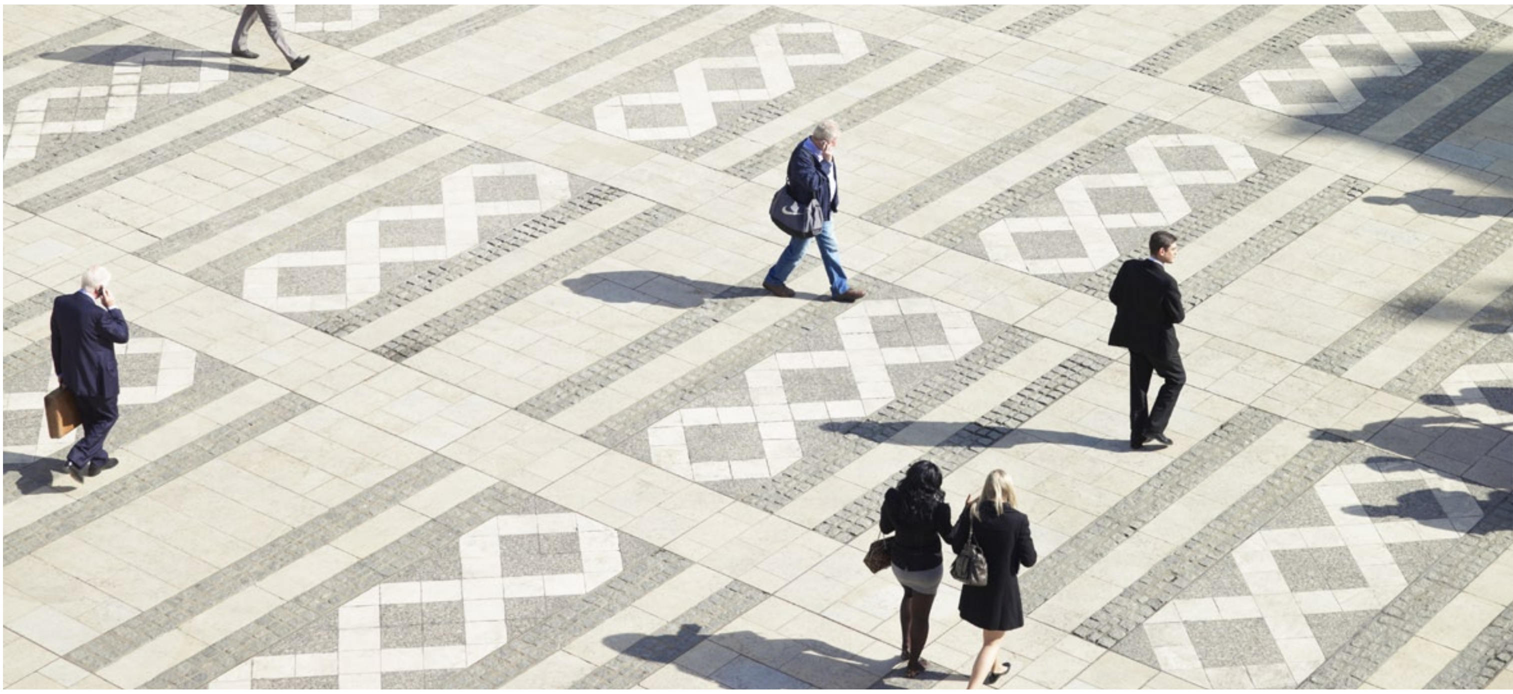
Banks return to normal, but not as we know it.

PwC analysis of the major banks' results for the second half of their 2010 financial years

Banking Perspectives

Major banks analysis February 2011

pwc



New Zealand's five major banks (ANZ National, ASB, Bank of New Zealand, Kiwibank and Westpac) have reported core earnings of $2.2bn in the second half of their 2010 financial years (2H10), down from $2.4bn for the first six months of their 2010 financial years (1H10). A strengthening in net interest income was offset by a reduction in other operating income and an increase in operating expenses. However, further reductions in bad debt charges have resulted in a rise in profit before tax from $1.6bn in 1H10 to $1.9bn in 2H10. All in all, a collective result which helps erase some of the scarring from 2009.

Profit before tax rose by $224m or 14%

Bad debt expense fell by $404m or 53%

Fragile lending growth at 0.7%

40% of mortgages now floating, compared with 14% in March 2007

Following the aftermath of the Global Financial Crisis (GFC) and resolution of the conduit tax disputes with the Inland Revenue, the major banks are returning to a period of stability or the “new normal”. However, this stability has some different features to those experienced pre-GFC.

These features include:

- A focus on core or ‘nouveau classic’ business
- A refocus on net interest margin
- Bad debt provisioning levels at elevated levels to that historically experienced during the early 2000s
- Increasing operating expenses as banks deal with a continued increase in the requirements of regulation and compliance through higher remuneration costs, business process redesign and other associated expenses
- A change in retail market preferences with a greater to an increased emphasis on floating rate residential mortgages as opposed to fixed.

This publication focuses on the major bank’s performances for 2H10 with reference to 1H10, and what we have seen is a period of solid profits, but not as we had previously known them.

The major banks have seen growth in their net interest income of $278 million in aggregate since 1H10, compared to a fairly flat position for the corresponding period ended 1H10 ($10 million reduction). This increase is somewhat surprising but nevertheless a positive sign given the pressures previously on their net interest margins as funding costs rocketed and their advances were progressively repriced. Clearly, we are now witnessing signs of the corrective actions taken by the banks coming through in their results and the reduction in the net interest margins experienced over the last 18 months has now been remedied.

Looking forward, maintaining this strength in the banks’ interest income could remain a challenge though. With limited balance sheet growth and the majority of loan repricing now completed, it’s unclear where the future income growth will come from.

In New Zealand, we were saved from the worst of the GFC as our banks largely avoided the excesses of scope and reach, undertaken by banks globally in growing their businesses. However, balance sheet growth has remained weak with the continued fragility in the lending market with advances to customers up by only 0.7% or $2bn. The lack of growth in the banks’ lending books is being driven by lack of demand in the market as both corporates and households look to cut outgoings and deleverage, or in the case of large corporates, further diversify their funding base. As a result, the steady source of interest income and profit growth over the last decade looks to be coming to an end for the banks, or at a minimum, a partial hiatus. Only a fast return to strong GDP growth will right this current trend.

Lack of interest income growth will also be compounded by continued price pressure on funding costs. While the increase in interest expense was lower in the current period, it is likely to continue increasing as competition for global funding increases and as pre-GFC long term funding prices at “new normal” spreads.

Basel III will also ensure competition for long term funding will not lessen. Even though its global phased introduction of Basel III does not start until 2013, banks are proactively positioning themselves to ensure compliance will be achieved ahead of this date, and are seeking long term funding which comes with higher costs.

Offsetting the increase in net interest income has been the continued reduction in transaction-based fee income. In the current period, fee income has dropped a further $165m to $800m as the full financial impact of the banks proactively managing their customer fee charges and lower transactional flows. Through the removal of certain transactional charges, the banks are endeavouring to create competitive advantages and to avoid negative customer sentiment. With the continued focus on transaction based fee income, banks will try to maintain strength in their net interest margin.

Good news continues to emerge from bad debt expenses, with the charge more than halving to $364m at 2H10 (1H10: $768m). The Everest of bad debt charges is seemingly in the background and we expect bad debt charges to continue to decrease, albeit at a more modest rate as the credit growth of the last decade continues to work its way through the banks’ books. However, with 90 day past due assets remaining high, it’s difficult to see the bad debt write-offs returning to pre-2007 levels in the short term.

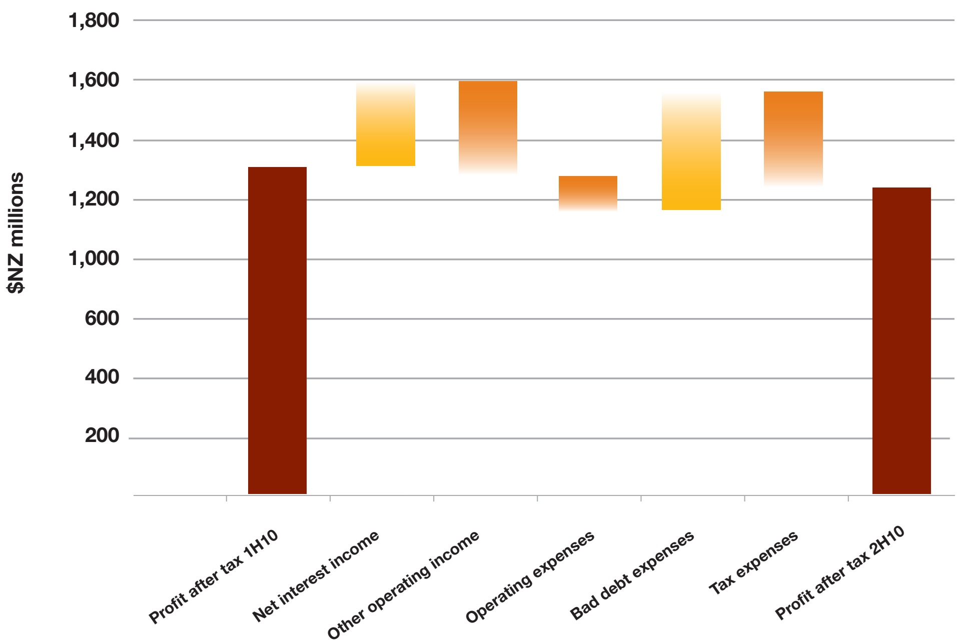
All of these trends suggest that the pressure on earning activities will remain, resulting in the banks continuing to focus on improving efficiencies. Tight labour markets and other inflationary pressures, in conjunction with increasing regulatory requirements, will make this tough going. But improving efficiencies is critical, and one of the reasons why the banks’ technology plans to generate efficiencies in back-office processes are so important.

The above has lead to a 14% increase in profit before tax for the banks when comparing 2H10 to 1H10. However the write-back from the settlement of the conduit tax disputes in the first half of the year has resulted in an overall reduction in profit after tax for the major banks causing return on equity to fall from 13.75% in 1H10 to 12.69% in 2H10

This strengthening in profit before tax represents a strong performance in a fragile local economy, although the majority of the risks now facing the banks are to the downside with expected flat or slow credit growth over the near term, no respite in funding costs, and no significant change in asset quality. This compares to last year as the banks were coming off a very low base, were still adjusting to the ‘new normal’, and had upside relating to re-pricing of customer loans and reductions in bad debt expenses.

Also of interest in looking at the results for 2H10 has been the composition of the banks’ residential mortgage books which has continued to move towards floating rates with only 60% of the mortgage book now fixed, compared to 86% in March 2007.

Figure 1: NZ major banks’ change in profit after tax



This wait-and-see attitude being adopted by residential borrowers, is giving the banks greater flexibility in managing their interest income in the short term. What will be of interest is how much of this change is structural, and how much is cyclical given New Zealand's historical interest in fixed rate residential mortgages.

As observed in the previous period, the banks have continued to mine the global debt markets with success backed by the strength of their underlying credit ratings. While we expect this to continue in the short term as the major banks continue to access the covered bond market, global competition for funding is growing and the various announcements of the Basel Committee around tighter liquidity regulations will only increase this global demand.

The proposed liquidity ratios would require significant increases globally in both liquid assets and long-dated funding in an attempt to remediate the ills that were brought to bear during the GFC. With the resulting global competition for long term funding, this will not only be a story about our major banks raising funds abroad, but also a story about the performance of New Zealand itself.

In addition, while the global transition to Basel III is more certain, particularly with the announcements over the long phase-in period for the liquidity and capital regulations, we shouldn't underestimate the tasks or risks facing the banks as we begin a new era for banking.

In an ever changing world with deleveraging on everyone's minds, and with capital and liquidity restrictions, the major banks will need to be more selective in finding innovative ways to connect with customers to drive growth in revenue and core earnings. One vehicle for this growth is through large investments in technology. This will help provide the depth and harnessing of customer information to better target marketing, perform credit assessment and assist in pricing for risk.

Banks' lending plateaus as corporates and households continue to deleverage.

Five majors' combined performance

Annual results

On an annual basis, the core earnings have remained largely unchanged at $4.6bn. This is reflected by small improvements in net interest income and other operating income being offset by rising operating expenses. This supports the premise that, on balance, the core operations of the banks remain somewhat resilient, no matter the economic conditions.

Yet, below core earnings, there have been dramatic improvements when comparing FY10 to FY09:

- $1bn or a 46% reduction in bad debt expenses, as major banks took considerable pain in FY09 getting their lending books in order
- $1.7bn or 65% reduction in tax expenses, due to the provision for the conduit disputes being raised in FY09, with excess provision being released in FY10.

The net effect of these items resulted in the overall statutory profits for the major banks in FY10 of $2.6bn , compared to an overall statutory earnings loss of $76m reported in FY09.

Semi-annual results

When comparing the results for 2H10 to 1H10, we see an 8% decrease in core earnings ($2.4bn to $2.2bn) and a 6% drop in statutory profits ($1.3bn to $1.2bn). The main drivers for these drops are:

- a 9% increase in net interest income as loans continue to reprice off the tight margins written pre-GFC
- a 25% decrease in other operating income resulting from the full period impact of the decreases in transaction based fee income and continued volatility in the fair value of financial instruments
- a 7% increase in operating expenses driven by increases in personnel and IT related costs
- a halving in bad debt expenses, which continues the fall seen in 1H10, demonstrating both the bad debt pains taken during FY09 and a strengthening economic environment
- tax expenses stepping back up to a more normal 32%, now that the financial impact of the conduit tax cases has washed through the banks' results.

An eight basis point rise in reported net interest margin driven by floating mortgage rate increases.

Figure 2: NZ major banks' combined performance ($NZ millions)

	2H10	1H10	2H10 v 1H10	FY10	FY09	FY10 v FY09
Interest income	9,500	9,117	4%	18,617	21,988	-15%
Interest expense	(6,167)	(6,062)	-2%	(12,229)	(15,681)	22%
Net interest income	3,333	3,055	9%	6,388	6,307	1%
Other operating income	981	1,302	-25%	2,283	2,249	2%
Operating expenses	(2,098)	(1,961)	-7%	(4,059)	(3,918)	-4%
Core earnings	2,216	2,396	-8%	4,612	4,638	-1%
Bad debt expenses	(364)	(768)	53%	(1,132)	(2,082)	46%
Profit before tax	1,852	1,628	14%	3,480	2,556	36%
Tax expenses	(598)	(298)	-101%	(896)	(2,595)	65%
Outside equity interest	(10)	(10)	0%	(20)	(37)	46%
Statutory profits/(losses)	1,244	1,320	-6%	2,564	(76)	3474%

The majors will undoubtedly respond on various fronts – new business models, a focus on key clients, improved productivity, new niche markets, new pricing – to preserve their RoE in the "new normal".

Net interest income

The major banks' **net interest income has risen by $0.3bn to $3.3bn** in the current period, an increase of 9% since 1H10. This is impressive considering the limited growth seen in the lending books. It represents an average 8bps increase in the major banks' reported net interest margin since 1H10. The increase in the net interest margin for the major banks is higher than experienced by the Australian banks, who reported a 5bps lift since 1H10, albeit that New Zealand's absolute net interest margin is still below their Australian counterparts.

The increase in the New Zealand banks' net interest margin has been driven by a 4% increase in interest income, with only a 2% increase in interest expense. So, the major banks have managed to increase the interest earned on their lending above the increase seen on their funding interest costs.

While a strong result has been seen in the current period, this is unlikely to repeat as the repricing of lending ends and the upward pressure on the cost of wholesale funding continues to flow through, eating into the major banks' results.

The question is how aggressive will the major banks be to protect their interest margins with the fear of starting bank regulation discussions, like those seen in Australia?

Interest income

In the corporate world, where floating rates are the norm, the major banks are continuing to improve their pricing for risk on new and rolling loans. That said, further improvements may prove to be difficult as large corporates continue to access debt markets and bypass the banks' balance sheets.

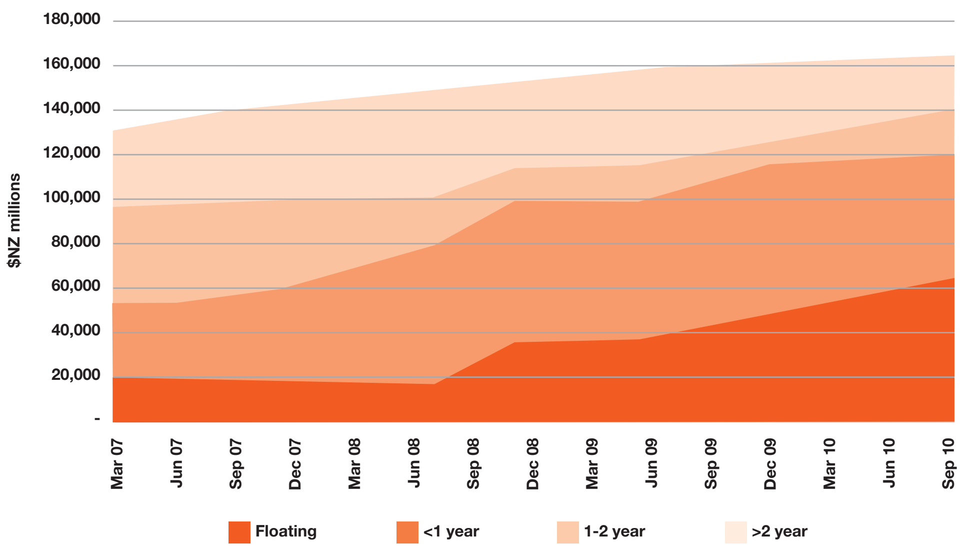
In the retail world, two factors have impacted interest income: borrower decisions on how to structure their loans (floating v fixed) and the interest rates being charged by the major banks.

The dramatic cuts seen in interest rates during the GFC, with many retail borrowers choosing to pay substantial fees to break their fixed rate mortgages, combined with the current uncertainty in the economic environment has lead to a wait-and-see attitude in New Zealand. This change in attitude has lead to a fundamental shift in the structure of the major banks' lending books.

In figure 3 you can see this has lead to floating rate mortgages changing from being a small part of the New Zealand banking environment, comprising only 14% of residential mortgage loans at March 2007, to playing a significant part in the banks' lending books with 40% of loans floating at September 2010.

This change in demand has impacted the interest rates being charged by the banks. As the yield curve continues to flatten, there have been interest rate increases for mortgages with maturities of one year or less and decreases for mortgages with longer maturities.

Figure 3: Maturities of residential mortgage lending performed by NZ registered banks



Source: Reserve Bank of New Zealand

The most significant increases are in floating rates. These rates are an interesting part of the normally competitive mortgage market. Adjustments to these rates are not typically announced with great fanfare and the rates themselves are not usually important in the decision over where to take out a home loan.

These combined changes have contributed to the increase in the interest income for the banks in the current period. The change to a higher percentage of floating rate mortgages will have broader implications for both the banks and the wider economy. This structural change will make work easier for the treasury function of the banks for managing interest rate risk.

This also makes managing inflation easier for the Reserve Bank as it is more likely that changes in the OCR will impact "Mum and Dad" New Zealand a lot quicker. This in turn, means that OCR increases can be deferred for longer.

Interest expense

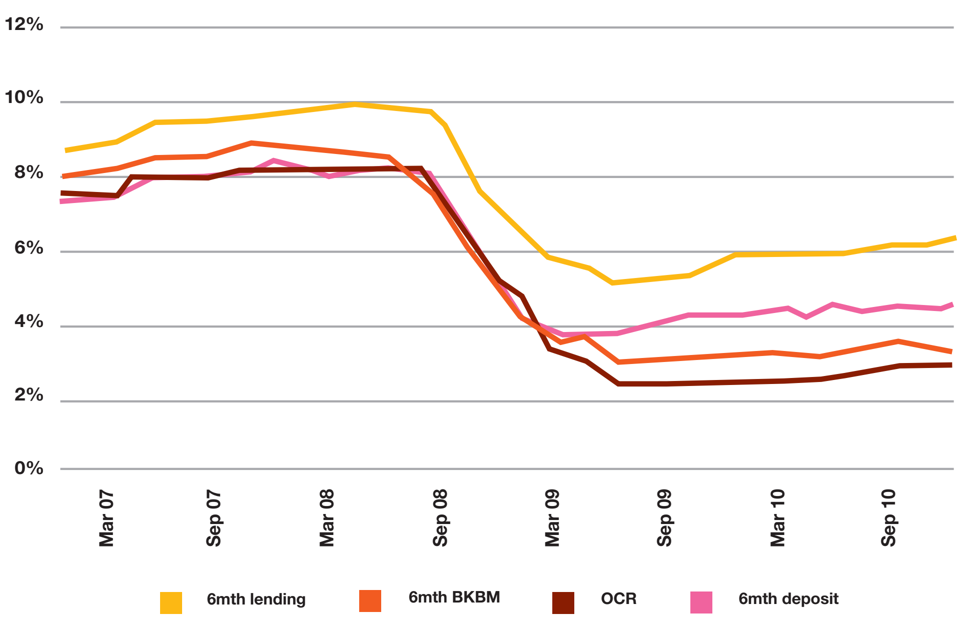
There has been a fundamental change to the factors impacting interest expense over the last three years, similar to interest income.

In figure 4 you can see banks used to borrow from the public below wholesale rates and lend above wholesale funding rates in the retail market. Yet, due to the disruption in the short term debt markets caused by the GFC and the liquidity requirements brought in by the Reserve Bank, bank retail borrowing rates have been forced above wholesale funding rates, in turn lifting lending rates as banks seek to limit the damage on their interest spreads.

The resulting retail deposit war amongst the majors has caused some of the increases seen in interest expense. Also in figure 4, you can see the term deposit rates tracked closely to the OCR prior to 2009. As the deposit war intensified, the spread between these rates increased to around 2% in March 2010. Recently, this deposit war has reached a stalemate, with spreads reducing to around 1.7% and retail deposit market share stabilising amongst the banks.

In wholesale funding, the spreads have also stabilised at levels well above those seen pre-GFC. As the major banks' funding continues to reprice onto these higher spreads, the interest expense on wholesale funding will continue to rise. While the major banks continue to use different products to ensure the funding markets remain open, the level of competition, both domestically and internationally, means that we do not expect any respite in this area.

Figure 4: Six month interest rates available in the NZ market



Source: Reserve Bank of New Zealand

Other income and expenditure

As in previous periods, the movement in the net interest income is only a part of the story of the major banks' results.

Other operating income

Other operating income continues to remain volatile, as seen over the last 18 months, reducing in the last six months by $321m to $981m, a reduction of 25%. This reduction is due mainly to decreases in fee income and in the change in value of financial instruments held at fair value.

The fees charged by the major banks continue the descent seen in 1H10, dropping by a further $165m, or 17%, in the current period. As well as falling transactional volumes, fees remain under pressure both from a commercial viewpoint, where some major banks have started to advertise their low fees, and from a political perspective. This continued drop bucks the long-term trend where the banks have been looking to diversify their income away from traditional net interest income, and indicates that banks will once again focus more on their core revenue stream.

It would be unrealistic for us to expect any material upside to the major banks' customers as a result of this. The major banks have shareholders and, like all shareholders, they require a return on the equity they have invested.

A lot of the volatility seen in other operating income has also come from the fair value movements in financial instruments held by the major banks. The $87m gain posted in the first half of the year has, to some extent, been reversed with a $47m loss in the second half of the year. While the interest rate market has calmed somewhat since the GFC, the New Zealand dollar continues to be volatile. As long as uncertainty remains in the global economy, we expect this volatility to continue.

Operating expenses

The major banks' operating expenses have spiked up in 2H10 rising 7%, or $137m, to $2,098m. Some of this growth has come from increases in the payroll expenses for the banks. This is likely to be driven by the people needed to address the operational issues currently facing the major banks, ranging from new regulations to aging computer systems. There will also be an element of costs relating to the recent rebranding of two of the major banks. Going forward, the GST hike will also bring upwards pressure on the bank's operating costs.

There is a continued focus on the operating expenses incurred by the banks. While we recognise the extra burdens being incurred, this remains an area with significant potential to improve the returns delivered to the shareholders, thereby reducing earning pressures felt in other areas. As always, there is a fine line to ensure customer satisfaction is not damaged, nor regulatory compliance weakened through cost cutting initiatives.

Tax expenses

The effective tax rate for the major banks has returned to a level of around 32% more in line with the statutory tax rate, after the turbulence caused by the settlement of the conduit tax cases with the Inland Revenue.

Pressure on fee income likely to be recouped through other revenue sources.

Funding

The cumulative funding book of the major banks has increased in the current period by $2bn to $301bn as the major banks fund the increase in their lending portfolios.

Change of focus for banks

The focus for the banks is no longer the liquidity rules of the Reserve Bank, which are now well established and incorporated into internal policies. The focus is now on ensuring the long term funding of the banks remains well positioned in this globally competitive market.

While the heat appears to have come off in the retail deposit war, no bank wants to step down and risk losing market share. So, deposits from customers held by the major banks have increased by $4bn, or 3%, in the current period, repeating the $4bn increase seen in the first half of the year.

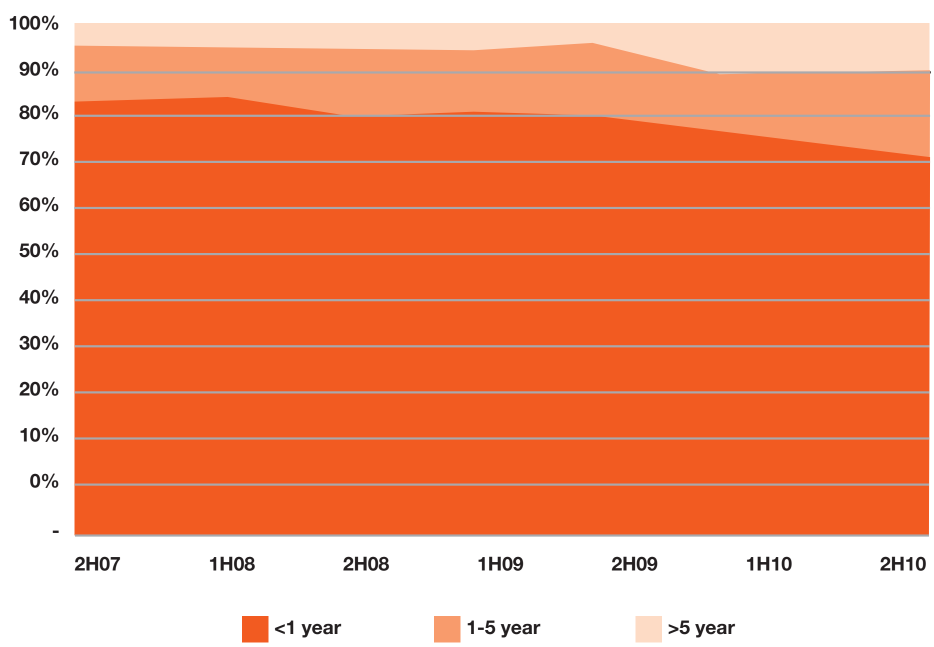
While being an area of focus for banks at the moment, the major banks' non-retail funding issued to the market through money market deposits, bond, notes or subordinated debt has fallen by $4bn.

Looking at the maturities of the total funding book including retail deposits, in figure 5, you will see short term funding is continuing to be replaced by medium term debt.

Success in international debt markets

The major banks have been successful in the international debt markets. This continued success is because New Zealand Inc. and our major banks are seen as safe investments by global debt investors and is also supported by the Reserve Bank's stance on the funding options available, including covered bonds, private placements and Rule 144A offerings, which caters for appropriate funding structures for the banks.

Figure 5: Relative maturities of funding for the NZ major banks



Covered bonds – the new kid on the block

Covered bonds, giving investors first security over a pool of assets in the event of default by the issuer, have recently seen uptake in New Zealand. The Reserve Bank, while in support of the development of this funding mechanism, has announced their use is limited to 10% of total assets. Banks have begun to use this source of funding, even with this limit, to continue to diversify their funding base and further reduce their funding risk.

The banks will have to balance the use of this lower cost funding with the knock-on impact on their credit ratings as assets are effectively removed from the general security pool.

In Australia, the government in conjunction with APRA, has introduced covered bonds as a funding option for the Australian banks.

To counteract this additional source of funding for the New Zealand market, there has been a noticeable decrease in the carry-trade. This is where money is borrowed in low-yield countries, such as Japan, and invested in high-yield countries, such as New Zealand. This form of funding has fallen away as the Australian interest rate has grown beyond that of New Zealand, relocating the carry-trade across the Tasman.

Lending

The 0.7% increase in the bank's gross lending book, from $277bn at 1H10 to $279bn at 2H10, suggests the major banks have navigated through the challenges discussed in the last edition of Banking Perspectives. Yet when you look at the underlying portfolios in figure 6, a different picture emerges.

The **previous robust household residential lending showed only a 0.9% increase** in 2H10 from $156.5bn to $157.8bn. In past years, this class of lending consistently produced semi-annual growth of between 2% and 8%, even in the midst of the GFC. The fall away from the previous growth range has been caused by the deleveraging occurring in the household sector.

The rather less predictable corporate lending halted the 4.6% decrease seen in 1H10 (a reduction of $5.7bn period on period), posting a 0.5% increase in 2H10 (a growth of $0.5bn period on period). This movement in corporate lending is consistent with the 3.7% decline in business credit experienced in Australia in FY10.

The **typical large corporate has now diversified its funding base** or has made business decisions which have enabled debt to be paid down. It is likely that these larger corporates will continue to access the public and private debt markets, further reducing their reliance on the banks, but making further credit available to those corporates that rely solely on bank funding. The take-up of this available credit may not be immediate however with recent reports suggesting that the majority of business reinvestment is still six months away.

Looking into the industries lent to by registered banks in New Zealand (figure 7), you will see the majority of lending is to the household sector, as you would expect. The bulk of the remainder is made up of lending to agriculture and property investors. Together, these three sectors have driven the growth seen in New Zealand banks' lending portfolios up $41bn to $279bn over the last three years, a staggering 17% growth. This now constitutes 75% of the total lending by registered banks in New Zealand.

Figure 6: NZ major banks' lending portfolios (by class)

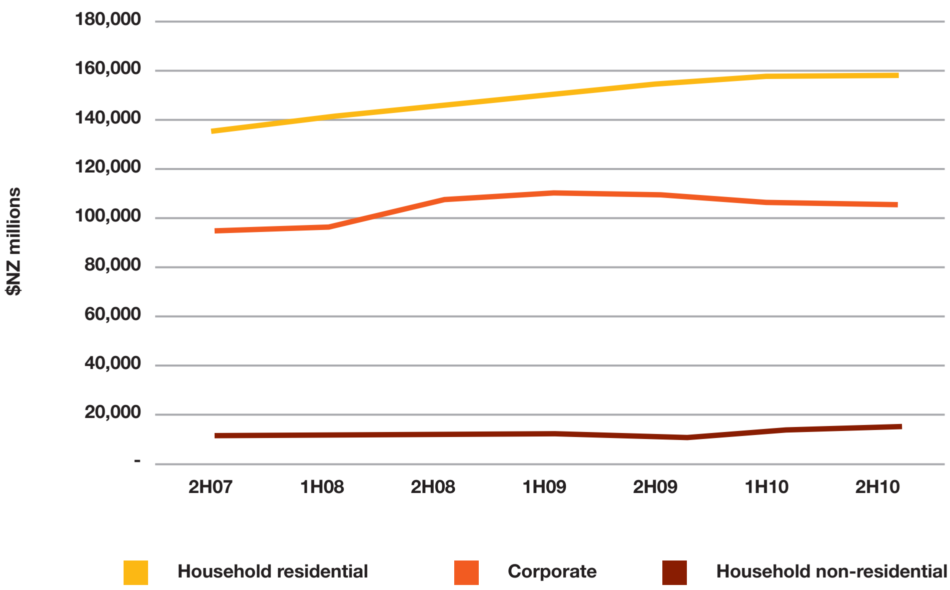


Figure 8 (next page) shows the level of growth seen by these industries – household residential grew by $24bn or 17%, agriculture by $14bn or 42% and property by $3bn or 13%.

The growth in each of these three sectors was driven by the asset price inflation seen throughout New Zealand. Significant investments were made either directly or indirectly into each of these industries to make capital gains.

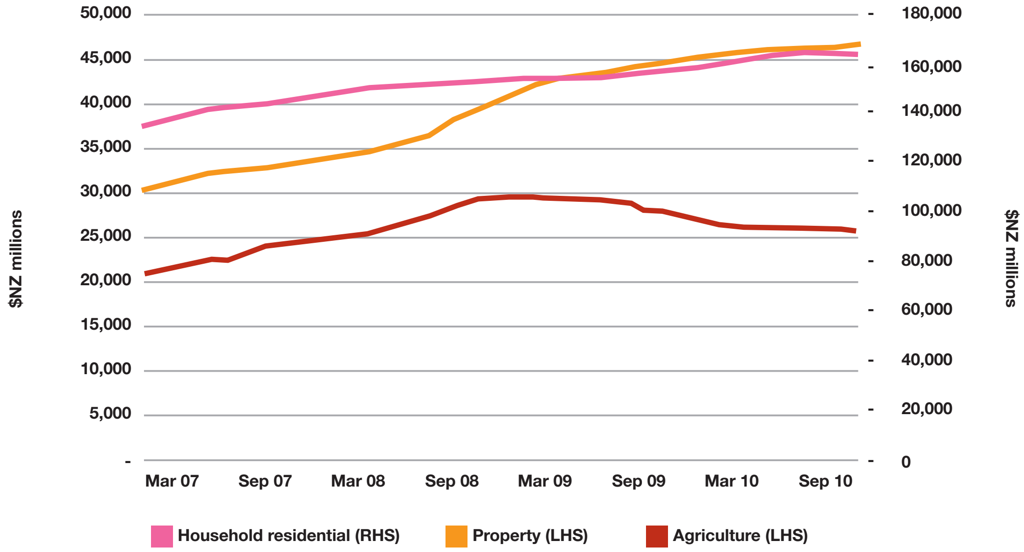
While the property bubble in New Zealand did not burst in the same way as in the United States of America, it certainly deflated, leaving behind investments of a very different nature and in some cases problematic loans. These industries became less attractive, causing their growth to tail off or decrease, with a resultant impact on the major banks' lending portfolios.The news recently has been about New Zealand deleveraging. Against this backdrop, the banks have performed strongly to record any growth in their lending book. While we acknowledge that any deleveraging takes time, especially in the residential market, we would not expect the first step of this to be an increase in borrowing levels.

Figure 7: NZ registered banks credit advanced by industry

	Sept 10
Household residential	52%
Agriculture	15%
Property	8%
Registered banks	4%
Trade (wholesale and retail)	3%
Other financial institutions	2%
Household non-residential	2%
Other	14%

Source: Reserve Bank of New Zealand

Figure 8: NZ Registered banks' lending portfolio (by industry)



Source: Reserve Bank of New Zealand

What is the future of the banks' lending portfolios?

New Zealanders are generally well serviced by banks and looking to cut their spending and reduce their borrowings. In addition the secondary lending market is now relatively small, meaning there are limited opportunities for banks to grow their market share. Some banks are trying to go down this route with offerings of equity release mortgages and of smaller asset finance deals. These approaches bring new risks with them and are unlikely to bring significant balance sheet growth.

So, unless there is a dramatic change in the economy in the short term, significant balance sheet growth doesn't seem realistic or achievable over the next 12 months. It might not even be desirable.

The most likely way another bout of significant balance sheet growth will occur would be through economic growth or asset inflation, causing security values to increase. Asset inflation may not be beneficial to New Zealand or the New Zealand banks, as while they have emerged relatively well when compared to their global counterparts, they might not find themselves in such a good position should another asset bubble emerge then subsequently burst.

Therefore, with overall systems growth seemingly out of the question in the short term, the major banks may look to obtain balance sheet growth by winning market share. The most obvious approach for this would be through lower lending rates.

While this would be good for the New Zealand public, the major banks would feel the pain through a reduction in their earnings as was shown when the banks last engaged in a lending price war a few years ago.

With the recent lessons on pricing credit still being felt by the banking sector as a whole, it is unlikely that we will see significant pricing wars in the short-term, more like calculated battles or campaigns to grow market share or secure high credit quality customers.

We also expect banks will attempt to differentiate themselves from the crowd using other approaches such as cutting edge technology and innovative customer experiences. While we have seen some new tactics in this area, we expect to see many more as the banks look to increase their brand loyalty with their customers.

Asset quality

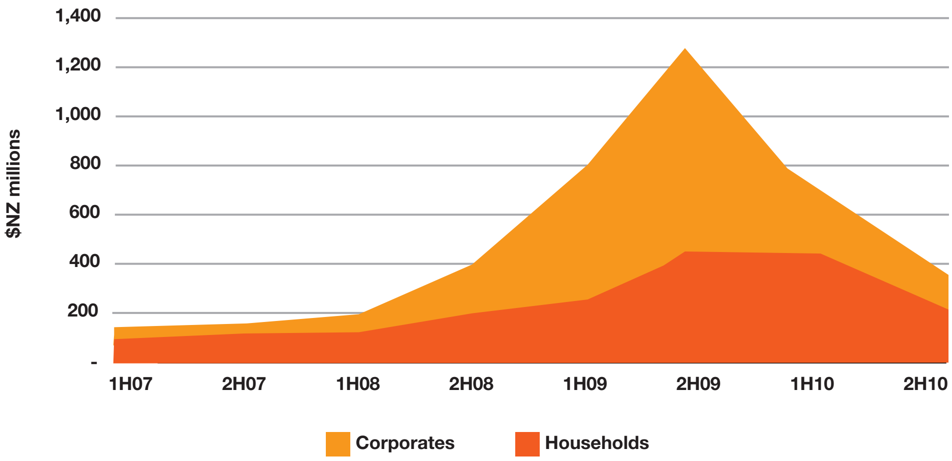
Bad debt expenses have continued to fall since 1H10 with a further reduction of $404m or 53%. The major banks appear to have successfully scaled Everest, in both the household and non-household sectors, and are now descending to the lowlands, as demonstrated in figure 9.

The aggregated bad debt charge for 2H10 of $364m represents 13bps of gross lending down from the 28bps experienced in 1H10. **We expect the bad debt charge to continue to decrease,** although at a lower rate, as the economic recovery continues to be reflected in underlying portfolio performance and household losses take time to flow through the credit cycle. However, this ratio of bad debt expense to gross lending is still above the levels seen pre-GFC, which was in the single figures. We do not expect the ratio to reduce back to this level until a strong rebound is seen in both the property market and in the New Zealand economy as a whole.

If you look into the bad debt expense in more detail, you will notice both household and non-household charges have roughly halved. The household charge has reduced from $453m in 1H10 to $199m in 2H10 and the non-household charge fell from $315m to $164m.

While the drop in the bad debt expense has been significant and speedy, **we should not underestimate the magnitude of risk that remains** in the lending books of the banks. The GFC (i.e. mid-2007 to mid-2009) was the culmination of events and trends which occurred over the last 10 years. This resulted in an unprecedented build-up in global leverage, in both the financial and non-financial sectors (particularly households), and in the public sector of many economies. What took a considerable period to build up will most likely still be casting a shadow globally for a decade or more. Household indebtedness by its nature takes a long time to repair given household incomes tend to rise quite slowly.

Figure 9: NZ major banks: composition of bad debt expenses



This is illustrated in New Zealand by the continued size of the 90-day past due assets. While they are down from their high of $1.4bn at 1H09, they have stabilised at $1.3bn in the current period. This is well above their pre-GFC norm of circa $0.3bn to $0.4bn. While the story is far from consistent amongst the major banks, with percentage changes for 2H10 ranging between a decrease of -31% and an increase of 43%, we consider the stabilising of the 90-day past due assets to be a leading factor of the stabilising of the bad debt expense.

The continuing good news in bad debt expenses in the current period, is joined by a favourable trend in the balance sheet with loan loss provisions held by the major banks have dropping marginally by $80m to $2.95bn. As with the bad debt expense in 1H10, the non-household provision has lead the way with the household provision staying flat. Yet the non-household loan loss provision as a proportion of non-household lending is still significantly above the household equivalent, as is seen in figure 10.

The collective provisions held by the major banks have dropped by $163m to $1.8bn in the current period, whereas the individually assessed provisions have increased by $83m to $1.2bn. This reflects the current stage of the credit cycle: collective provisions are established for those bad debts already incurred but not yet identified; and as the loans are subsequently identified, the collective provisions are converted into individually assessed provisions.

Using the same logic, we expect the collective provisions to begin to stabilise as bad debt write-offs match new provisions and as the data used for calculating the collective provision fully reflects the improvements made to the internal credit processes within the banks.

Impaired assets have continued their increase by another $200m to just over $4bn at 2H10. This is understandable as the continued uncertainty in the business environment keeps the internal credit ratings higher, as banks look to remain prudent in respect of their approach to credit risk and exit strategies still remain constrained. As confidence returns over the next 12 months, we expect to see some reductions in these assets, but the impaired asset levels will still remain above the pre-GFC norm. Some of this improvement may be beginning to be reflected in the figures as the growth in the impaired assets slowed from the $937m increase experienced in 1H10.

One element of the loan loss provisions not explicitly seen in the financial statements is the economic overlays. These overlays were applied to the collective provisions of the major banks during the GFC to adjust for the fact that the mathematical formulae used were backward-looking and therefore may not be taking full account of the current economic conditions (the lagging effect). It is likely that as we stabilise at the new normal, the levels of these overlays will be reassessed, potentially leading to releases from the overall provision figure.

Figure 10: NZ major banks: basis point loan loss provisions

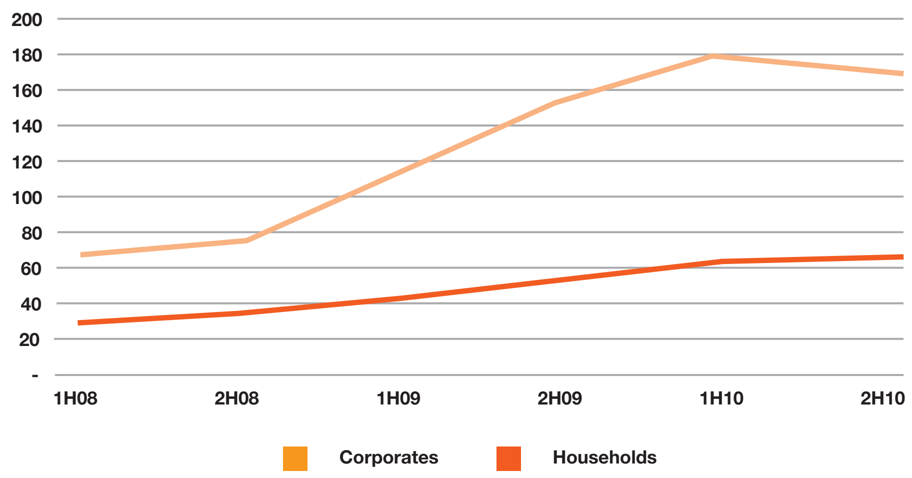
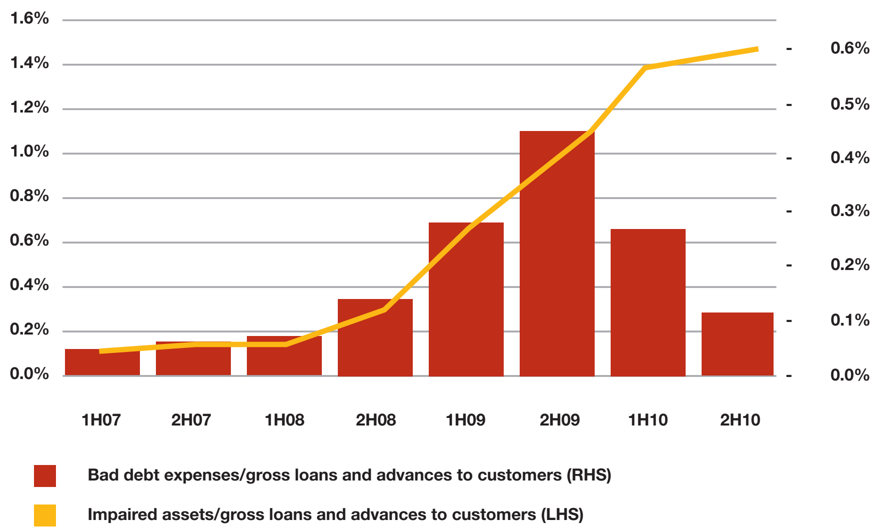
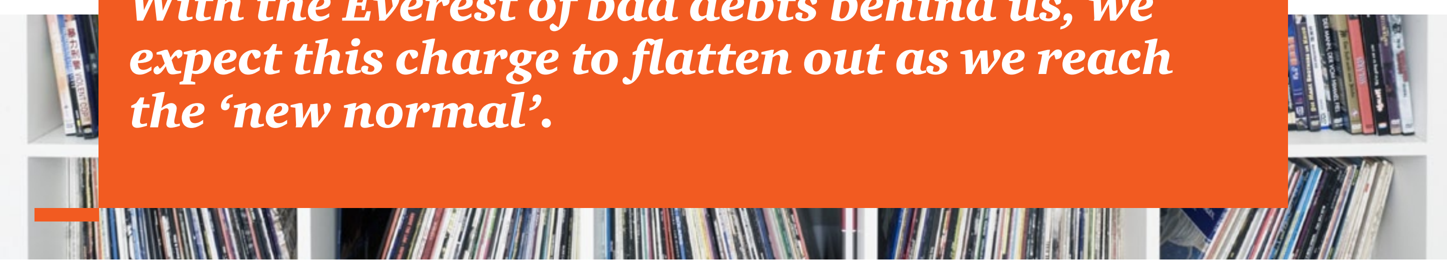


Figure 11: NZ major banks: impaired assets and bad debt expenses



Source: Reserve Bank of New Zealand



With the Everest of bad debts behind us, we expect this charge to flatten out as we reach the 'new normal'.

Capital adequacy

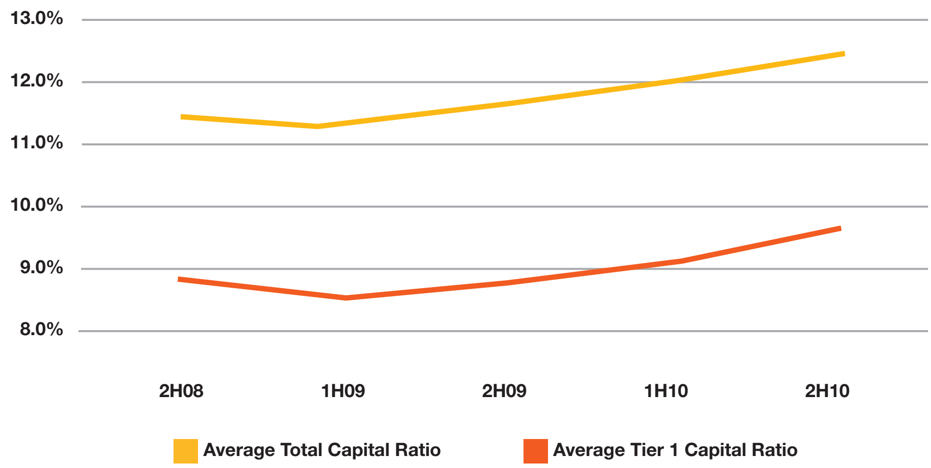
The major banks continue to comply with the Basel II capital ratio requirements with significant headroom. Yet, as you can see from figure 12, they are **continuing to grow this headroom in anticipation of Basel III** typically through earnings' retention but also aided by lower credit growth.

Basel III is set to redraw the global banking landscape. It will have a profound impact on profitability and may force many banks globally to transform their business models. It will require the major New Zealand banks to undertake additional process and system changes. In anticipation of these changes, the majors have been building their capital reserves.

The key points of the Basel III global framework are:

- All banks must hold a minimum common equity (common shares and retained earnings less deductions – some of which were previously taken against lower forms of capital) of 4.5% of risk weighted assets, and this may be supplemented by Pillar 2 requirements.
- A "conservation buffer" of 2.5%, above the 4.5% minimum, to absorb losses during periods of financial and economic stress. Drawing on this buffer during times of stress will result in constraints on earnings distributions.
- A "counter cyclical buffer" ranging from 0 – 2.5% of common equity, determined by local regulators as required, for instance in times of excessive credit growth.

Figure 12: Average capital ratios of major banks



The result of all these measures is that **the new common equity (core tier 1) ratio will be at least 7%**. In addition, the banks will want to hold their own internal buffer, over and above this regulatory minimum, as part of normal risk management, particularly as the sanctions for going under 7% will involve restrictions on the ability to pay dividends.

As well as these requirements for common equity, the banks are also required to hold tier 1 capital to a minimum of 8.5% (i.e. including the conservation buffer, and of which at least 7% is common equity) and total capital (i.e. tier 1 and tier 2) of at least 10.5%.

Our expectation is that the recent increases in capital by the banks will mean that the banks will be largely compliant with the Basel III tier 1 and total capital ratios minimums. However, we do expect that further capital will be required to be held by the banks to give a prudential buffer above the Basel III ratios.

Interestingly the Basel Committee has announced that a study showed that there would have been a capital shortfall of €577bn if this 7% requirement had been applied for the world's top 94 internationally active banks in December 2009.

It is uncertain what the Reserve Bank's revised capital adequacy framework will look like. We have already seen variations from the global requirements in Switzerland where capital requirements have been announced in the high teens. Historically, the Reserve Bank has included prudential supervision adjustments to the capital adequacy calculations and so we expect tailoring to be made in the New Zealand market.

Commercially, the global markets have already started to price the impact of Basel III, with instruments such as credit default swaps already seeming to pay more attention to capital adequacy under Basel III rather than current standards. We expect the New Zealand major banks will begin to articulate their strategies in respect of Basel III and start to publish Basel III figures in order to market themselves in the global debt markets.

The phased introduction of the Basel III framework does not commence until January 2013 and its full effects will not be felt before January 2019, when the new regime's transitional period ends. Nonetheless, it is critical that banks start to reset their business models now to adapt to the new capital and liquidity standards. Therefore the views of Reserve Bank will be awaited so that the details of these plans can be refined.

As under Basel II, the banks' focus will be on risk weighted asset (RWA) mitigation and optimisation. This will mainly centre on improvements in data quality and changes to the models used, although there may some work in the treasury space to reduce counterparty credit risk.

The Basel Committee has also designed new liquidity ratios to ensure banks' funding is on a more sustainable, long-term basis, thus enabling better liquidity during times of market turbulence:

- The net stable funding requirement (NSFR) to ensure better duration matching of assets and liabilities.
- The liquidity coverage ratio (LCR) to ensure banks hold sufficient high quality assets to survive periods of severe market stress.

Globally these ratios are seen as very challenging for banks and have been described by some international banks as unworkable. The NSFR is a challenge because it allows minimal funding of assets through short-term liabilities, whereas the banks have, in the years leading up to the GFC, relied quite heavily on short-term funding. The LCR is a challenge because there is a relatively small pool of high quality liquid assets available during periods of market stress - being government securities. With the adoption of BS13 (the Reserve Bank's policy on liquidity) in New Zealand, the major banks will have a head start in meeting these requirements.

Overall the impact of these reforms is likely to result in extra capital requirements for each of the banks. Furthermore, the high level of low yielding liquid assets (qualifying liquid assets are in short supply) will depress returns and soak up funding. This in turn will increase the demand for funding, which is already in short supply, and hence limit growth in the credit market. Therefore, the pressure on net interest margins will remain.

These concerns add to those already raised in the lending section but interestingly, this extra regulation actually increases the barriers to entry for potential competition, and hence protects our major banks. This provides an additional angle to the political discussions occurring in Australia and increases the likelihood of them repeating in this country.

Basel III may squeeze credit supply as banks comply with planned capital and liquidity requirements.

Other regulatory changes

Anti-money laundering (AML)

On 9 August 2010 the Ministry of Justice (MOJ) released the Regulations and Codes of Practice Consultation Document. This is the prelude to finalising regulations that will provide the detail to the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 ("Act"). The Act and regulations will have a significant impact on financial institutions in New Zealand and how they operate. There were few surprises in this document following the discussion document, released in February 2010, and the lengthy consultation period undertaken so far.

On 15 November 2010, the MOJ announced that Cabinet had made decisions in relation to what the regulations supporting the Act should cover. The next steps are for the MOJ to draft the regulations and for Cabinet to approve them. We expect this to take place towards the end of February with final approval from the Governor General in mid-March. Following this there is expected to be a two year transition period.

Under the Act, reporting entities will have a range of responsibilities but the whole regime is intended to be underpinned by a risk-based approach largely allowing businesses to make decisions about how to best manage and mitigate their money laundering and terrorist financing risk. The MOJ has tried, where it deems appropriate, to set thresholds to align with Australia to achieve trans-Tasman harmonisation, comply with the Financial Action Task Force recommendations and to minimise (as far as possible) compliance costs to industry.

The new regime will have a significant impact on those entities designated as "reporting entities". This definition essentially covers all financial organisations. Overseas experience shows that implementing this type of regime will often take longer and cost more than originally anticipated. The major banks have instigated projects to enable them to comply with these requirements with significant costs expected. The key tasks and issues New Zealand banks are dealing with in moving to the new regime are:

- performing a gap analysis between what will be required under the Act and what banks are currently doing
- determining the systems and technology obligations to meet the obligations of the legislation and managing and implementing those requirements
- aligning the requirements across the various business units in a bank including not only the core banking activities, but also the provision of any other financial services products such as insurance or funds as well as the back office functions
- training the staff in the relevant requirements
- educating the bank customers to deal with the impacts they will face under the new requirements
- continuing strong engagement with the Reserve Bank's AML team and the NZ Bankers' Association.

International financial reporting standards (IFRS)

On 31 January 2011, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) published a proposed joint approach on credit impairment of loans and other financial assets managed in an open portfolio. This is a "supplementary document" to the exposure draft published last year.

The accounting for credit losses determines how non-performing loans that are measured under amortised cost should be impaired. The **current accounting standards apply an 'incurred loss' approach** to loan loss provisions, whereby specific evidence of a loss is required before a loan can be impaired. This approach was criticised during the GFC for preventing entities from accounting for expected losses early enough.

The **proposal is an impairment model based on accounting for expected losses**, providing a more forward looking approach to accounting for credit losses. The actual proposal involves the recognition of lifetime expected credit losses using a time proportionate approach for a 'good book' (adjusted to ensure the good book allowance is always sufficient to cover expected losses in the foreseeable future, but not less than 12 months) and immediate recognition of lifetime expected losses for a 'bad book'. The intention is for this proposal to be finalised within IFRS 9 by 30 June 2011 with mandatory application for periods beginning on or after 1 January 2013.

Some key considerations for banks in relation to this proposal are:

- How will this impairment model calculation compare to the regulatory calculations prepared in accordance with Basel?
- The general expectation would be that transitioning from an incurred loss model to an expected loss model would result in a step up in the impairment provisioning level.
- Time proportionate does not necessarily mean straight line.
- Where do you draw the line as to what loans stay in 'good book' versus the loans that fall into 'bad book'?
- What potential operational difficulties will exist in obtaining the appropriate information and performing the calculations required under the proposed model?

OTC derivative market reform

The G20 believes that the counterparty credit risk associated with the over the counter (OTC) derivative market was a key factor in the GFC. The G20 wishes to promote a greater level of transparency to enable regulators to take actions to mitigate the risk of systemic threats to the economy which might arise from unobserved excessive risk taking. That view has set in motion a change agenda that seeks to revolutionise the OTC derivative market.

The G20 has communicated that all standardised OTC derivative contracts should be traded on exchanges or electronic platforms, where appropriate, and cleared though central counterparties by the end of 2012. OTC derivative contracts should be reported to trade repositories and non-centrally cleared contracts should be subject to higher capital requirements.

Unfortunately, the changes to the OTC derivative market are being implemented on a country-by-country basis across the G20. This will lead to some confusion and differences in form and timing over the next 12-24 months, the period that it is expected to take for the majority of OTC derivatives within the G20 to move to a centrally cleared model.

We believe that these changes will lead to:

- standardisation of derivative contracts
- changing costs of derivatives including margining requirements which will lead to changes to fair value measurement methodologies
- potentially, changes to other financial markets including increasing levels of embedding derivatives within other financial instruments, such as debt funding.

The impact in New Zealand will depend, to a large extent, on the approach adopted in Australia as this is the most significant G20 market associated with our banking system.

Contacts

Sam Shuttleworth
Partner

Financial Services
+64 9 355 8119
sam.shuttleworth@nz.pwc.com

Paul Skillender
Partner

Financial Services
+64 9 355 8004
paul.skillender@nz.pwc.com

Karl Deutschle
Director

Financial Services
+64 9 355 8067
karl.p.deutschle@nz.pwc.com

Matt Hearley
Senior Manager

Financial Services
+64 9 355 8531
matthew.c.hearley@nz.pwc.com

pwc.co.nz

Key Banking Statistics – Full Year 2010
$NZ millions

	BNZ			WBC (i)			CBA (ii)			ANZ (iii)			Kiwibank		
	6 months	6 months	6 months	6 months	6 months	6 months	6 months	6 months	6 months	6 months	6 months	6 months	6 months	6 months	6 months
	2H10	1H10	2H09	2H10	1H10	2H09	2H10	1H10	2H09	2H10	1H10	2H09	2H10	1H10	2H09
Income statement															
Interest income	1,759	1,688	1,729	1,977	1,995	2,062	2,093	2,094	2,329	3,375	3,072	3,246	296	268	286
Interest expense	(1,100)	(1,066)	(1,082)	(1,261)	(1,301)	(1,353)	(1,550)	(1,568)	(1,816)	(2,027)	(1,925)	(2,134)	(229)	(202)	(202)
Net interest income	659	622	647	716	694	709	543	526	513	1,348	1,147	1,112	67	66	84
Other operating income	140	221	(36)	253	279	241	184	293	295	324	421	241	80	88	75
Operating expenses	(414)	(404)	(405)	(413)	(375)	(425)	(346)	(323)	(299)	(817)	(748)	(740)	(108)	(111)	(105)
Core earnings	385	439	206	556	598	525	381	496	509	855	820	613	39	43	54
Impairment losses on credit exposures	(99)	(88)	(91)	(112)	(220)	(352)	(14)	(125)	(220)	(131)	(325)	(595)	(8)	(10)	(8)
Total operating profit before income tax expense	286	351	115	444	378	173	367	371	289	724	495	18	31	33	46
Income tax expense	(99)	64	(696)	(137)	77	(908)	(110)	(320)	(123)	(243)	(109)	(246)	(9)	(10)	(8)
Net profit to minorities	0	0	0	(2)	(1)	(1)	(8)	(9)	(16)	0	0	0	0	0	0
Net profit attributable to shareholders	187	415	(581)	305	454	(736)	249	42	150	481	386	(228)	22	23	38
Balance sheet															
Trading securities	3,231	3,221	3,662	5,674	6,854	5,442	6,026	5,616	6,773	8,967	8,216	5,679	1,216	1,769	1,424
Loans and advances to customers	54,986	54,647	55,142	56,738	56,215	55,592	58,295	58,121	58,846	96,015	95,689	97,024	10,419	9,726	8,492
Derivative financial instruments	5,650	4,770	5,918	5,685	4,938	6,328	1,979	1,979	2,517	10,854	9,087	11,015	46	52	49
Total assets	69,647	67,268	69,862	72,783	72,159	73,444	69,941	70,554	72,056	127,029	123,504	126,314	12,238	12,018	10,371
Due to central bank and other financial institutions	1,575	1,786	3,892	794	597	485	311	396	312	1,811	1,045	3,228	164	581	317
Other money market deposits / bonds and notes	21,655	20,293	18,345	17,341	19,236	15,837	17,393	19,626	20,267	26,846	27,151	27,140	795	884	913
Deposits from customers	28,663	27,909	27,233	36,118	34,508	32,944	31,202	30,541	29,376	59,743	59,270	59,931	10,295	9,740	8,266
Derivative financial instruments	6,421	5,489	7,643	5,501	4,938	6,970	2,723	2,706	4,239	10,727	9,109	10,974	203	216	304
Amounts due to related parties	6,042	6,744	7,149	7,822	6,708	9,463	11,151	10,551	13,404	16,483	15,729	14,096	12	(1)	38
Subordinated debt	370	373	375	0	796	0	2,790	3,053	608	1,777	1,783	1,785	143	142	144
Total liabilities	65,645	63,293	66,117	68,655	67,772	69,539	66,122	66,882	68,631	119,208	116,119	118,999	11,649	11,597	10,016
Total shareholders equity	4,002	3,975	3,745	4,128	4,387	3,905	3,819	3,672	3,425	7,821	7,385	7,315	439	421	355
Asset quality & provisioning															
Gross loans and advances	55,369	55,029	55,428	57,568	56,982	56,203	58,575	58,489	59,114	97,316	96,976	97,861	10,438	9,742	8,505
Gross other individually impaired assets	769	727	636	890	759	675	273	556	355	2,047	1,736	1,188	38	32	19
Gross impaired assets as a % of loans and advances	1.39%	1.32%	1.15%	1.55%	1.33%	1.20%	0.47%	0.95%	0.60%	2.10%	1.79%	1.21%	0.36%	0.33%	0.22%
Gross restructured assets	3	3	1	0	0	1	166	200	65	9	8	2	0	0	0
Gross other assets under administration	29	8	8	0	0	0	37	37	34	4	0	0	0	0	0
90 day past due assets	196	284	210	397	312	346	369	318	374	313	369	446	30	21	23
Allowance for impairment losses on individual financal assets	148	147	159	356	233	152	67	119	124	616	608	477	10	7	5
Individual assessed provision as a % of impaired assets	19.25%	20.22%	25.00%	40.00%	30.70%	22.52%	24.54%	21.40%	34.93%	30.09%	35.02%	40.15%	26.32%	21.88%	26.32%
Allowance for impairment losses on groups of financial assets	203	188	153	516	597	510	223	259	199	804	867	804	10	8	7
Bad debt charge as a % of loans and advances	0.18%	0.16%	0.16%	0.19%	0.39%	0.63%	0.02%	0.21%	0.37%	0.13%	0.34%	0.61%	0.08%	0.10%	0.09%

(i) Represents the aggregated results of the New Zealand banking operations of Westpac Banking Corporation.

(ii) Represents the aggregated results of the New Zealand banking operations of Commonwealth Bank of Australia including ASB Bank.

(iii) Represents the aggregated results of the New Zealand banking operations of Australia and New Zealand Banking Group including ANZ National Bank.