insurance company has become involved in banking and there is the prospect of further financial conglomerates emerging. There has also been a good deal of discussion amongst the international supervisory community on the issue of supervision of financial conglomerates.

These developments have motivated a review of what kind of supervisory approach is appropriate for financial conglomerates operating in New Zealand. The outcome of this review has been a set of policy proposals from the Bank dealing with financial conglomerates and lending by banks to connected parties. In essence we are proposing a framework that separates banking from non-banking activity, with Reserve Bank supervision focused on banking, and affiliated non-banking activities being subject to disclosure requirements. At the same time we are seeking to ensure that connected lending does not undermine the capital buffer of banks, but to do so in a way that provides more flexibility to banks. We are currently in consultation with the industry on these proposals.

Another major development in international banking that has implications for banking in New Zealand has been the review of the 1988 Capital Accord by the Basel Committee on Banking Supervision. The Committee released its first consultative package in June 1999, with a second round of consultation documents published in January of this year. The aim of the revision is to improve safety and soundness in the banking system. The Committee's proposals are built around three pillars – minimum capital requirements, a supervisory review process and market discipline. In our submission to the Committee we indicated broad support for the proposals in the minimum capital requirements and market discipline pillars, but expressed concern about the proposed supervisory review process, which envisages the supervisor being directly and explicitly involved in validating a bank's measurement of risk and assignment of capital. We see this undermining a regulatory approach aimed at strengthening the incentives on the private sector (directors, management, and the creditors of a bank) to promote prudent bank behaviour, and have recommended that the Committee allow for a review process that places primary responsibility on bank directors, with supporting independent expert advice from the private sector. The Committee expects to publish the new Accord at the end of this year with implementation envisaged by 2004.

In addition to these internationally generated initiatives there have been a number of policy developments aimed at strengthening the prudential policy approach applied to banks in New Zealand. One of these was a review by the Bank of its policy on credit rating for registered banks. When the disclosure based supervision regime was introduced in 1996, we considered the provision in the Reserve Bank Act which enables us to require banks to obtain a credit rating, but decided not to implement mandatory ratings at the time. However, banks were required to disclose whether they had a rating applicable to their long-term senior unsecured New Zealand dollar debt payable in New Zealand. Where they did have such a rating, it had to be disclosed in the quarterly disclosure statements. After revisiting this issue and consulting with banks, we have now decided that all registered banks will be required to obtain and subsequently maintain a current rating. Banks will continue to be required to publish the rating in quarterly disclosure statements.

The Bank has also placed increasing emphasis on the need to ensure that the New Zealand banking system will be resilient in the face of bank distress. This has led to a range of initiatives including a review of bank organisational form, and the role of innovative capital instruments in meeting a bank's regulatory capital requirements.

In the past, the Bank has been largely indifferent as to the organisational form of foreign owned banks and in particular whether they operate in New Zealand as branches of an overseas bank or as locally incorporated subsidiaries. Following a review and consultation with the industry, banks falling into certain categories will now be required to incorporate locally. The relevant categories are banks that are systemically important; and retail deposit takers that have more than $200 million in retail deposits if they are from jurisdictions with statutory preferences for local creditors in a winding-up or if they have inadequate disclosure in the home jurisdiction. The main rationale behind the new policy is to improve the ability of the Reserve Bank to manage the failure of a systemically important bank effectively and to ensure that retail depositors have access to the information they need to assess the risk of dealing with a particular bank.

In order to implement the new policy, regulations have been made under section 73(2)(g) of the Reserve Bank Act. These regulations prescribe additional matters to which the Bank must have regard when it considers applications for bank registration and in respect of which it can impose conditions of registration on registered banks. The additional matters prescribed in regulations include the size and nature of any part of the (proposed) bank's business, disclosure in the home jurisdiction and the priority of creditors in a winding up. The Bank is still consulting on the local incorporation issue with affected parties.

The work on innovative capital instruments (ie instruments that have both equity and debt characteristics) has involved looking at the components of capital and deciding whether capital instruments of a hybrid nature should be eligible for inclusion in tier one capital. We reached a preliminary view that such instruments should not be included in tier one capital because of our wish to ensure that banks will have a capital buffer in place that is not only adequate in size, but also of sufficient quality to withstand significant adverse events. The Bank will, however, be giving further consideration to the advantages and disadvantages of different types of capital instruments, in discussion with the industry.

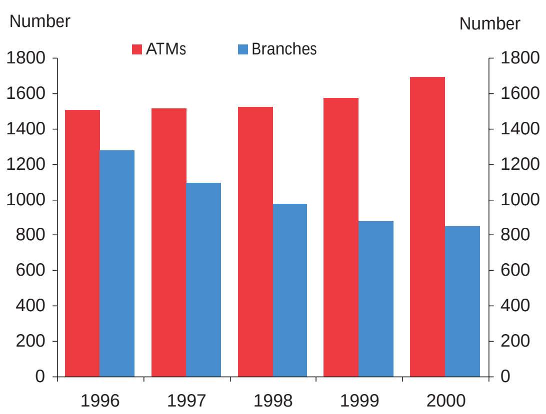
Finally on the policy front, we have begun consulting with the banking sector on proposals for updating the statutory framework under which the Reserve Bank supervises registered banks. The proposed changes include amendments that deal with the restrictions on business names that include the word "bank" and its derivatives and refinements to the rules covering the registration and supervision of banks by the Reserve Bank. Some provisions need to be updated to reflect recent technological innovations and changes in banking practice. Other suggested changes help bring New Zealand into line with recognised international standards, while some others represent fine-tuning in the light of experience. There is also a proposal to add a new part to the Reserve Bank Act to clarify and make explicit the Bank's oversight interest and responsibility in the payment system in New Zealand. This function has previously been conducted informally and the proposed new part is little more than a codification of the Bank's current role. Consultation on these changes should be finalised shortly and final recommendations will be made to the Government.

3 Structural developments

We comment now on some structural developments in the financial system. Last year we remarked on the expansion of electronic banking. This trend has continued. For example, all major banks are now offering online banking facilities. A recently published survey by KPMG[1] shows that the number of Internet banking customers increased rapidly during 2000 from 112,890 at 31 March 2000 to 345,130 at 31 December 2000. While the number of users continues to grow, globally there seems to be a recognition in the industry that the Internet will not, at least in the immediate future, replace the branch network and telephone channels for the delivery of banking services. While the number of bank branches has continued to decline, the pace of decline has slowed considerably compared with closures during the previous five years. Figure 1 shows the number of bank branches and the growth of automatic teller machines during the period from 1996 to 2000.

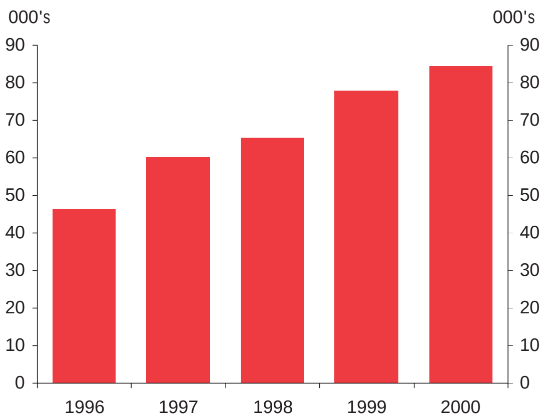
New Zealanders continue to be enthusiastic users of debit cards. Convenience and the fee structure that banks have put in place for electronic payments seem to be contributing to this growth. The convenience is evidenced by the growth in the number of Automatic Teller Machines and particularly in the number of electronic funds transfer at point of sale (EFTPOS) terminals in recent years. Figure 2 shows the growth in EFTPOS terminals over a four year period. These increased from 46,360 in 1996 to 84,351 at the end of 2000. On a per capita basis, the availability of terminals in New Zealand appears to be as widespread as in any developed banking systems overseas.

Figure 1
Number of automatic teller machines and branches



Source: New Zealand Bankers' Association

Figure 2
Number of EFTPOS terminals



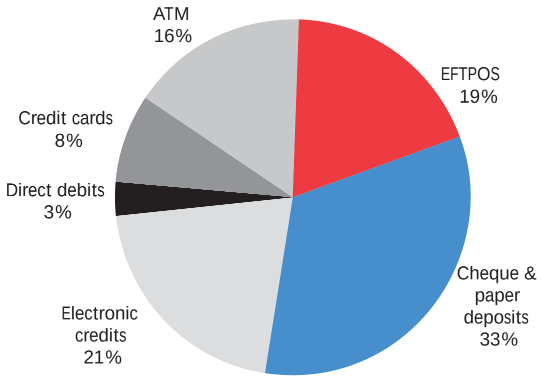
Source: New Zealand Bankers' Association

More evidence of the shift to electronic payments is provided in figure 3, which compares the number of non-cash payment transactions in 1996 and 2000. Cheque use as a percentage of total transactions continued to decline, although the total number of cheque transactions increased very slightly during the year. Figure 3 shows that cheque transactions accounted for 18 per cent of the volume of payments made in the year 2000, whereas EFTPOS transactions made up 32 per cent of the total. This is almost the reverse of the situation four years ago when cheques represented 33 per cent of the volume of payment transactions and EFTPOS transactions made up only 19 per cent. Credit card transactions also increased significantly during the year, with their use being boosted by the loyalty programs that have been put in place.

The number of registered banks stood at 18 as at 31 December 2000, an increase of one over the previous year, but this number has since declined to 17. A list of the registered banks as at 31 December 2000 is set out in appendix 1. The new entrant was Commonwealth Bank of

[1] KPMG, Financial Institutions Performance Survey 2001, April 2001.

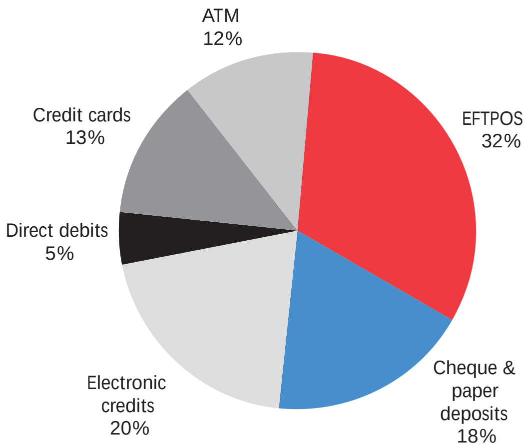
Figure 3: Payment methods (1996)



Total number of transactions in 1996 was 1,070 million

Source: New Zealand Bankers' Association

Payment methods (2000)



Total number of transactions in 2000 was 1,515 million.

Source: New Zealand Bankers' Association

Australia, which was registered as an overseas incorporated bank in June 2000. During the year, Commonwealth Bank of Australia also increased its shareholding in ASB Bank Limited, a New Zealand incorporated registered bank, to 100 per cent by purchasing the 25 per cent shareholding that was held by ASB Bank Community Trust. In March 2001, BNP Paribas SA, (formerly Banque Nationale de Paris SA), which had been an overseas incorporated bank since March 1997, relinquished its bank registration as part of a rationalisation of the bank's operations worldwide.

4 Financial performance of banks in New Zealand

The commentary in this section is based on data for the year to December 2000, compiled from registered bank disclosure statements. The data disclosed in the four quarterly disclosure statements for each bank over the calendar year have been aggregated where appropriate. Where there is more than one registered bank in a corporate group, totals have been adjusted to avoid double counting. Figures for BNP Paribas SA have been included, as the bank's registration was not relinquished until March of this year.

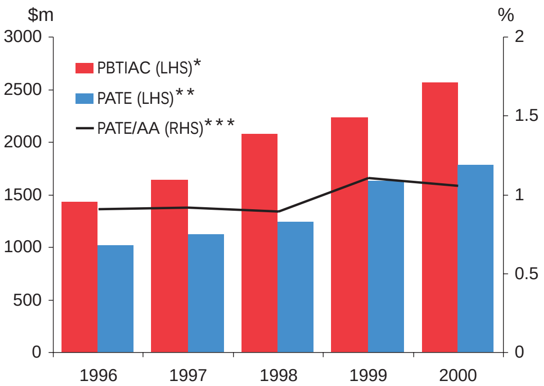
The results for the year 2000 show a banking sector that remains healthy, with many of the characteristics and trends we noted last year continuing. These included an increase in profitability, growth in lending, containment of costs and a further tightening of interest margins. The banking sector remains highly competitive.

Profitability

Profits after tax and extraordinary items for the sector increased by 9 per cent for the year ended December 2000. This was down on the 32 per cent increase for 1999, but last year's increase was boosted by the dual effect of two extraordinary items – a $107 million gain in 1999 on the sale of Bankers Trust funds management business and a lower 1998 figure as a result of a $120 million restructuring charge recorded by one bank. As shown in figure 4, net profit after tax as a proportion of average total assets (the rate of return on assets) was 1.05 per cent, the second year in a row that it was above the frequently quoted benchmark of 1 per cent for international banks. Net profit after tax and extraordinary items as a proportion of average shareholders' funds (the rate of return on equity) for New Zealand incorporated banks was 23.98 per cent, up from 22.47 per cent in 1999.

The growth in banks' profit was the result of increases in both interest and non-interest income (refer to table 1 and figure 5). Net interest income, the largest component of banks' income, increased by 7 per cent during the period, compared with a 3.5 per cent increase in 1999. The increase was attributable to the growth in interest earning assets, which increased by just over 13 per cent for the second year in a row. The increase in net interest income occurred despite another drop in interest margins, a trend in recent years both

Figure 4
Profitability

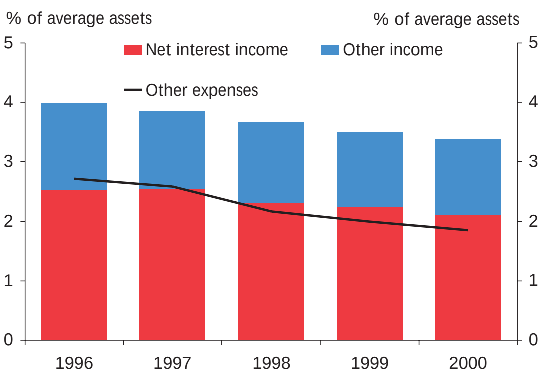


* Profit before tax and impaired asset charge

** Profit after tax and extraordinary items

*** Profit after tax as a percentage of average assets

Figure 5: Income and expenses as a percentage of total assets



in New Zealand and globally. The interest rate margin for the sector declined to 2.29 per cent in 2000, down 13.5 basis points from 1999.

Non-interest income, which is made up of items such as trading income, fees and commissions, grew by a strong 15 per cent during the year. In contrast, the growth rate for the previous year was less than 1 per cent. However, as a proportion of assets non-interest income has remained unchanged. We have noted in past articles the trend, both internationally and in New Zealand, for banks to seek to diversify their revenue from other sources.

Ongoing containment of costs also contributed to the rise in profitability. Operating costs increased in dollar terms but continued to decline as a percentage of total assets. They have now fallen to 1.84 per cent from 1.99 per cent last year as banks continue to achieve cost efficiencies in an increasingly competitive market, as shown in figure 5. Another measure of cost containment is operating costs to total income. That ratio has also been tracking downward in recent years and was 54.8 per cent for 2000, with six banks having ratios below 47 per cent. In 1999 the average ratio for banks was 56.9 per cent, and as recently as 1997 the figure was above 65 per cent. The ratio has been dropping steadily in recent years as banks have controlled costs and achieved efficiencies by consolidating their branch networks, centralising and outsourcing services, and encouraging customers to use lower cost channels. In future, it may be difficult to sustain the improvements seen in recent years, as the major efficiencies available now seem to have been realised.

Assets and liabilities

At the end of December 2000 banks held assets to the value of $180 billion, which was up a strong 14 per cent on a year ago. Figure 6 provides a graphical representation of the growth in bank assets and their composition based on the data in table 2. As can be seen, growth occurred in all areas. Residential mortgage growth slowed to 7 per cent for the

Table 1: Aggregate income statement
Year to December

$ million	1996	1997	1998	1999	2000
Net interest income	2,827	3,095	3,193	3,307	3,527
plus Other income	1,638	1,705	1,862	1,865	2,140
less Operating expenses	3,038	3,158	2,982	2,944	3,106
Underlying profit	1,427	1,642	2,073	2,228	2,561
less Impaired asset costs	-42	88	201	144	127
less Tax and other items	453	430	637	451	658
Net Profit	1,016	1,124	1,235	1,633	1,776

Table 2
Composition of assets
As at 31 December

$ billion	1996	1997	1998	1999	2000
Investments	21.5	19.2	24.3	28.2	37.1
Mortgages	45.7	50.6	54.5	61.0	64.3
Other lending	43.9	48.3	52.5	60.3	66.3
Other assets	7.5	12.1	10.3	9.0	12.4
Total assets	118.6	130.2	141.6	158.5	180.1

Figure 6
Composition of assets

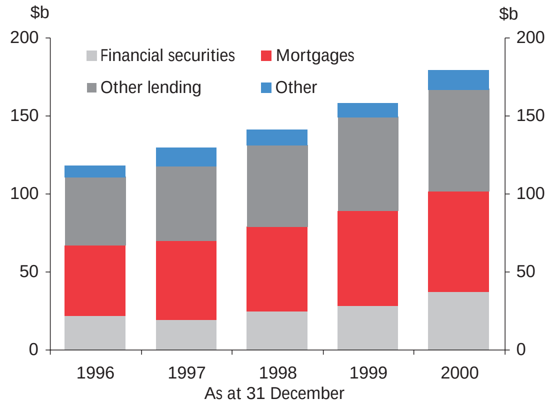
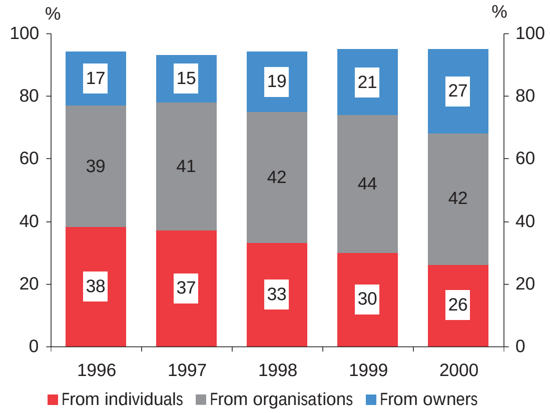


Figure 7
Composition of funding



Note: Information for this graph has been extracted from half-year or end-of-year General Disclosure Statement. Therefore the data is either from 30 September or 31 December.

year compared with an increase of 10 per cent last year, with mortgages representing 49 per cent of total lending, down slightly from 50 per cent last year. Other lending increased by 10 per cent, compared with an increase of 14 per cent for 1999, and is now the dominant system asset at $66 billion. Financial securities, a more volatile asset, stood at $37 billion in December 2000, an increase of 31 per cent over the 1999 figure.

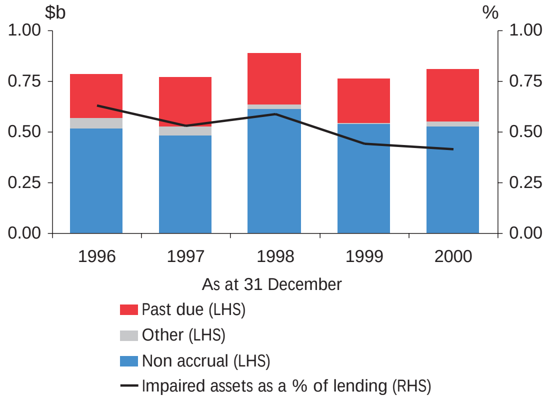
Figure 7 shows the sources of bank funding (ie the liability side of the balance sheet). The funding structure of the various banks is not uniform and varies depending on the markets in which the banks are active. Bearing in mind this qualification, for the banking industry as a whole the proportion of funding from individuals has continued to decline over recent years, in part as competition by the non-bank sector for household savings has increased. While funding from other financial institutions (ie wholesale funding) remains the dominant source of funds, bank owners have been contributing an increasing share of total funding. The proportion of funding from outside New Zealand has also been increasing steadily in recent years.

Asset quality

Although there was some degree of pessimism among both consumers and businesses during 2000, significant parts of the New Zealand economy were operating at close to capacity and the economy grew moderately. Exports grew steadily as world demand raised the prices of most of the commodities that New Zealand exports. Towards the end of the year, there was a slowdown in the world economy as the United States economy slowed, as did the economies of Australia and some countries in Asia. Against this background, asset quality across the banking system remained strong during 2000. While there was a slight deterioration in impaired asset and past due asset levels, this came off a very low base and was not widespread.

Total impaired assets at the end of December 2000 stood at $548 million, up from $541 million in 1999. However, impaired assets as a proportion of total lending has been tracking downward in recent years (except for 1998), and

Figure 8
Asset quality

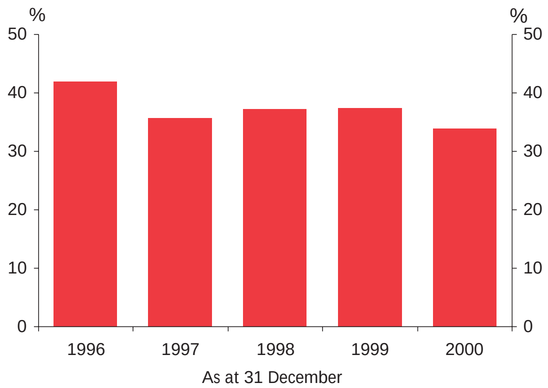


continued to do so again in 2000 (refer to figure 8). Impaired assets as a percentage of total lending fell to 0.42 per cent at the end of December 2000, from 0.44 per cent a year earlier. This compares very favourably both internationally and historically, possibly suggesting that further improvement may be difficult to achieve.

Past due assets (loans that have been in arrears for 90 days or more but where the bank does not expect to make a loss) increased by $36 million during the year to $259 million. This represents an annual rate of increase of 16 per cent, compared with a decrease of 13 per cent in the previous year.

Total provisioning for bad and doubtful debts increased by $11 million. Total provisions as a percentage of lending have decreased slightly from 0.57 per cent in 1999 to 0.54 per cent in 2000. Specific provisions as a percentage of impaired assets also declined slightly during the year from 37 per cent

Figure 9
Specific provisions as a percentage of impaired assets

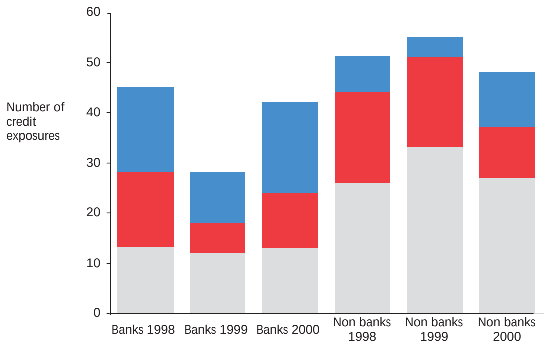


to 34 per cent (refer figure 9). All of this suggests that banks do not currently see the slight deterioration in impaired and past due assets as being the beginning of a significant worsening in asset quality.

Large exposures

Banks are required to report large exposures to individual counterparties that exceed 10 per cent of the bank's equity. The number of exposures to bank and non-bank counterparties are reported separately. Because branch banks have few exposures in New Zealand which exceed 10 per cent of the bank's global equity, the measure is more relevant for New Zealand incorporated banks. Exposures to other banks are typically short-term, while exposures to non-bank counterparties are generally longer term in nature.

Figure 10
Number of large exposures to bank and non-bank counterparties



	Banks 1998	Banks 1999	Banks 2000	Non banks 1998	Non banks 1999	Non banks 2000
>40% of equity	17	10	18	7	4	11
20-40%	15	6	11	18	18	10
10-20%	13	12	13	26	33	27

As at 31 December.

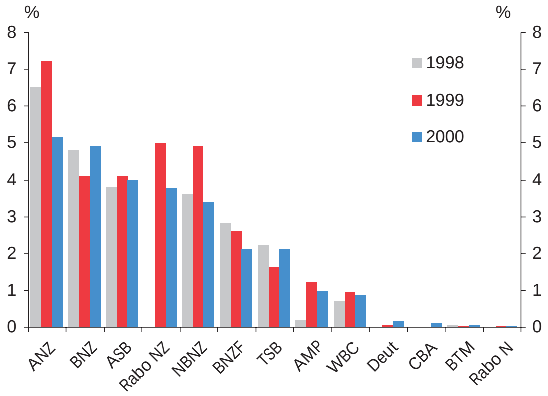
Figure 10 indicates the trends in large exposures at year end from 1998 to 2000. Last year we explained that the marked reduction in large exposures to banks at the end of 1999 primarily reflected changes to the institutional composition of New Zealand's banking sector, notably the purchase and amalgamation of Bankers Trust New Zealand Limited's business into a branch operation. As explained above, branches seldom have exposures that exceed the 10 per cent reporting requirements. At year end 2000, exposures to banks have increased in aggregate since the end of 1999 in all ranges. Exposures to non-banks have decreased in the 10 to 20 per cent and the 20 to 40 per cent of equity ranges but increased in the above 40 per cent of equity range.

Aggregate bank equity has also increased in recent years. The increasing equity base may accommodate some increase in counterparty credit limits in dollar terms without adding to credit concentration.

Market risk

Market risk disclosure gives an indication of a bank's vulnerability to the change in the value of its 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, by component, as an amount and as a percentage of equity.

Figure 11
Peak interest rate risk as a percentage of equity



Note: See appendix 1 for full bank names

The largest component of reported market risk tends to be interest rate risk. Figure 11 shows details of peak interest rate risk for 1998, 1999 and 2000 for individual banks. As the graph shows, interest rate risk levels are small in terms of equity at risk for all banks, with no bank having a material risk position for the three years shown.

Operational risk

Operational risk has become more of a focus for banks in recent years and generated considerable attention with the century date change. The banking industry successfully carried out a program of systems testing and contingency planning to ensure that systems would be able to cope with the date change.

The Basel Committee on Banking Supervision is proposing in its new capital framework that an explicit capital charge be made for operational risk. They see this as being a major source of risk in banking and expect, on average, 20 per cent of a bank's minimum capital requirement to cover this form of risk. There is no universally agreed definition of what operational risk is, but the Committee has defined it as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events".[2] Examples of operational risk caused by people are unauthorised trading, fraud, employee errors and dependence on key individuals. Operational risk caused by technology includes programming errors, computer viruses and security breaches. The risk can be a legal one, for example where a contract cannot be enforced, or a business interruption risk due to the failure of a key service provider, or flood, fire or earthquake.

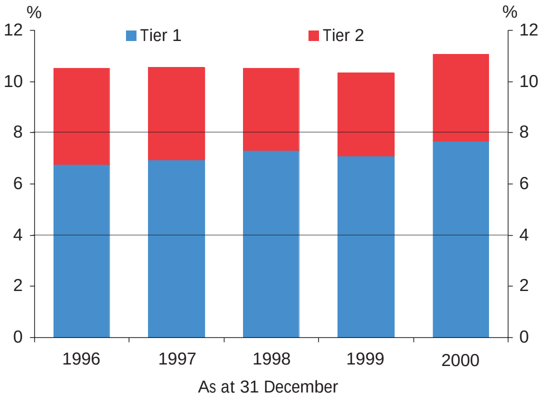
Operational risk management in banks involves management oversight, measurement and monitoring of risk, and the use of risk mitigation techniques. Internal audit and risk assessment units assist bank management in monitoring and managing the various types of risk. In recent years, the century date change and the Auckland power crisis were events where the banks' operational risk systems were put to the test and were found to cope well.

Capital adequacy and credit ratings

Registered banks that are incorporated in New Zealand must maintain a tier one capital ratio of 4 per cent of risk-weighted exposures and an overall 8 per cent total capital ratio, measured using the standard Basel capital methodology. Overseas incorporated banks that operate as branches are not required to observe a capital requirement in New Zealand as they are subject to capital ratio requirements on their global operations in the country of incorporation. New Zealand incorporated banks remain comfortably above the minimum levels, as do the parent banks of overseas incorporated banks with operations in New Zealand.

[2] Basel Committee on Banking Supervision, Bank for International Settlements, *Consultative Document, Operational Risk, Supporting Document to the New Basel Capital Accord*, January 2001.

Figure 12
Capital adequacy

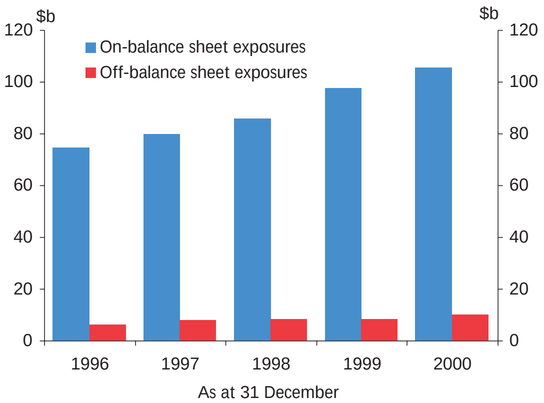


As shown in figure 12 the aggregate total capital ratio of New Zealand incorporated banks increased to 11.05 per cent as at the end of December 2000, from 10.32 per cent a year earlier. Over the same period, aggregate tier one capital increased by 15 per cent compared with a 5 per cent increase in 1999, with higher retained profits in the capital measure being the main source of the increase.

Figure 13 shows the risk-weighted exposures for all registered banks. These increased by 9 per cent during the year 2000. Risk-weighted on-balance sheet exposures increased by 8 per cent during the year. Off-balance sheet exposures grew by 23 per cent, but represent only 9 per cent of total risk-weighted exposures.

Another indicator of the financial strength of banks is the credit ratings that are provided by credit rating agencies. The credit ratings for New Zealand registered banks that have a rating portray not only a banking system that is financially sound but also a system whose soundness is improving. The ratings of two banks were upgraded during the year and no banks were downgraded. As at 31 December 2000, 10 banks had a rating of AA- or above, whereas a year earlier only eight were in that group. A double A rating is the second highest in the rating scale and means that rating agencies judge these banks to have very strong capacity to pay interest and to repay principal in a timely manner.

Figure 13
Risk-weighted exposures



4 Conclusion

The New Zealand banking system performed well during the past year. A profitability performance which achieved international benchmarks came from a combination of system asset growth, cost containment, and a rise in non-interest income. Interest margins continue to be squeezed in what is a highly competitive market. While there was a small rise in asset impairment, asset quality remained in very good shape. Measures of financial strength show a banking system that is well capitalised and highly rated by credit rating agencies. Developments overall seem to be well aligned with the Bank's goal of promoting a financial system which is both sound and efficient.

Appendix 1

Registered banks as at 31 December 2000

New Zealand incorporated banks

Registered bank	*Owner*	*Abbreviation*
ANZ Banking Group (New Zealand) Limited	Australia and New Zealand Banking Group Limited	ANZ
ASB Bank Limited	Commonwealth Bank of Australia	ASB
Bank of New Zealand	National Australia Bank Limited	BNZ
BNZ Finance Limited	National Australia Bank Limited	BNZF
The National Bank of New Zealand Limited	Lloyds TSB Group plc	NBNZ
Rabobank New Zealand Limited	Rabobank Nederland	Rabo NZ
TSB Bank Limited	TSB Community Trust	TSB

Overseas incorporated banks

Registered bank	*Abbreviation*
ABN AMRO Bank N.V.	ABN AMRO
AMP Bank Limited	AMP
Bank of Tokyo-Mitsubishi (Australia) Limited	BTM
BNP Paribas SA	BNP
Citibank N.A.	CITI
Commonwealth Bank of Australia	CBA
Deutsche Bank A.G.	DEUT
Hong Kong and Shanghai Banking Corporation	HKSB
Kookmin Bank	KMIN
Rabobank Nederland	RABO
Westpac Banking Corporation	WBC