Developments in the banking industry

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This article reviews developments in the New Zealand banking system over the 1998 calendar year, within the context of the international banking environment. Financial information reported in banks' quarterly disclosure statements indicates that the banking system has weathered the brief economic recession early in 1998 reasonably comfortably. While profitability and asset quality measures deteriorated marginally over much of the period, they were improving towards the end of the year. The banking sector is relatively well positioned to benefit from a recovery in economic activity but the industry's structure and performance continues to be influenced by events in the world economy and global trends in the finance industry.

1 Introduction

During 1998, international financial markets have been adjusting to the impact of Asian economic and financial sector difficulties, and more recent problems in other emerging markets. The New Zealand financial system is significantly influenced by international developments, with all but one of the 18 registered banks operating in New Zealand being components of large international banking groups. The banking system is intensely competitive, with a few banks operating in narrowly focused niche markets, putting pressure on the larger trading banks through fine pricing and low cost structures. The major banks in particular are constantly striving for improved operating efficiency through economies of scale and reductions in costs.

In this article, we review the financial performance of banks in New Zealand on the basis of financial data for 1998 published in banks' disclosure statements. The banking sector produced a slightly lower return on average assets for the year after experiencing difficult trading conditions for much of the period in a low inflation, low margin environment. The rural sector has been adversely affected by prolonged drought conditions in parts of the country. Asset growth continued at a moderate rate similar to last year, but asset quality deteriorated somewhat as the economy slowed down early in 1998. By the end of the year, prospects were improving for a better performance in 1999 provided the economy picks up. Capital ratios have been steady, above required levels, and risk exposures appear to be well controlled.

2 Structural and policy issues

International developments/trends

In the aftermath of the Asian financial crisis which captured world attention in 1997, the global financial environment has been undergoing some significant changes. Internationally, banks have been responding in several different ways to the more volatile market conditions and continuing competitive pressures. Some groups have maintained a strategy of growth by acquisition of complementary banking operations to increase market share, either regionally or globally. A few groups have formed 'strategic alliances' or mergers across markets, bringing banks together with insurance and securities companies or investment banks to gain from broader market reach and a wider product range. These newly created global financial conglomerates have yet to reap the expected benefits, which include increased fee revenue from cross-selling opportunities between banking, securities, funds management and insurance business, and the potential for economies of scale and savings on overheads where merged operations are similar in nature. On a smaller scale, some insurance and funds management groups have acquired or established banks to become full financial services providers in direct competition with the traditional banks.

Other banking groups have identified strategic opportunities to add value by alternate routes. Some have refocused on more familiar markets nearer to their home base, withdrawing from their earlier expansion into distant markets where the risks were more difficult to assess accurately. In contrast to the full financial service approach, there are also examples where banks have successfully added value to existing franchises through specialisation in a narrower range of banking business, for example either retail, corporate or investment banking. Those groups have chosen not to provide all types of financial services. They have carefully targeted acquisitions in their preferred markets and sold or closed operations that do not fit the new direction.

A number of the more troubled economies have restructured their financial sectors. Part of the rationalisation and restructuring process has opened up opportunities to international banks to expand by entering markets that were previously closed to foreign banks, at the same time providing much needed capital and expertise to struggling banking sectors. In the developed countries as well as in the troubled economies, those institutions whose risk profile or sphere of operations have been most exposed to the problems are more vulnerable to takeover. The spate of mergers and acquisitions looks set to continue in the international arena as poor performers come under threat.

The increasing trend towards the establishment of large financial conglomerate organisations operating in all spheres of the financial system has led financial sector regulators in some countries to move away from the previous approach of separate regulators for different sectors of the financial system. Australia, the United Kingdom, Japan and Korea have each established slightly different forms of a 'mega-regulator' with co-ordinated supervision and regulation covering banking, insurance and securities markets under a single 'umbrella' organisation.

Internationally, there is increasing recognition that supervision and regulation of globally oriented financial institutions must involve a degree of 'self-regulation' by the institutions themselves, as the increasingly complex structure and activities strains the boundaries of national supervisory regimes. Increasing emphasis is being given to the importance of effective market disciplines. The Basle Committee on Banking Supervision released guidelines to enhance bank transparency in September 1998. The objective is to increase the quality and consistency of public disclosure about banks' financial condition and performance, their risk exposures and risk management strategies and practices. The Basle Committee's amendment to the Capital Accord, to incorporate additional capital requirements for global banks with significant market risk exposures, provides another example of the changing approach to supervision internationally. The amended arrangements have been adopted by several overseas supervisory authorities, and implicitly place a degree of supervisory responsibility back on to the institutions themselves. Banks' own internal risk management models have been recognised as an acceptable alternative to standard formulae for assessing the amount of additional capital required to support market risks, provided the models continue to meet tight technical criteria.

The upheavals in global financial markets and increasing technical sophistication of banks' operations and risk management has led to an international consensus that the 1989 Basle Capital Accord is overdue for review and modernisation. Weaknesses in the original relatively simple approach, based on approximate measures of relative credit risk, have been recognised since its inception. Nevertheless, it has reasonably effectively achieved the original objective of increasing the level of capital held by international banks to act as a buffer against unanticipated losses. A consensus has emerged internationally that better recognition of credit risks and other banking risks is desirable in assessing the adequacy of banks' capital. It appears, however, that reaching a conclusion on an acceptable alternative configuration of the Capital Accord may take some time yet.

Developments in Australia

Developments in the economy and the financial system in Australia can directly affect the structure and financial condition of the banking sector in New Zealand. Partly as a result of take-overs and consolidation within the banking sector in recent years, just under 70 percent of NZ registered banks' assets are now held by four banks which are majority-owned in and controlled from Australia. Those same four major banks also control approximately two-thirds of the assets of the Australian banking system at present.

As recommended in the Wallis Committee's Financial System Inquiry report, the Australian Government has passed legislation to establish a single financial sector supervisory authority, the Australian Prudential Regulatory Authority (APRA), which came into existence on 1 July 1998. The prudential regulation of banks has been transferred to APRA from the Reserve Bank of Australia (RBA), and regulation of insurance companies and superannuation funds has been inherited from the Insurance and Superannuation Commission. Supervision and regulation of building societies and credit unions is expected to be transferred from the Australian Financial Services Commission once enabling legislation is passed within each state.

In respect of the supervision and regulation of banks, APRA initially adopted almost all of the prudential policies, standards and guidelines formerly applied by the RBA. It has now begun modifying its structure and approach where appropriate to realise the benefits expected from having a single prudential regulatory agency. A separate organisation, the Australian Securities and Investment Commission (ASIC) was also established from 1 July 1998 to administer and enforce the Corporations Law and consumer protection legislation governing investments and other financial services.

The RBA has retained responsibility for maintaining the stability of the financial system and the safety and stability of the payments system, along with its monetary policy function. A new Payments System Board has been established under the Payments System (Regulation) Act with additional powers to regulate clearing and settlement systems and to promote payment system efficiency. The RBA retains its role as the provider of liquidity to the financial system in times of crisis. The banking industry successfully implemented a Real Time Gross Settlement System (RTGS) for high-value payments in June 1998 in conjunction with the RBA. Wider access to the payments system is to be permitted for entities with a proven need for clearing arrangements, on the basis of criteria established by the Payments System Board.

A Council of Financial Regulators comprising representatives of the three main bodies (APRA, RBA, ASIC) has also been established to facilitate communication and minimise gaps or inconsistencies in regulatory approach. Cooperation and collaboration between RBA and APRA will be essential to enable the RBA to fulfil its system stability responsibilities, and has been formalised through a memorandum of understanding.

Competition within the financial sector has been intensifying in recent years with a resultant narrowing of bank interest margins. A small number of financial services groups with significant insurance and funds management activities have broadened their scope to include retail banking, aiming to provide their customers with an integrated range of financial products. Banks' share of financial system assets has been decreasing, while the market share of superannuation fund and managed fund assets has been rising as investors seek higher returns than those paid on bank deposits. In response, banks have been expanding their own funds management activities. The growth of low-cost housing mortgage origination companies has put further pressure on banks to cut costs and diversify their product ranges, with various forms of electronic banking playing a major role in these strategies.

Despite strong lobbying from some quarters, the Australian Government has not yet agreed to remove its 'four pillars' policy for the banking system. Under the current policy, a merger or takeover between the four major banks will not be permitted at present, but it appears that the possibility of a takeover by a foreign bank has not been entirely ruled out. APRA, ASIC and the Federal Treasurer would each have a role assessing aspects of merger or take-over applications. Material concerns are likely to relate to possible excessive concentration in the industry, reduced competition, and any other possible detrimental impact on consumers or the banking system.

If a merger or takeover involving one of the four major Australian banks was approved, it would have significant implications for the New Zealand banking system. As might be expected in view of the close ownership relationships between the two financial sectors, the strategies adopted by institutions in Australia are directly impacting on the New Zealand banking system. Some banks are moving to 'global' management of business lines so that functional management in the New Zealand operations of those banks report directly to functional heads outside New Zealand, rather than to the local chief executive officer. One approach adopted to reduce cost structures in New Zealand has been to 'out-source' aspects of support services to regional service centres or banks' head offices in Australia. Areas such as information technology, dealing operations and back office support, and finance and accounting operations are examples where savings have been sought. Foreign branch banks operating in the wholesale/corporate sector in New Zealand rely significantly on services provided from Australia. During 1998, two large New Zealand banks were also involved in the ‘hollowing-out’ of some support services, which will be provided from Australia in future.

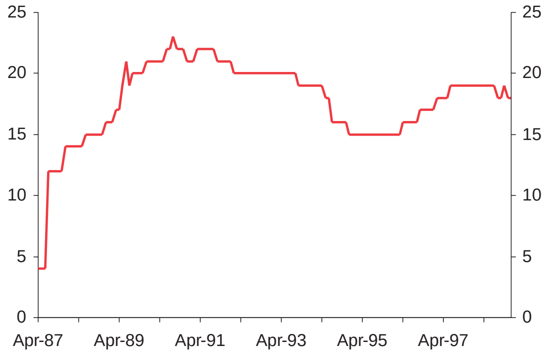
New Zealand experience

The New Zealand economy in 1998 suffered to some extent from the continuing global impact of the economic and financial difficulties experienced by several Asian and other developing countries during 1997 and 1998. Export earnings and tourist visitor numbers from Asian countries contracted for several months. Combined with drought conditions in some regions of New Zealand in the latter part of 1997 and into 1998, these factors contributed to a downturn in domestic economic conditions and business and consumer confidence. The downward trend in the trade-weighted exchange rate index which began in the second half of 1997 continued through to the middle of 1998. That was followed by a decline in wholesale and retail interest rates in the September quarter. Towards the end of the year, economic activity began to pick up, forecasts for economic growth have improved and there has been a strengthening of the exchange rate index in the early months of 1999.

Banks have responded to the difficult operating environment over the last two years in a number of ways. The competitive pressures that have been driving mergers, restructuring and consolidation by large international banking groups over recent years are continuing to be reflected in the changing composition of registered banks in New Zealand. Some banks have responded by amalgamating operations within the region or selling business lines which no longer match the group’s profit performance or strategic interests in the region. Other changes have resulted from the desire to form or develop financial conglomerates which can maximise the anticipated synergies and cross selling opportunities from insurance, funds management, banking and securities business.

The number of registered banks in New Zealand fell by one during the year, bringing the total to 18 at the end of December 1998. Two new banks were registered, while three banks voluntarily relinquished their registration. The two new banks were ABN AMRO Bank N.V. (ABN AMRO), registered in March 1998, and AMP Bank Limited (AMP Bank) registered in October 1998. In both cases, these banks were

Figure 1
Number of banks registered in New Zealand



registered in New Zealand as branches of the respective overseas-incorporated banks.

Barclays Bank Plc relinquished its registration in March 1998, as a result of the UK group’s refocusing of its global operations and sale of its assets in New Zealand and Australia to ABN AMRO. Credit Agricole Indosuez relinquished its license in August 1998 following a strategic review of its business. The group concluded that significant critical mass was necessary to improve its competitive advantage, and that the New Zealand clients’ needs could be served effectively from Australia. Both of these banks had been operating in the highly competitive merchant banking/corporate banking sector in New Zealand.

AMP Bank commenced banking operations in Australia in mid-1998, although the AMP group has been developing its non-bank, non-insurance financial services activities in both New Zealand and Australia for a few years. AMP Bank’s New Zealand branch commenced with the purchase of the local retail banking business of Citibank N.A. AMP Bank is likely to assimilate some or all of the banking-related activities of a sister subsidiary company, AMP/ERGO Mortgage and Savings Ltd during 1999. These companies have focused on electronic banking and telephone-based contact with customers, particularly in the mortgage market, with relatively few branch locations to maintain a low-cost operation.

The retail banking sector in New Zealand saw further merger/acquisition activity during the year. The National Bank of New Zealand Limited (National Bank) acquired ownership of Countrywide Banking Corporation Limited (Countrywide) in

September 1998. Countrywide was formerly owned by the Bank of Scotland, with its business dominated by the housing mortgage portfolio and related customer base built up from its origins in the building society sector. Countrywide's registration was voluntarily relinquished in November 1998 when its business was amalgamated with the National Bank under the provisions of the Companies Act 1993.

Following the announcement in 1998 of the proposed acquisition of the global operations of Bankers Trust New York Corporation by Deutsche Bank A.G. of Germany, the registered bank operations of these two groups in New Zealand are expected to be consolidated into a single entity, Deutsche Bank, A.G. in mid-1999.

Another trend being observed in the New Zealand banking sector is a reduction in funds management activities by a few banking groups which had earlier aggressively sought to expand this fee-based business, particularly for larger (non-retail) clients. The business has been transferred to other parts of the global banking group, or sold to external parties. Within both New Zealand and Australia, larger operators are tending to benefit from cost savings, through economies of scale, as the amount of funds under management increases. Since the end of 1998, Citibank has announced that its NZ Funds management activities will be transferred to its Sydney operation. Bankers Trust's funds management operations in New Zealand and Australia have been put up for sale as part of the rationalisation resulting from the takeover by Deutsche Bank.

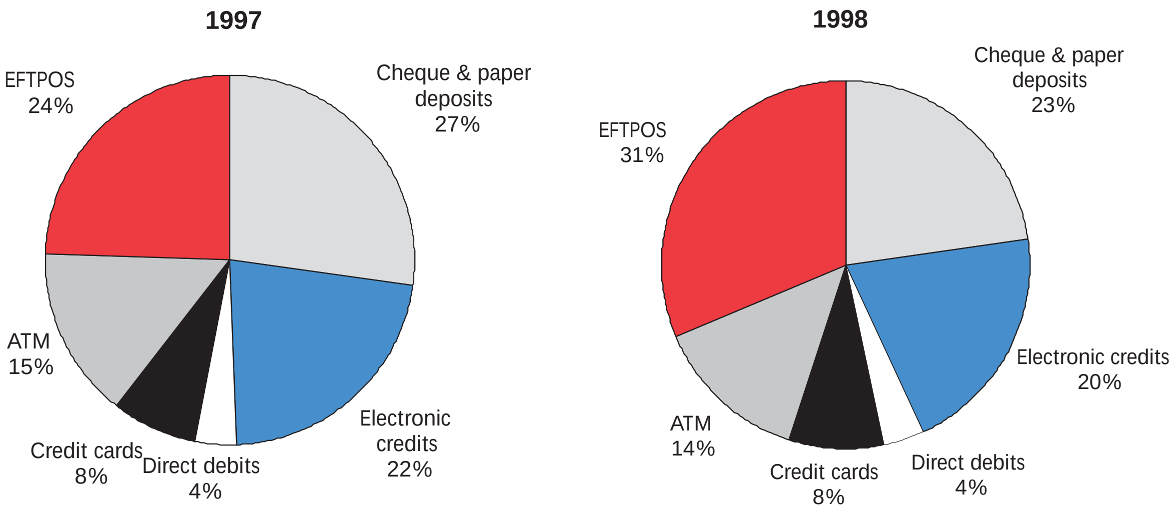
The various changes in the registered bank sector reflect the intense competition in both retail and wholesale/corporate banking sectors. Most new entrants are focusing on niche markets rather than attempting to provide broad-based financial services. Some non-bank financial institutions have been extending their range of retail banking products, and are increasing market share at the margin, through electronic product delivery and low overhead costs. There also appear to be prospects of retailers of consumer goods moving further into the provision of financial services to customers in the near future.

The impact of electronic banking has contributed substantially to the scope for the larger banks in particular to trim back their relatively expensive retail branch networks. Automatic teller machines have taken the place of the closed retail branches in many urban locations. Telephone banking is gaining acceptance, and usage has increased as banks modify their fee structures to alter customers' banking behaviour and reduce the proportion of transactions conducted over the counter at branches, where transaction costs are higher. To help keep overhead costs down, one or two banks have implemented telephone banking combined with agency arrangements through nation-wide retail shop networks to provide customers with limited banking services in locations far away from the bank's own branch operations. One or two other banks have indicated that similar arrangements may be trialled in 1999.

Over the last couple of years, the number of electronic funds transfer at point of sale (EFTPOS) transactions, mostly at retails stores, has almost doubled so that EFTPOS is now the most widely used medium for non-cash payments in New Zealand. Data provided by the New Zealand Bankers Association on the relative proportions of non-cash payments transactions conducted in 1997 and 1998 is depicted in figure 2. For the first time, in 1998, EFTPOS transactions were used more often than paper-based payments. The number of payments by cheque and paper deposits have continued to decline, from 27 percent of the total in 1997 to 23 percent in 1998. Electronic credit transactions have remained close to 20 percent of the total for the last six years. Funds transfer and bill payment transactions have increased five-fold since 1995 as the banks have marketed the convenience of telephone banking and direct payments of bills. The decline in paper based transactions has been strongly influenced by increased charges for those transactions, particularly for over-the-counter transactions.

Internet banking for domestic customers appears to have been successfully implemented in New Zealand by one retail bank so far, with the objective of providing a low-cost, 'branch-less' form of delivery of banking products. It has reported good customer acceptance to date, becoming the market leader in that niche using state-of-the-art systems and technology in order to provide secure transactions. It appears that other banks are at various different stages in implementing internet banking at the retail level.

Figure 2
Payment methods



In early 1998, New Zealand joined a growing number of countries to introduce real time gross settlement (RTGS) for most high value wholesale payments. This process for 'instantaneous' electronic settlement of large payment transactions throughout the day significantly reduces the interbank settlement risk associated with the former deferred net settlement arrangements, which now only apply to lower-value payments. The RTGS environment is operating smoothly and has substantially reduced the level of systemic risk in the financial system. The Bank is continuing to work with the banks to find ways to reduce remaining risks in other areas of the payments system and cross-border foreign exchange settlement risk (Herstatt risk).

3 Financial performance of banks in New Zealand

The commentary in this section is based on data for 1998, 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 for use in this article.

Profitability

Banks have two main elements to their earnings stream. Net interest income represents the larger share, at just under two thirds of total operating income for banks in New Zealand, as shown in figure 3. Other (non-interest) income comprises trading income, and fees and commissions, and has provided between 35 percent and 37 percent of operating income for the last five years. Although there is evidence of a rising trend in non-interest income as proportion of total income towards the end of 1998, it is not yet clear if any significant increase in reliance on non-interest income sources will emerge over the coming year.

Figure 3
Income and expenses as a percentage of total income

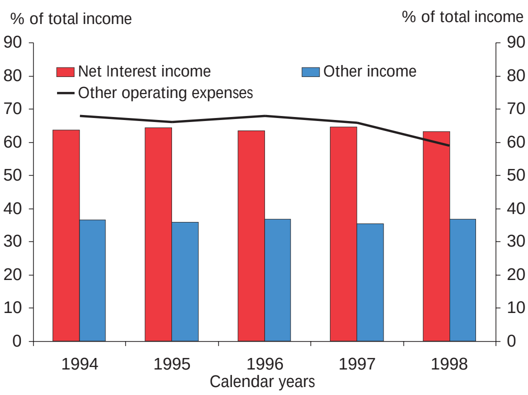


Figure 3 also shows the trends in a common measure of the operating performance of banks, the 'efficiency' ratio reflecting the average proportion of each dollar of total income that has been used up by operating expenses. The ratio of (non-interest) operating expenses to total income has been falling lately, from a level of around 68 percent maintained for the three years from 1994 to 1996, to 66 percent in 1997 and 59 percent in 1998. Almost all of the banks reported an improvement in efficiency ratios for 1998. Some banks overseas have explicitly targeted reductions in this ratio in the past. The average efficiency ratios for major banks in Australia and United Kingdom in 1998, for example, are also close to, or slightly below 59 percent. Note however that the average ratios for New Zealand disguise quite a wide range of efficiency performance between different types of banks. Some of the wholesale/corporate banks with streamlined operations have been reporting efficiency ratios as low as 30 percent.

Also reflecting improved operating efficiency, there has been a marked declining trend in non-interest operating expenses in relation to average total assets. An aggressive approach to controlling costs has become a major driving force for banks in recent years, as they seek to generate to stronger profit performance and returns to shareholders in circumstances where income growth is becoming more difficult to achieve. From around 3 percent in 1994 and 1995, the operating expenses to average asset ratio has improved significantly, to 2.6 percent in 1997 and further, to 2.2 percent in 1998. Almost all banks recorded an improvement in 1998. The trend to increase 'out-sourcing' of some services to Australia is likely to have contributed to the improved operating performance for the year.

In most cases where branch offices acquired during bank take-overs have not fitted the new owner's strategy, rationalisation has usually been progressed sufficiently slowly to achieve gradual cost efficiency gains while maintaining good customer relationships. Nevertheless, branch rationalisation has caused some public discontent, particularly where closing 'the last bank in town' in rural districts has left communities without local branch-based banking facilities. Banks are recognising that they need to focus on maintaining and improving customer relationships. Products are being tailored to specific niche segments of the client base, and several banks are explicitly seeking to target a small but potentially lucrative pool of high net worth individuals.

As in the previous year, the various projects to ensure that banks' computer systems and other operating facilities are 'Year 2000' compliant have impacted on costs in 1998. With banks' critical systems and the banking system's interchange networks now tested successfully as compliant, the focus in 1999 will be on non-critical supporting systems, with a likely lower impact on costs in the coming year.

Table 1 confirms that these various measures are proving successful, with banks reporting a decline in operating expenses of $166m in 1998. Total operating expenses were $2,982m, more than 5 percent lower than in 1997 and reversing the rising trend of the previous three years. Note however, that the acquisition and amalgamation of one bank into a larger banking group during the year involved an abnormal restructuring expense of $120m that is not included in operating expenses.

On the income side, growth in net interest income has been squeezed in the declining domestic interest rate environment observed over much of 1998, (see figure 5 and discussion below regarding interest margins). On the other hand, banks'

Table 1
Composition of income and expenses

$ million	**1994**	**1995**	**1996**	**1997**	**1998**
Net interest income	2,462	2,794	2,827	3,090	3,193
plus					
Other income	1,409	1,557	1,638	1,694	1,862
less					
Operating expenses	2,634	2,877	3,038	3,148	2,982
equals					
Underlying profit	**1,237**	**1,474**	**1,427**	**1,636**	**2,073**
less					
Impaired asset costs	-97	-8	-42	88	201
less					
Tax and other items	494	477	453	431	637
equals					
Net profit	**840**	**1,005**	**1,016**	**1,117**	**1,235**

other income showed the opposite trend, increasing only slightly in 1997, but growing by $168m or 10 percent in 1998. It appears that net gains from trading activities in the securities, foreign exchange and derivatives markets have contributed a much higher proportion of other income in 1998 than in 1997, with most of those gains being recorded in the second half of the year. Banks are also continuing to seek alternative sources of revenue, for example to recover costs where possible through fees and charges.

The overall impact of reduced operating costs and increased total income has been a significant increase of 27 percent in underlying profit performance for the year. Underlying profit measures the operating profit of banks before deducting impaired asset charges, tax and abnormal or extraordinary items. As shown in figure 4, underlying profit of banks in 1998 exceeded $2 billion for the first time. Almost all banks reported a marked improvement in underlying profit for the year. From figure 4, however, it is also clear that the increase an impaired asset charges, and an abnormal restructuring charge for expenses relating to a bank takeover, have contributed to a much smaller increase in net profit after tax and extraordinary items, compared with the increase in underlying profits.

Figure 4
Profitability

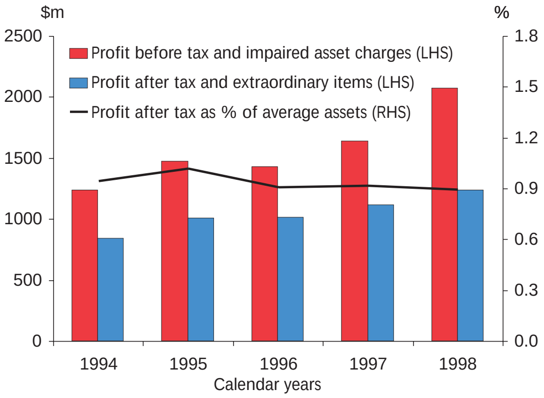
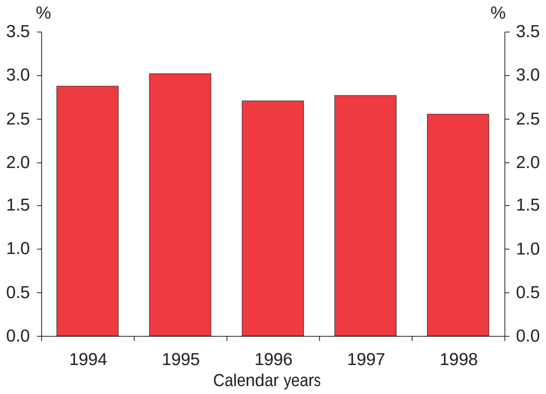


Table 1 shows that charges for impaired asset costs have climbed substantially in 1998 to $201m, from $88m in 1997. Several factors contributed to that increase, including a slight deterioration in asset quality generally, and the adoption by two major banks of a modified approach to setting the level of general provisions, based on the average expected loss over the economic cycle. That approach is similar to the general provisioning techniques adopted earlier by some of the other banks. The objective is to recognise potential declines in overall asset quality at an early stage, by increasing general provisions and reducing the volatility of subsequent impaired asset charges in the income statement. Note that there was a net credit for impaired asset expenses during the period from 1993 to 1996 as some banks had been able to boost income by writing back recoveries of impaired asset expenses charged in earlier years. The impact of those large recoveries appears to have ceased during 1997.

Overall, net profit after tax improved by 11 percent in 1998, after increasing by nearly 10 percent in the previous year. The profit result can be regarded as indicating a comforting degree of resilience in the financial performance of banks in New Zealand, taking into account the difficult trading conditions during the year. Net profit after tax as a proportion of average total assets (often referred to as after-tax return on average assets or ROA) fell fractionally, from 0.92 percent in 1997 to 0.89 percent in 1998. While it is below the often-quoted target level for international banks of 1 percent, it represents a reasonable outcome in the circumstances. (Note that the average assets for the year have been adjusted to reflect the increased level of assets reported in quarterly disclosure statements during the middle part of the year. The level of average assets, as used for these ratio calculations, is greater than would be produced from a simple average of the beginning and end of year totals.)

Interest margins have been under pressure throughout the year, with a sharp fall in both lending and deposit rates during the second half of 1998. In 1997, net interest income had increased by slightly more than the increase in interest-earning assets, generating a tiny increase in the interest rate margin (net interest income as a proportion of average interest-earning assets). In the more difficult operating environment of 1998, net interest income rose by a much smaller 3 percent, while interest-earning assets increased by 11 percent. As a result, the interest rate margin fell from 2.8 percent in 1997 to 2.6 percent in 1998. See figure 5.

Figure 5
Interest rate margin



Balance sheet

Total assets of the banking system have been steadily growing for the last five years, increasing by 9 percent in 1998 to $142 billion. Figure 6 provides a graphical representation of the growth in bank assets, and the changing composition, based on the data in table 2. In both absolute and percentage terms, investment in financial securities (including short-term liquid assets) has shown the largest increase for the year, rising by over $5 billion to represent 17 percent of total assets. As a rule, banks' holdings of financial securities and liquid assets might be expected to fluctuate depending on comparative interest rate yields for securities versus other assets, and on the demand for new loans. With the introduction of Real Time Gross Settlements (RTGS) for banks in February 1998, it is possible that some of the increase in financial securities relates to securities to be used as collateral in the intra-day settlement of gross interbank transactions through the RTGS system.

A relatively rapid growth in residential mortgages had fuelled asset growth in the period from 1994 to 1996. Mortgage growth slowed to 10 percent in 1997 and further to 8 percent in 1998. Residential mortgages have remained at 51 percent of total bank lending, from 1996 to 1998. Other lending has been growing at a more even rate each year, of around 9 percent per annum, and outstripped mortgage growth in 1998, for the first time in several years. Of the $4.2 billion increase in other lending in 1998, approximately 15 percent arises from a bank's acquisition of a non-bank financial services company specialising in lending to the rural sector. For other banks, increased lending to the corporate sector was a more significant component.

The small contraction in other assets from 1997 to 1998 follows the trend of some banks to reduce their property assets as branches are closed or buildings are sold and leased back by the bank. In some other cases, there has been a noticeable reduction in the level of unrealised gains recorded on-balance sheet relating to outstanding interest rate and foreign exchange derivative contracts.

Asset quality

Unlike banks in a number of other developed countries, New Zealand banks carried low direct exposures to Asian borrowers and did not incur lending losses from the increasing levels of bankruptcies and failures of businesses and banks in the troubled Asian economies. Similarly, New Zealand was largely insulated from the immediate impact of the financial crises in Russia and Brazil in the latter part of 1998.

Figure 6
Composition of assets

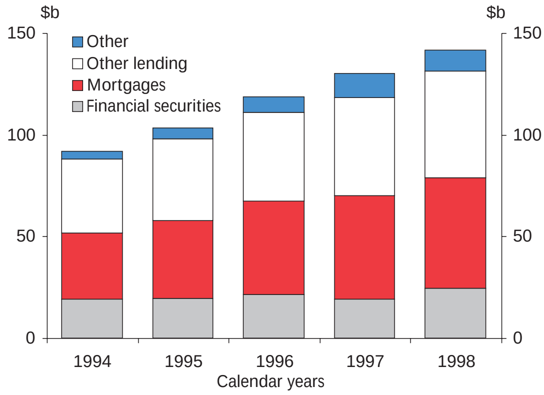


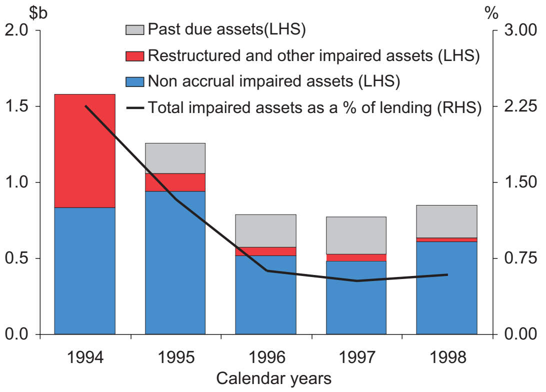
Table 2
Composition of assets

$ billion	**1994**	**1995**	**1996**	**1997**	**1998**
Investments	19.0	19.4	21.5	19.2	24.3
Mortgages	32.7	38.5	45.7	50.6	54.5
Other lending	36.2	40.1	43.9	48.3	52.5
Other assets	4.1	5.1	7.5	12.1	10.3
Total assets	**92.0**	**103.1**	**118.6**	**130.2**	**141.6**

However, declining exports to some markets and the economic slow-down in New Zealand during 1998 put pressure on some borrowers, with the asset quality position of banks deteriorating somewhat.

Other exporters benefited from the continued growth in the Australian economy, our largest export market, over the period of the Asian financial crisis. Australia was able to build on strong domestic demand and switch some of its own exports away from Asia towards new markets and stronger economies. In turn, banks in New Zealand are likely to have experienced fewer asset quality problems with firms exporting to Australia, the USA and Europe than with those whose main markets remained in Asia and consequently suffered reduced demand and prices for their products.

Figure 7
Asset quality



In general, the New Zealand corporate sector was regarded as having been in better financial health coming into 1997/98 than it was at the time of the economic downturn nearly a decade earlier. However, the drought conditions in some regions caused added problems for farming sector borrowers. In many cases where borrowers appeared to be heading into difficulties, banks have endeavoured to work through the problems with the borrowers at an early stage.

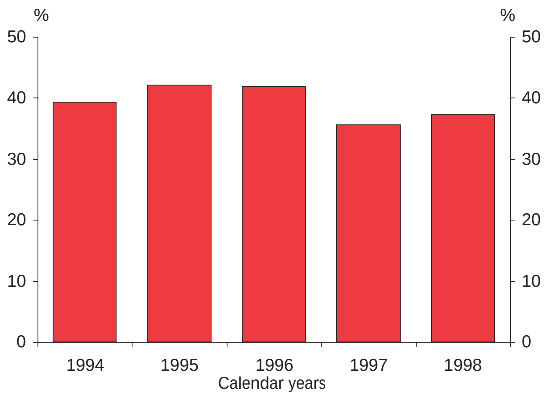
Figure 7 highlights the reversal, in 1998, of the improving trend in asset quality in previous years. Impaired assets as a proportion of total lending increased marginally, from 0.53 percent to 0.59 percent over the year, which is still regarded as a comfortably low level by most international and historical comparisons.

Although impaired assets of banks increased by 20 percent in the year to December 1998, the reported quarterly information suggests that the total level of impaired assets has begun to decline from a high point in September 1998. The indicated improvement in asset quality towards the end of the year is also reflected in a decline in the reported level of past due assets to $211m in December 1998, down 14 percent from December 1997, after reaching a peak in the middle of 1998.

Another measure of banks' asset quality is the coverage provided by the level of balance sheet provisions for bad and doubtful debts. Total provisions have increased by $201m or 41 percent to $697m over the last year, with the majority of that increase being a result of a change in methodology for setting general provisions by two major banks. Total general provisions now represent 0.65 percent of total bank lending, up from 0.5 percent in 1997. Some banks do not carry a general provision for loan losses in their New Zealand books, but are covered by the general provisions in their parent or head office financial statements.

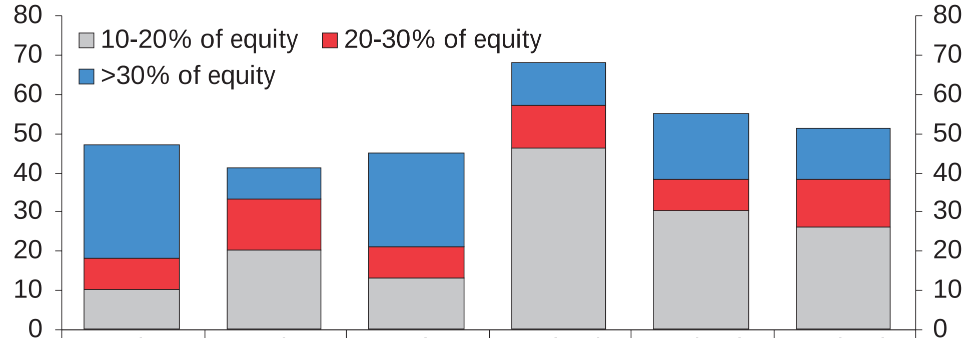
Figure 8
Specific provisions as a percentage of impaired assets

Note: As at 31 December



Specific provisions for bad and doubtful debts are more directly related to the likely un-recoverable portion of existing impaired assets. Total specific provisions increased by 26 percent during 1998, from $188m to $236m. Figure 8 shows the slight increase in coverage of specific provisions as a proportion of impaired assets, from 36 percent to 37 percent of impaired assets at the end of 1998. Although an improvement on 1997, it is at a comparatively low level by historical

Figure 9
Number of large exposures to bank and non-bank counterparties
Note: As at 31 December



	Banks 1996	Banks 1997	Banks 1998	Non banks 1996	Non banks 1997	Non banks 1998
>30% of equity	29	8	24	11	17	13
20-30% of equity	8	13	8	11	8	12
10-20% of equity	10	20	13	46	30	26

standards, which could suggest that further provisions would be necessary for some banks if asset quality were to deteriorate further.

Large exposures

Banks are required to report large exposures to individual counterparties which exceed 10 percent of the bank's equity. The number of exposures to bank and non-bank counterparties are reported separately. The information is more relevant for New Zealand-incorporated banks because the branch banks have few if any exposures in New Zealand which exceed 10 percent of the bank's global equity.

In terms of relative credit risk, short-term exposures to internationally-recognised banks are generally regarded as involving potentially lower credit risk than longer-term exposures to non-bank counterparties. It is therefore not surprising that as at December 1998, banks carried relatively higher concentrations of credit to other banks. More than two-thirds of large exposures to banks were greater than 20 percent of equity, whereas over half of the non-bank large exposures were in the 10 percent to 20 percent range.

Figure 9 indicates the trends in large exposures at year-end from 1996 to 1998. Large exposures to non-bank counterparties have been reducing in aggregate over the three years. The increase in the exposures in the 20 percent to 30 percent range in 1998 appears to reflect a decline in the number of exposures over 30 percent, compared with 1997. Overall, the implication is that banks have been reducing credit concentrations to non-bank counterparties. That trend is consistent with a prudent reduction in credit limits in an environment where banks anticipate some deterioration in asset quality.

The basis for the changing pattern of large exposures to bank counterparties is less clear, with higher concentrations reported in both 1996 and 1998 than in 1997. On average, banks appear prepared to grant higher limits to other banks than to non-banks. The levels of actual exposures to banks, in normal circumstances, may therefore be influenced by several factors other than bank credit risk, such as the yields available on alternative investments, and by the non-bank demand for credit. Lending limits to other banks are only likely to be a binding constraint on the size and number of exposures to banks in a few instances, such as where there is an increased risk of default resulting from developments in overseas markets.

The other notable factor in assessing large credit exposures is the change in banks' equity base over time. Aggregate bank equity has been increasing over the last couple of years at a similar rate to the increase in lending. Therefore, the increasing equity base appears to have been able to accommodate a reasonable expansion in individual non-bank counterparty credit limits without necessarily contributing to any increased credit concentration in the financial system.

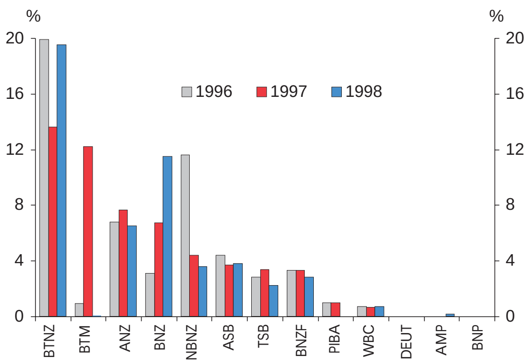
Market risk

The market risk disclosures by banks are designed to give an indication of the potential for 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). From December 1996, banks have been required to disclose these components of market risk on a quarterly basis as an amount, and as a percentage, of equity. From December 1998, the market risk disclosures have been included in the external audit review requirements which apply at six-monthly and annual balance date, to provide independent scrutiny of the processes by which the reported data is produced.

Interest rate risk tends to be the largest component of reported market risk. Figure 10 shows details of peak interest rate risk for 1996, 1997 and 1998 for individual banks. As can be seen in the graph, market risk levels as a percentage of capital tend to be reasonably small for most banks, and in general, are negligible for branch banks. The reported levels of interest rate risk vary significantly between banks. These differences reflect characteristics such as the nature of banks' business and their incorporation structure in New Zealand. Banks which actively seek to take positions in financial markets will have larger market risks than banks which concentrate on lending.

In respect of the locally incorporated banks, perhaps the most useful indication that these measures provide is to show the

Figure 10
Peak interest rate risk as a percentage of equity
Note: See appendix 1 for full bank names



changing appetite for risk within an individual institution over time. It suggests that one of the major banks has altered its strategy over the last three years to reduce its exposure to interest rate risk, while another major bank may have been seeking to take an increasing level of unhedged positions in the market to profit from expected movements in rates.

The level of bank capital is an important factor in assessing reported market risks. 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 market risks is expected to provide banks with sufficient incentives to hold additional capital to cover the risks involved.

Operational risk

Banks are constantly coping with elements of operational risk in their day to day business. Operational risk may, for example be caused by a breakdown in internal controls, from accidental or wilful breaches of procedures and limits, or from disruption to business from failures in communications or computer systems. Banks have established internal audit and risk assessment units to assist management in monitoring and managing various types of risks.

As the trend continues towards 'out-sourcing' of some banking support services, for example to parent banks or regional head offices, each bank will need to reassess carefully the vulnerability of New Zealand business to operational risk. Some risks may be increased by transfer of service functions outside New Zealand, while other risks may be reduced. However, they will all need to be managed appropriately.

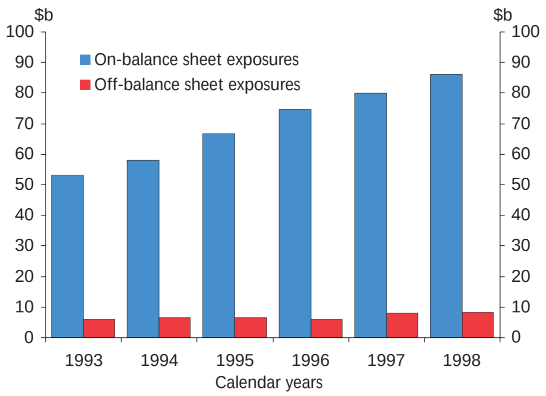
Banks have been undertaking the intensive modifications necessary to ensure Year 2000 compliance for their computer environment and other electronic equipment. An industry working group has facilitated cooperation and interbank compliance testing of payments systems. The increased attention focused on crisis events as a result of the 1998 Auckland power crisis and Year 2000 preparations has also contributed to the establishment of more structured business continuity plans by some institutions, so that the industry should be better prepared for the possibility of future disasters.

Capital adequacy

As a condition of registration, banks which are incorporated in New Zealand are required to maintain a tier one capital ratio of 4 percent of risk-weighted assets and an overall 8 percent total capital ratio. Branch banks are not required to maintain a capital requirement in New Zealand as they are subject to capital ratio requirements on their global operations in the country of incorporation.

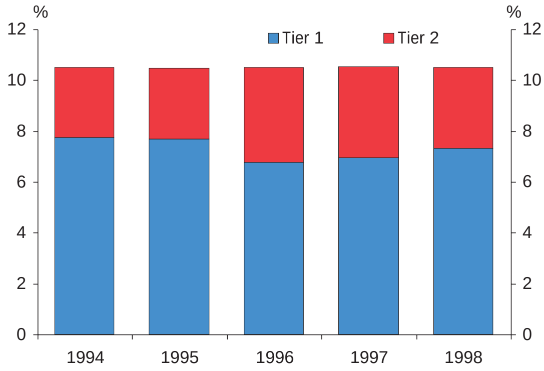
The end-of-year total capital position of the New Zealand banking system has remained almost unchanged at 10.5 percent of risk-weighted assets for the last three years. Increases in capital have approximately kept pace with the rise in banks' on- and off-balance sheet exposures of 9 percent in 1997 and 7 percent in 1998. As figure 11 indicates, risk-weighted on-balance sheet assets have been growing every year. However, the risk-weighted value of off-balance sheet assets was unchanged from 1997 to 1998 and has declined as a proportion of the total risk-weighted assets.

Figure 11
Risk-weighted exposures
Note: As at 31 December



There was a $523m increase in banks' tier one capital in 1998, which was primarily due to improved retained profits, with a lesser net impact from the increase in new shares issued by two major banks during the year. Figure 12 shows that the aggregate tier one ratio has increased from 6.8 percent at the end of 1996 to 6.9 percent in 1997 and to 7.3 percent in 1998. Tier two capital has fallen slightly during the year. General provisions for bad and doubtful debts have been rising, and can be an eligible element of tier two capital for banks under strict criteria. However, for several banks, the increased general provisions are no longer eligible for inclusion in their regulatory capital base. The tier one and overall capital ratios for all banks remain comfortably above the international minimum standards of 4 percent and 8 percent respectively.

Figure 12
Capital adequacy
Note: As at 31 December



4 Conclusion and outlook

Decisions affecting the changing composition of the New Zealand banking sector and the scope of banks' operations are mostly being driven by the strategic initiatives of the parent organisations outside New Zealand. The changes also reflect the competitive pressures and narrowing margins in the local market. Mergers and acquisitions between banks, and moves to create financial conglomerates covering all aspects of financial services are continuing at a fast pace within the international financial community. Poor performing institutions remain vulnerable to takeover in the current intensively competitive environment. As a result, New Zealand is likely to see further changes in the banking system in the period ahead.

The banking sector has weathered the upheavals in Asian markets, and the resulting slowdown in the domestic economy with only a small decline in overall profitability and asset quality. In the current highly competitive environment, banks will find it difficult to reverse the longer term downward trend in interest margins. Following overseas trends, banks have achieved cost savings and improved operating efficiency through reduced infrastructure and extensive use of new technology to provide lower-cost delivery of services through electronic banking. Customers' banking habits are being modified through fees and charges structured to encourage reduced reliance on the higher cost services associated with traditional branch banking.

Contingency planning for the possibility of Year 2000-related operational disruptions arising from external sources is being given a high priority by banks. Banks appear to be taking appropriate steps to minimise the possibility of problems arising from areas which are within their control. Core computer-based systems have already been upgraded or replaced and industry-wide testing has been completed. Additional liquidity will be made available from the Reserve Bank to the banking system should the need arise.

From a broader perspective, banks in New Zealand remain reasonably well placed to handle adverse developments. Market risk levels are relatively low and capital ratios remain comfortably above international standards. The prospect of an improvement in bank performance in 1999 will depend to a significant extent on whether the economy maintains the forecast level of moderate growth during the rest of the year.

Appendix 1

Registered banks as at 31 December 1998

New Zealand incorporated banks

Registered bank	Owner(s)	Abbreviation
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
The National Bank of New Zealand Limited	Lloyds TSB Group plc	NBNZ
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
Banque Nationale de Paris S.A.	BNP
Citibank N.A.	CITI
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