Developments in the New Zealand banking industry during 2003

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This article reviews developments in the New Zealand banking industry over the year ended 31 December 2003. It describes structural changes in the industry, comments on current issues in the area of banking supervision in New Zealand, and examines trends in payment methods and distribution channels. The article analyses banking system data from 2003, looking at aggregate financial position, financial performance and risk indicators. The data indicate that the banking system continues to display considerable stability, with good profitability and asset quality. Some comments on developments in the non-bank financial sector and the Australian banking sector are also included. Concluding remarks are made about areas of potential vulnerability for the New Zealand banking system.

This is the final article on the state of the banking system to appear in the *Bulletin* for the foreseeable future. Commencing later this year, the Reserve Bank plans to publish a regular report, probably six monthly, on the New Zealand financial system. That publication will include analysis of the state of the banking system and related issues. The *Bulletin* will continue to include articles discussing specific policy developments in the financial system.

1 Introduction

This article is a continuation of the annual series of articles that review developments in the New Zealand banking industry. The article begins by describing changes in the structure of the industry during 2003 and then comments on other current issues that are relevant to banking supervision in New Zealand. In 2003, this included amendments to the Reserve Bank of New Zealand Act 1989 and a number of policy developments of a regulatory nature. Trends in payment distribution channels (eg bank branches, ATMs) and in payment systems (eg EFTPOS, cheques) are described, drawing on data provided by the New Zealand Bankers' Association. The article also analyses aggregate data for the New Zealand banking system for 2003, drawn from the quarterly disclosure statements that all registered banks are required to publish. It looks at trends in aggregate financial position and performance and risk indicators in respect of registered banks in New Zealand.

2 Structural issues in the banking sector

As at the time this article was prepared, there were 18 registered banks in New Zealand. The number of banks increased by one in 2003 with the registration of St George Bank New Zealand Limited. During March 2004 there occurred the simultaneous voluntary de-registration of the New Zealand branch of Bank of Tokyo-Mitsubishi (Australia) Limited (an Australian subsidiary of Bank of Tokyo-Mitsubishi) and the registration of Bank of Tokyo-Mitsubishi, which now operates directly as a branch in New Zealand. A list of registered banks as at the time of publication of this article is shown in the Appendix.

A significant change to the structure of the banking industry during 2003 was the acquisition by ANZ Banking Group (New Zealand) Limited of The National Bank of New Zealand Limited on 1 December 2003. Both banks have, to date, continued to be separately registered as banks in New Zealand (although National Bank has given notice that it wishes to be removed from the register of banks on 26 June 2004). This acquisition created the largest banking group in New Zealand, which as at 31 December 2003 held 34 per cent of the total assets of the New Zealand banking system. The next largest bank was Westpac with 20 per cent of total system assets. Bank of New Zealand had 18 per cent of system assets and CBA banking group had 15 per cent.

Another effect of the merger was to increase the concentration of Australian ownership of the banks operating in the New Zealand banking system. As at 31

December 2003, Australian owned banks held 87 per cent of total banking system assets.

The merger required the approval of both the Commerce Commission (which considered market dominance issues) and the Reserve Bank (which considered financial stability issues). The Commerce Commission gave an unconditional consent to the merger. The Reserve Bank consented to the merger subject to a number of conditions. These conditions required National Bank to remain a separate entity, with no significant changes occurring to its structure or operations until further consents were given by the Reserve Bank.

The purpose of imposing these conditions was to ensure that there was no movement to Australia of any functionality of National Bank unless specifically approved by the Reserve Bank. These conditions ensured that a plan for the ultimate location of the systems, back-up arrangements and management of the ANZ/NBNZ group in New Zealand would need to be submitted to, and approved by, the Reserve Bank before changes could be made. Issues related to the giving of these further consents are currently being worked through, with National Bank remaining a separate entity at the time of writing.

3 Amendments to the Reserve Bank of New Zealand Act

The Reserve Bank of New Zealand Amendment Act 2003, enacted in August 2003, made a number of changes to the provisions of the Reserve Bank of New Zealand Act 1989 that related to bank registration and supervision. Changes were also made to other provisions in the Act. The changes were described in an earlier *Bulletin* article (March 2004, vol. 67 no. 1). The main changes to banking registration and supervision were as follows:

- The matters that the Reserve Bank must take into account when considering an application for bank registration were expanded to include the suitability of proposed appointees for the positions of the directors and senior managers of the applicant, risk management systems and policies of the applicant, and outsourcing arrangements proposed by the applicant.
- The Amendment Act introduced a requirement that any person or entity wanting to obtain an ownership or controlling interest in a registered bank of 10 per cent or more must first obtain the consent of the Reserve Bank.
- The scope of disclosure statements was extended so that disclosures about registered banks' subsidiaries and subsidiaries of holding companies may be required .
- Disclosure statements of an overseas incorporated bank operating in New Zealand as a branch must now be signed by the New Zealand chief executive, as well as the directors of the overseas bank board.
- Home country banking supervisors may now, with Reserve Bank approval, conduct on-site examinations that include examinations of individual customer files of New Zealand branches or subsidiaries of banks that they are responsible for supervising.
- The Reserve Bank's powers to obtain information from registered banks have been strengthened. The Reserve Bank can require registered banks to provide reports on any issues that impact on the operations of banks.
- Some streamlining of the statutory management process was also included in the Amendment Act. This included more flexibility in the appointment and termination of statutory managers. Amendments were also included to make it easier and faster for the Reserve Bank to take investigative steps or direct banks' actions in times of financial stress.

4 Current supervisory issues

The last year or so has been a busy one for the Bank in the development of banking supervision policy. This section briefly highlights the main policy initiatives undertaken in 2003 and currently underway.

The Australian and New Zealand banking markets are highly integrated and interdependent. A working group of the Australian Treasury and New Zealand Treasury, Reserve Bank of New Zealand, Reserve Bank of Australia and the Australian Prudential Regulation Authority, has been formed to develop policy options for closer integration of trans-

Tasman banking regulation. Officials are due to jointly report to their respective Ministers by 30 June 2004.

The trans-Tasman working group is assessing the possible options for more closely integrating the banking regulatory frameworks of the two countries. In assessing the options, a number of considerations need to be borne in mind so that any closer integration of regulatory frameworks meets the needs of both countries. One of these considerations is the need to ensure that any agreed trans-Tasman regulatory framework enables the authorities to respond quickly and effectively to a financial crisis in either country. It would also need to make allowance for the possibility that an economic or financial shock might affect one country more than the other. In such a case, the regulatory framework needs to facilitate quick and effective responses that minimise the impact on the country's financial system.

There is also a need to ensure that any agreed trans-Tasman regulatory arrangements are consistent with maintaining sound and efficient financial systems in both countries, taking into account the particular circumstances of each country. The Reserve Bank is working with the New Zealand Treasury and Australian officials to these ends, and will report to the New Zealand Minister of Finance and the Australian Treasurer.

Regulatory capital continues to be on the Reserve Bank's agenda for further consideration, pending the finalisation of the Basel Committee's revisions to its Capital Accord "Basel II". The Reserve Bank will consider the merits of alternative approaches to implementing changes to the Capital Accord, taking into account trans-Tasman integration of banking regulation, among other factors. The Reserve Bank's preference at this stage is to require banks to calculate their capital on the basis of the Basel II standardised model, rather than allowing banks to use their own credit risk/capital allocation models (which would require approval by the supervisory authority). The bank disclosure framework will also be reviewed in light of the disclosure element of Basel II.

Separate from the Basel II capital changes, the Reserve Bank will also be considering possible changes to the level of capital ratio for banks in New Zealand. Since the introduction of minimum capital requirements under the Basel capital framework in the late 1980s, the Reserve Bank has applied the international standard minimum capital ratio of 8 per cent (with at least 4 per cent being in the form of tier one capital and the balance being allowed as tier two capital). Consideration will be given to the possible costs and benefits of increasing the minimum capital requirement to a higher level, to further bolster the strength of banks' balance sheets and the financial system as a whole. Consideration will also be given to the allowable mix of capital instruments banks are permitted to include in their qualifying capital, with a view to ensuring that the capital instruments are of high quality and provide a genuine loss absorption buffer for a bank. In addition, the Reserve Bank intends to require banks to maintain the same minimum capital adequacy levels on a solo basis as they do on a banking group basis.

Another issue under consideration is the treatment of outsourcing of functionality by banks – the provision of IT systems and other bank functionality by an entity other than the bank in New Zealand – especially where the outsource provider is the parent bank. Outsourcing has the potential to compromise the ability of the board and management of a bank in New Zealand to manage its core business, when the supplier of the outsourced functionality is unable to provide the required services. Although outsourcing is now a common arrangement in many companies (including banks) around the world, the issue of particular concern to the Reserve Bank is where the outsource provider is a related party of a bank in New Zealand, such as a parent bank. In such a case, outsourcing arrangements might not be on arms' length terms or subject to robust documentation. Under such outsourcing arrangements there may also be less consideration given to the nature of contingency arrangements should the related party, such as a parent bank, fail or become dysfunctional. In these circumstances, there is a serious risk that a bank in New Zealand could be rendered dysfunctional in the event that the parent bank or other related party provider of functionality fails, leaving the bank in New Zealand unable to meet its obligations to creditors or conduct normal banking business. This has the potential to cause severe disruption to the New Zealand financial system.

In view of these concerns, the Reserve Bank's position is that a bank's board, or a statutory manager acting in place of the board, needs to have unambiguous legal authority and practical ability to control the core functionality of the bank on a stand-alone basis. The Reserve Bank is currently developing the details of a policy on outsourcing that will meet this objective.

Another aspect of the banking supervision arrangements currently under review is the Reserve Bank's policies with respect to the corporate governance arrangements for banks. Corporate governance in banks is an important element in the promotion of sound risk management practices; strong risk management systems are unlikely to exist where corporate governance is weak. This is a core element in the Reserve Bank's "self discipline" pillar in the banking supervision framework.

As part of the preparation for the Financial Sector Assessment Programme (FSAP) assessment of the New Zealand financial system last year, the Reserve Bank undertook a survey of directors and auditors to gain a better understanding of corporate governance processes that are currently used in banks. The results of these surveys are being incorporated into a review by the Reserve Bank of bank corporate governance arrangements. The review takes into account international and national developments in corporate governance, with a particular focus on the role of directors and related issues. A discussion paper will be released for consultation with the banking industry later this year and may include some proposals for further strengthening corporate governance arrangements in banks.

Another aspect of the bank corporate governance policy theme is the process for ensuring that bank directors and senior managers have the qualifications and experience to discharge their responsibilities. Although the principal responsibility for ensuring that directors and managers do have suitable skills and experience, and are of appropriate character, lies with the bank boards and shareholders, the Reserve Bank, as supervisory authority, has responsibility to consider the suitability for their positions as directors and senior managers of banks. The Reserve Bank has developed new policy on this which it will implement soon.

The Reserve Bank continues to work on various aspects of managing bank distress and failure events. This is a core function of any supervisory authority and central bank. Although bank distress or failure events are expected to be rare, there is nonetheless a need to ensure the financial authorities have the capacity to respond quickly and effectively to any crisis situation, so as to minimise impact on the financial system. In this context, the Reserve Bank is advancing a number of projects to further strengthen its capacity to manage financial crises.

These projects include:

- Developing a capacity to manage a large bank failure by using depositors' and creditors' funds to absorb estimated losses and provide the basis for a recapitalisation of the bank, in a situation where the bank's shareholders' funds and other capital have been extinguished by losses. A prototype of this model being assessed in cooperation with one of the large banks to evaluate its feasibility and cost.
- Developing other options for dealing with bank failure events, including:
  - possible use of loss-sharing arrangements, where the government and a failed bank's depositors and other creditors jointly absorb a bank's losses and facilitate its recapitalisation;
  - the possibility of some form of banking industry support for a bank in distress;
  - the possible use of "good bank"/"bad bank" restructuring of a failed bank (ie: transferring the non-performing loans of a failed bank into a separate entity and recapitalising the bank); and
  - various structures to wind down a bank without causing significant disruption to the financial system.
- Further developing the Reserve Bank's capacity to provide emergency liquidity support to the financial system or to a particular bank.
- Further enhancing the Reserve Bank's operational capacity to respond effectively to a range of financial

crisis situations, including through the use of occasional crisis simulation training exercises.

A further important element in failure management is to ensure that the operation of payment systems is not compromised in the event of a bank failure. The adoption some years ago of real time gross settlement for large-value payment systems and the implementation of legislation to facilitate robust netting of payment obligations have gone a long way towards making the New Zealand payment system robust in the face of a bank failure. One remaining area requiring attention is to ensure that the main retail payment systems do not cease operating if there is a bank failure. Good progress is being made in this area in association with the New Zealand Bankers' Association, with a view to implementing robust failure-to-settle arrangements for retail payment systems in the near future.

Another policy area currently under review within the Reserve Bank is in relation to the use of the Reserve Bank's powers under section 95 of the Act to require a bank to undergo an independent review of its risk management systems and other controls or systems. The Reserve Bank is planning to make regular use of its powers to require a bank to supply it with a report prepared by a person approved by, and in accordance with terms of reference set by, the Reserve Bank. The use of independent reviews of banks' systems and controls will provide the Reserve Bank with a greater capacity to evaluate the adequacy of banks' risk management and governance arrangements, and will be a valuable tool to further encourage the maintenance of sound risk management practices in the banking system.

5 Australian banking sector

As noted earlier in this article, some 87 per cent of the assets of the New Zealand banking sector are held by Australian-owned banks. Thus, the strength of the Australian banking sector is of direct relevance to the New Zealand banking sector. Accordingly, the Reserve Bank monitors the Australian banking system and especially the parent banks of the banks operating in New Zealand. We also have close regard to analysis released by the Reserve Bank of Australia and others on the state of the Australian financial system, with a particular focus on those aspects with possible implications for the New Zealand financial system, such as channels of contagion via ownership linkages, connected exposures and linkages between New Zealand and Australian financial markets.

In its Financial Stability Review released in March 2004, the Reserve Bank of Australia (RBA) conducted a comprehensive analysis of the Australian financial system. Some of the key points in that report are summarised below:

- The RBA's overall assessment of the Australian financial system is that it is currently in a sound condition, with the banks being profitable, with low levels of impaired assets and with capital considerably in excess of the minimum regulatory requirements.
- The RBA notes that since the early 1990s there has been a significant shift in banks' assets away from business lending towards lending to households. More than a decade of continual economic growth has seen a striking increase in residential property prices and household debt. Household lending is generally seen as lower risk for financial intermediaries than lending to corporates. However, now that both residential property prices and household lending are high relative to historical benchmarks, the RBA's view is that the overall riskiness of the banks' mortgage lending portfolio is likely to have increased. The RBA states that these developments raise the possibility that future default rates may not be as benign as those in the past. However there are currently few signs that households are having difficulties meeting their financial obligations.
- In the opinion of the RBA it remains difficult to envisage circumstances in which developments in the housing market alone could cause major difficulties for the Australian financial system. There have been few instances in which adjustments by the household sector have been a major factor in shaping an economic downturn. It is usually adjustments by the corporate sector or financial institutions that are the source of difficulties.
- Overall, the RBA believes the Australian financial system is currently well placed to ride through economic

and financial shocks, with a relatively low risk of any significant damage to the financial system.

6 New Zealand payment system and credit distribution channels

The New Zealand payment system continued to perform efficiently over the year under review, with no significant interruptions to the payments processing or settlement functions occurring in any of the payment switches. The use of electronic payment instruments and remote access facilities continued to increase, while the paper-based payments instruments, such as cheques, continued to decline in use, albeit at a slower pace than in previous years.

These trends are discussed in this section of the article, drawing on data published by the New Zealand Bankers' Association.

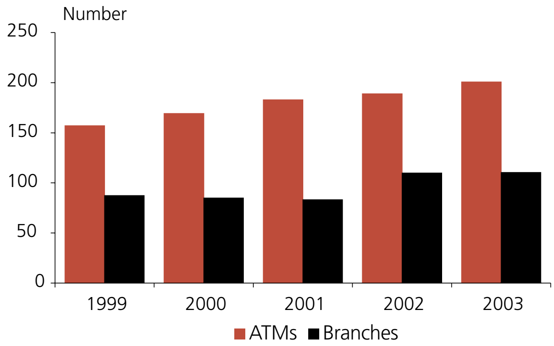
The number of ATMs has risen 28 per cent over the last five years, with more than 2000 ATMs now being in operation. The number of bank branches, which was static from 1999 to 2001, showed a significant rise in 2002, mainly due to the addition of branches of Kiwibank Limited, but remained largely unchanged in 2003. Figure 1 shows the number of ATMs and branches over the last five years.

The number of EFTPOS terminals has also been subject to a steady rise since 1999 (24 per cent over that period). This is shown in Figure 2.

The total number of banking transactions rose from 1,655 million in 2002 to 1,759 million in 2003, a rise of 6 per cent. The trends apparent for the last few years in payment system methods have continued in 2003. Table 1 shows the percentage of total transactions represented by each payment method since 1999.

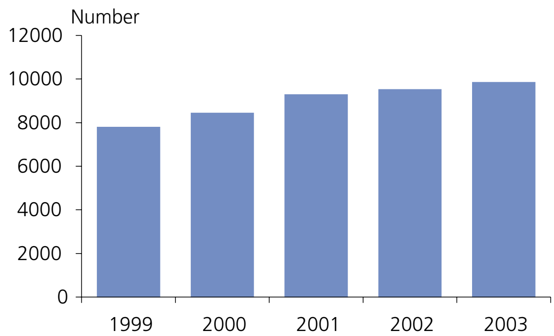
The most significant changes between 1999 and 2003 are a substantial reduction in cheque usage and an increase in credit card usage. In absolute terms the number of cheque transactions fell from 277 million to 206 million, and the number of credit card transactions rose from 144 million to 296 million over this period.

Figure 1
ATMs and bank branches



(Source: New Zealand Bankers' Association)

Figure 2
Number of EFTPOS terminals



(Source: New Zealand Bankers' Association)

Table 1
Payments methods (% of total transactions)

	1999	2000	2001	2002	2003
Cheques	20	17	14	13	12
Electronic credits	20	20	19	18	17
Direct debits	4	5	5	5	5
Credit cards	10	13	16	17	17
ATM	13	12	12	12	11
EFTPOS	33	33	34	35	38
Total	100	100	100	100	100

Table 2

Computer banking (millions of transactions)

Year	Transactions
1999	80
2000	93
2001	104
2002	116
2003	159

(Source: New Zealand Bankers' Association)

The number of transactions undertaken by either personal computer banking or internet banking continues to rise rapidly – a 99 per cent increase over the last five years. This is shown in Table 2.

Electronic transactions have dominated payment methods for some years now. While there is some evidence that a steady-state situation between electronic and non-electronic transactions may now be developing, the relative proportionate usage of the various types of electronic transactions is likely to change, reflecting the changing impact of cost and convenience.

7 State of the New Zealand banking system

The New Zealand banking system continues to display strength across all relevant indicators, with a high level of profitability (although down on earlier years), a very low level of impaired assets, capital at a level similar to that in other advanced economies, and exposure concentration levels that generally maintain a strong degree of diversification across most banks' asset portfolios. Although individual banks displayed different levels of financial performance, asset quality and capitalisation over the year, none of the banks breached prudential limits imposed by the Reserve Bank. All of the banks, and their parent banks where applicable, continued to show indicators of a sound financial condition.

The strength of the banking system reflects a combination of several factors. These include strong bank ownership, where the parent banks are currently in a sound financial condition and are mainly based in countries with robust banking systems, sound risk management practices and good quality management in the parent operations and New Zealand operations, and favourable economic conditions in New Zealand and in parent bank economies. Reflecting these factors, the credit ratings of banks in New Zealand have remained stable over the last year and are relatively high by international standards.

Table 3

Aggregate income statement for registered banks

$million	**1999**	**2000**	**2001**	**2002**	**2003**
Net interest income	3307	3527	3911	4699	5009
Less					
Impaired asset costs	144	127	191	196	553
Equals					
Net interest income after impaired asset costs	**3163**	**3400**	**3720**	**4503**	**4456**
Plus					
Other income	1865	2140	2264	2254	2390
Less					
Operating expenses	2944	3106	2987	3165	3418
Equals					
Profit before abnormals	**2084**	**2434**	**2997**	**3592**	**3428**
Plus/Less					
Abnormals	125	-7	-11	196	16
Equals					
Profit before tax	**2209**	**2427**	**2986**	**3788**	**3444**
Less					
Tax	566	606	799	991	1013
Equals					
Net profit after tax	**1643**	**1821**	**2187**	**2797**	**2431**

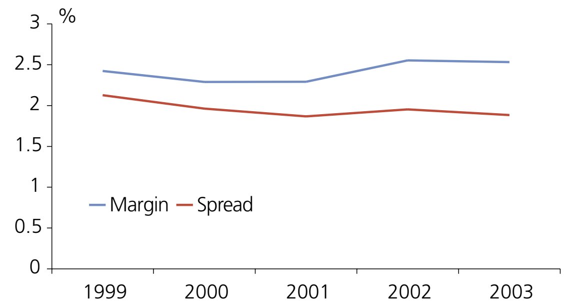
Although the analysis in this article is based on data for the year to December 2003, developments in the banking sector since then have not significantly changed the picture. Economic and financial conditions in New Zealand remain favourable for the banking system and there have been no material adverse developments affecting banks' earnings, asset quality or capital position in the last six months.

Financial performance

For the year ended 31 December 2003, aggregate profit after tax for registered banks was $2.4 billion, which was a 13 per cent decrease on the previous year. An aggregate income statement for registered banks over the last five years is shown in Table 3.

ABanks' income from net interest and other sources has continued to increase, rising about 6 per cent in 2003. The margin (defined as net interest income divided by average interest earning assets) and the spread (defined as gross interest income divided by average interest earning assets minus interest expense divided by average interest bearing liabilities) have remained similar to the previous year, as shown in Figure 3. This means that the increase in net interest income has come from an increase in the amount of lending.

Figure 3
Margins and spreads

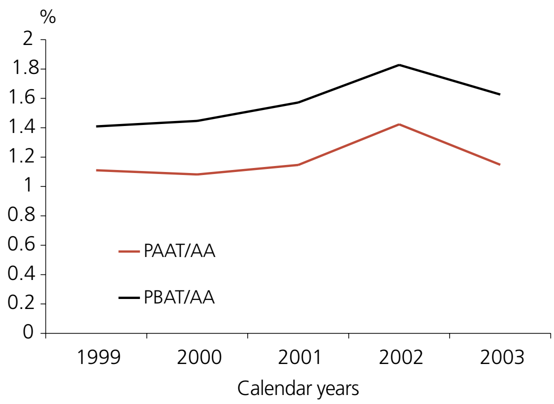


The reasons for the decline in net profit in 2003 are related to changes in expenses and abnormal items. Impaired asset costs rose significantly in 2003. This was principally due to increased provisioning by two banks. National Bank increased its provisioning after its acquisition by ANZ Bank, and Westpac moved its general provisioning for its New Zealand lending onto the New Zealand balance sheet. Neither of these changes represented an increase in impaired asset expectations, but simply reflected changes in provisioning policy. Operating expenses also increased during 2003, and this was mainly associated with changes to National Bank's recorded expenses related to its sale to ANZ Bank. A third factor reducing the net profit in 2003 compared to 2002 was that there was a significant level of abnormal income in 2002 from the sale of assets by some banks (which was not a strong feature in banks' financial statements during 2003).

Reflecting continued strong underlying profitability, the profit before tax after excluding impaired asset costs and abnormal items increased from $3,788 million in 2002 to $3,981 million in 2003, an increase of 5.1 per cent. This indicates a continuing strength in the underlying business of the banking sector after the deduction of factors unrelated to the underlying performance.

The 2003 net profit represented an after tax return on average assets of 1.1 per cent (1.4 per cent in 2002), compared to the benchmark level of 1 per cent which is generally accepted as a minimum satisfactory level of performance for banks by international standards. The trend in returns on assets is shown in Figure 4.

Figure 4
Profitability as a percentage of average total assets



Financial position

For the year ended 31 December 2003, aggregate total assets for registered banks was $221 billion, which was an 8 per cent increase on the previous year. A summary aggregate

Table 4
Aggregate balance sheet for registered banks

$billion	1999	2000	2001	2002	2003
Assets					
Financial investments	28.2	37.1	36.1	38.7	35.5
Mortgages	61.0	64.3	67.3	73.1	85.7
Other lending	60.3	66.3	75.7	81.5	83.3
Other assets	9.0	12.4	10.5	11.2	16.1
Total assets	158.5	180.1	189.6	204.5	220.6
Liabilities					
Equity	8.9	9.5	10.7	13.3	16.9
Related party exposures	26.0	35.4	33.0	30.0	30.1
Other borrowing	116.2	124.3	138.1	149.8	161.0
Other liabilities	7.4	10.9	7.8	11.4	12.6
Total liabilities	158.5	180.1	189.6	204.5	220.6

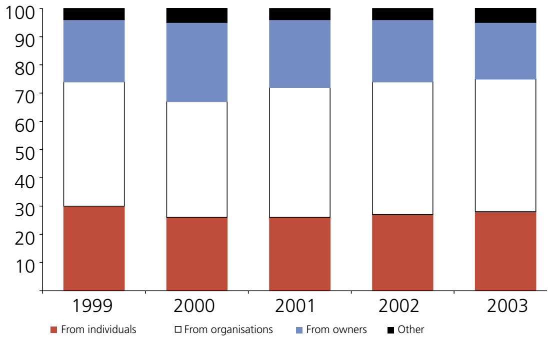
balance sheet for registered banks over the last five years is shown in Table 4.

The big change on the asset side of the balance sheet was the increase in lending on residential mortgages, which went up from $73.1 billion at the end of 2002 to $85.7 billion at the end of 2003, an increase over the year of 17 per cent. This increase was driven by the continued buoyancy of the housing market and reflects registered banks' continued dominance of residential mortgage lending - see comments below on the non-bank financial institution sector. The increase in 'other assets' was mainly due to an increase in intangible assets, being goodwill related to the acquisition of National Bank.

On the funding side of the balance sheet, equity increased principally because ANZ Bank in New Zealand received additional equity from its parent to fund the acquisition of National Bank. The big change on this side of the balance sheet was the increase in 'other borrowing' (retail deposits and wholesale market borrowing) from $149.8 billion at the end of 2002, to $161.0 billion at the end of 2003, an increase of 7.5 per cent. This funding largely financed the increase in mortgage lending. Related party funding (loans generally provided by parent banks) remained broadly stable over 2003, in contrast to quite rapid growth in related party funding in the late 1990s and in 2000.

Figure 5 shows the composition of funding in percentages. There was little change from 2002 to 2003, and even over the longer term funding sources have remained relatively stable.

Figure 5
Composition of funding



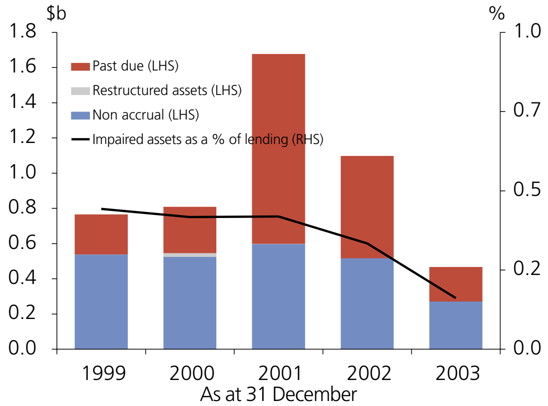
Risk indicators

Asset quality

Asset quality in the banking system is assessed by looking at both the level of impaired assets (assets on which a full recovery of principal and interest is in doubt) and past due assets (assets more than 90 days in arrears, but not considered impaired).

The quality of registered bank assets is very high by international standards and in historical terms. As at 31 December 2003, impaired assets were 0.16 per cent of total

Figure 6
Asset quality

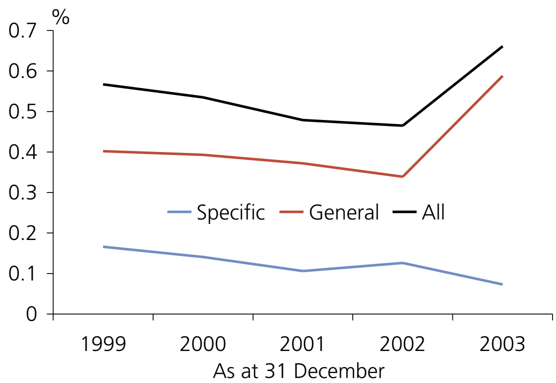


lending, which is extremely low by international standards. Figure 6 shows changes in asset quality over the last five years. The rise in past due assets during 2001 was attributable to exposures to the Central North Island Forestry Partnership. By the end of 2003, these exposures had been resolved and were no longer classified as past due or impaired.

Provisioning

Specific provisioning as at 31 December 2003 was 45 per cent of impaired assets, up from 37 per cent in 2002. Total provisioning as at 31 December 2003 was 0.66 per cent of total lending, compared to impaired assets of 0.16 per cent of total lending. Provisioning levels are shown in Figure 7.

Figure 7
Provisioning as a percentage of total gross loans



Large exposures

Registered banks are required to disclose quarterly the number of exposures to individual borrowers or groups of closely related borrowers that exceed 10 per cent of each bank's equity, distinguishing between exposures to banks and exposures to non-bank entities. This requirement impacts mainly on locally incorporated banks, as exposures in New Zealand rarely exceed 10 per cent of the equity of overseas incorporated banks operating in New Zealand as branches.

At the end of 2003, there were 41 such exposures to banks (45 in 2002) and 32 such exposures to non-banks (50 in 2002). The total number of large exposures has continued to fall over the last five years. Some banks reported exposures in excess of 30 per cent of equity, but these were generally either to banks or to highly rated non-bank corporates. Overall, banks' exposure concentration suggests that banks continued to maintain generally well diversified loan portfolios, with an appropriate spreading of risk. However, the Reserve Bank intends to keep the large exposure disclosure framework under review and to assess whether disclosure alone remains an appropriate mechanism to ensure that banks avoid excessive exposure concentration. In that context, the Reserve Bank will shortly be introducing a new disclosure requirement for banks, requiring them to disclose large exposures broken down into categories showing the credit rating of borrowers. This will further assist in the assessment of the potential vulnerability associated with exposure concentration.

Exposures to connected persons

The Reserve Bank imposes limits on the exposures of locally incorporated banks to connected persons (such as parent banks or other entities capable of controlling or significantly influencing the bank in New Zealand, and entities connected with such parties). The purpose of these restrictions is to prevent bank subsidiaries in New Zealand lending their capital back or otherwise acquiring credit exposures to their parents or other parts of the parent banking group, thereby effectively reducing the bank's level of capital in New Zealand. This is particularly important in times of crisis affecting a parent banking group, when capital requirements are designed to provide a loss absorption role to help a bank to maintain its operations, including where the parent bank gets into difficulties.

There was a change during 2003 to the manner in which these limits are set. The intention of these changes was to further limit the amounts that banks can lend to connected persons, and so increase their resilience to a crisis. Previously, all banks were subject to a limit on such exposures of 75 per cent of tier 1 capital (with a sub-limit applying at 15 per cent in the case of exposures to non-bank entities). The limits are now set by reference to the credit rating of a registered bank, with the limit being lower in the case of banks with lower credit ratings. For example, the limit for banks rated AA or above is 75 per cent, of their one capital reducing to 70 per cent for AA- rated banks, and so on down to 15 per cent for banks rated BBB- and below. The exposures as at 31 December 2003 for the major locally incorporated banks ranged from 33 per cent to 14 per cent, with all banks being well below their applicable limits.

Market risk

Market risk arises because changes in interest rates, exchange rates and equity prices impact on the value of banks' financial assets and liabilities. These changes can damage a bank's capital position if the bank has large open positions to exchange rates or interest rates, or large holdings of equities. Banks are required to disclose information on their exposure to this risk as a percentage of their capital. No limits are applied to banks' market risk positions.

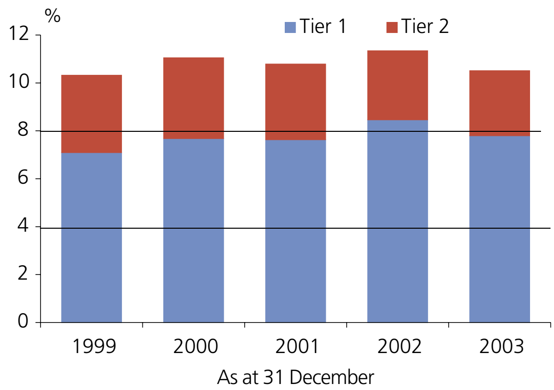
Banks in New Zealand have small, or in some cases nil, exposures to exchange rate risk (because of the use of currency hedging) and equity risks, but most carry some degree of interest rate risk, albeit generally quite low. The level of risk held by banks fluctuates over the course of a year, but in 2003 peak exposures to interest rate risk ranged up to 6.6 per cent of capital (2002 6.3 per cent), reflecting a high degree of interest rate risk management by banks in New Zealand.

Capital adequacy

The Reserve Bank imposes minimum capital adequacy ratios for all banks in incorporated in New Zealand, using the standard Basel capital framework, of 4 per cent tier one capital and 8 per cent total capital relative to risk-weighted credit exposures (on and off the consolidated bank balance sheet). Tier one capital essentially comprises issued share capital and audited retained earnings. Tier 2 capital comprises other forms of quasi-equity, such as subordinated debt. Total capital is essentially the sum of the two. Capital ratios are calculated by dividing capital by risk-weighted credit exposures.

There was a slight fall in the capital ratios of locally incorporated banks during 2003, in both aggregate tier 1 capital (from 8.5 per cent to 7.8 per cent) and total capital (from 11.3 per cent to 10.5 per cent). However, these levels are still well in excess of the minimum permissible levels for individual banks and are similar to capital ratios in many developed economies, including Australia. All banks maintained capital ratios in excess of the required minimum. The aggregate level of capital adequacy of locally incorporated banks over the last five years is shown in figure 8.

Figure 8
Capital adequacy



Credit ratings

All registered banks are required to have and disclose a credit rating from a rating agency acceptable to the Reserve Bank. Ratings as at the time of publication of this article are shown in the Appendix. All banks registered in New Zealand currently have an 'investment grade' credit rating (BBB- or better), with the five major retail banks all having a credit rating of at least AA-. As noted earlier, the ratings of most banks in New Zealand compare favourably to the ratings of banks globally and reflect the generally high quality of banks in New Zealand and their parent banks.

8 Non-bank financial institutions

This article is primarily about the banking sector. However, to put that in perspective in relation to non-bank financial institutions (NBFIs), some comment on the significance and performance of the NBFI sector is appropriate. An aggregate balance sheet as at 31 December 2003 of all significant NBFIs (except credit unions which have aggregate assets of only about $400 million) is shown in Table 5. This information is compiled from surveys the Reserve Bank undertakes.

The NBFI sector is small in comparison to the bank sector, but is generally growing at a considerably faster pace. Total assets in the NBFI sector were $15 billion compared to $220 billion for banks. The NBFI sector had housing loans of $3 billion, compared to $85 billion for banks. Over the 12 months ended 31 December 2003, housing loans by the NBFI sector increased 31 per cent, compared to 17 per cent for banks. Total lending by the NBFI sector to households increased by 18 per cent over 2003, and deposits from the household sector increased 22 per cent over this period, which exceeded the growth rates for banks.

The financial performance and condition of individual NBFIs varied considerably across the NBFI sector, reflecting differing risk appetites, nature of business, quality of management and risk management systems.

9 Conclusion

The banking system continues to be in robust health, with a good level of profitability, high asset quality, sound capitalisation and a generally well diversified portfolio of assets. These positive attributes reflect generally high quality of management across the banks and strong ownership structures, with most banks in New Zealand being supported by strong and well-performing parent banks.

However, the banking system is not immune to potential vulnerabilities. These vulnerabilities are related to concentrations of risk in a number of areas. Banks operating in New Zealand are heavily exposed to the New Zealand housing market. This market is currently buoyant, with some indications of over-valuation in parts of the property market. However, current indications are that banks should

Table 5
Aggregate balance sheet for NBFIs (except credit unions)

$ millions	1999	2000	2001	2002	2003
Assets					
Housing loans	1197	1287	1420	1720	2071
Consumer loans	2381	2658	3172	3895	4280
Other loans	3199	4015	5201	5800	7052
Other assets	606	763	1043	1560	1879
Total assets	**7383**	**8723**	**10836**	**12975**	**15284**
Off-b/s housing loans	255	442	644	807	1240
Off-b/s consumer loans	480	570	626	696	833
Liabilities					
Household deposits	3482	4141	5190	6105	7454
Deposits from banks	1368	1929	2321	1493	1577
Other deposits	1373	1428	1735	3518	4184
Other liabilities	329	339	527	599	671
Equity	831	886	1063	1260	1398
Total liabilities	**7383**	**8723**	**10836**	**12975**	**15284**

be resilient to even a relatively large decline in house prices. Stress testing done for the FSAP assessment indicated that house prices would need to fall substantially and unemployment rise significantly in order to have a major impact on banks.

Because the ownership of the New Zealand banking system is dominated by Australian banks, indirectly the New Zealand system is exposed to changes in the Australian banking system. While Australian banks are currently sound, they are heavily exposed to the Australian housing market, which, like the New Zealand market, is subject to some risk of contraction. Again, however, analysis by the Australian authorities suggests that the Australian banks are likely to be resilient to most plausible declines in house prices.

The New Zealand banking system has also become more concentrated in terms of the number of banking groups. The acquisition of National Bank by ANZ Bank reduced the number of large banking groups operating in New Zealand from five to four, and created one banking group that has a third of the assets of the total banking system. At present, these concentration factors are potential risks rather than currently impacting on the system, but banks will need to deal with the consequences of these risks if they eventuate. The Reserve Bank is undertaking a number of policy initiatives aimed at effective outcomes in the soundness and efficiency of the financial systems in times of stress.

Appendix

List of registered banks in New Zealand and their credit ratings

The credit ratings are applicable to long-term unsecured obligations of the registered bank, payable in New Zealand and in New Zealand dollars, and are as disclosed in the bank's most recently published Key Information Summary. Ratings may have changed since the publication of the most recent Key Information Summary.

Banks marked (B) operate in New Zealand as branches of overseas incorporated banks. All other banks are incorporated in New Zealand.

Name	Registration Date	Standard & Poor's	Moody's
ABN AMRO Bank NV (B)	2 March 1998	AA-	Aa3
AMP Bank Limited (B)	12 October 1998	BBB+	-
ANZ Banking Group (New Zealand) Limited	1 April 1987	AA-	Aa3
ASB Bank Limited	11 May 1989	AA-	Aa3
Bank of New Zealand	1 April 1987	AA	-
Citibank N A (B)	22 July 1987	AA	Aa1
Commonwealth Bank of Australia (B)	23 June 2000	AA-	Aa3
Deutsche Bank A G (B)	8 November 1996	AA-	Aa3
Kiwibank Limited	29 November 2001	AA-	-
Kookmin Bank (B)	14 July 1997	BBB+	A3
St George Bank New Zealand Limited	3 February 2003	BBB-	-
Rabobank New Zealand Limited	7 July 1999	AAA	-
Rabobank Nederland (B)	1 April 1996	AAA	Aaa
The Bank of Tokyo-Mitsubishi, Ltd. (B)	1 March 2004	BBB+	A2
The Hongkong and Shanghai Banking Corporation Limited (B)	22 July 1987	-	Aa3
The National Bank of New Zealand Limited	1 April 1987	AA-	Aa3
TSB Bank Limited	8 June 1989	BBB-	-
Westpac Banking Corporation (B)	1 April 1987	AA-	Aa3