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New Zealand Bank Credit Ratings Remain Stable As Banks Navigate A Range Of Market Challenges

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New Zealand's banking landscape features 21 registered banks. Ten of them operate as branches of overseas-incorporated banks, and 11 as locally incorporated. New Zealand bank ratings are robust by international standards and with the exception of Rabobank New Zealand Ltd. and Bank of India (New Zealand) Ltd. (whose ratings and outlook are aligned with guarantor parents; see table 1), all other rating outlooks on New Zealand incorporated banks are stable. Despite the sound and relatively stable ratings, since the global financial crisis the banks have needed to navigate through a range a domestic and external issues that have generally brought on downward rating pressure for the banking system.

Table 1

Rating Summary Of Locally Incorporated Banks

At Nov. 14, 2012	Issuer credit rating
Locally incorporated banks	
ANZ Bank New Zealand Ltd.	AA-/Stable/A-1+
ASB Bank Ltd.	AA-/Stable/A-1+
Bank of Baroda (New Zealand) Ltd.	Not Rated
Bank of India (New Zealand) Ltd.	BBB-/Negative/A-3
Bank of New Zealand	AA-/Stable/A-1+
KiwiBank Ltd.	A+/Stable/A-1
Rabobank New Zealand Ltd.	AA/Negative/A-1+
Southland Building Society	Not Rated
The Co-operative Bank Ltd.	BBB-/Stable/A-3
TSB Bank Ltd.	BBB+/Stable/A-2
Westpac New Zealand Ltd.	AA-/Stable/A-1+

Banking System Remains Vulnerable To External Pressures

Similar to Australia, New Zealand's private sector is highly indebted, leaving it vulnerable to a downturn in global economic and financial market conditions. In our opinion, a severe downturn could result in downward pressure on a bank's stand-alone issuer credit ratings. However, underpinning the currently stable outlook is the growth of private sector savings relative to income levels, and the decline of private sector appetite for debt. These two factors reduce the vulnerability of households to deterioration in the operating environment. On a positive note, house prices in New Zealand have abated in an orderly manner in the past few years--more significantly than what has been observed in Australia, where property prices remain more inflated. This smooth process reduces the prospect that the New Zealand banks' asset qualities will be materially negatively affected by a sharp correction in housing prices. This said, an increase in buyer activity, supported by the low interest rate environment, has underpinned a recent modest rise in property prices house prices; and a sharp fall in housing prices remains a key risk for bank ratings in New Zealand.

Growth To Remain Low, For Longer

The low credit growth outlook is expected to limit profit growth for New Zealand's banks in the medium term. Although bank profitability has benefitted recently from some growth in net interest margins (reflecting a change in stance from the banks with respect to loan pricing, most notably their sharper position on pricing for risk; banks' increased willingness to pass on higher funding costs to borrowers; and a prevailing customer preference for high variable-margin loans through the downward trending interest rate cycle), and lower loan loss provisioning, competition is expected to escalate as banks compete for a smaller pool of available business. When combined with anticipated ongoing funding cost pressure, we expect this to have a constraining effect on overall profitability.

In our view, New Zealand's major banks are well placed to compete in the current operating environment. This opinion is underpinned by the stronger business franchises of the larger major New Zealand banks, and their superior underlying operating earnings, which benefit from greater economies of scale that afford them with a greater capacity to compete for the limited pool of new lending opportunities.

Table 2

Selected Statistics

	ANZBNZ	ASB	BNZ	WPAC NZ	Coop Bank	Kiwi Bank	TSB Bank
Reporting Period	31-Mar-12	30-Jun-12	31-Mar-12	31-Mar-12	31-Mar-12	30-Jun-12	31-Mar-12
Total assets (bil. NZ$)	115.31	63.54	71.72	67.88	1.45	14.74	5.16
Net interest income/average interest earning assets (%)	2.71	2.19	2.32	2.31	2.78	1.85	2.1
Non-interest expense/operating revenues (%)	47.06	42.8	42.7	44.31	85.69	61.34	40.24
Net interest income/operating revenues (%)	73.39	73.05	82.63	79.78	69.53	61.34	87.13
Core earnings/average adjusted assets (%)	1.13	1.1	0.88	0.91	0.39	0.6	0.97
Return on equity (%)	11.83	19.02	17.77	11.33	4.47	13.26	12.69
Core deposits/funding base (%)	68.82	68.51	55.07	64.3	92.77	83.97	98.94
Total loans/customer deposits (%)	136.45	136.55	175.14	153.77	99.8	109.87	59.12
Residential mortgage loans/total loans (%)	51.81	62.08	47.19	58.83	90.95	83.72	88.77
Gross nonperforming assets/customer loans (%)	2.16	0.98	1.29	1.86	0.68	0.96	0.43
New loan loss provisions/average customer loans (%)	0.22	0.09	0.1	0.35	0.14	0.29	0.13
Net charge off /averagae customer loans (%)	0.25	0.13	0.24	0.31	0.15	0.26	0.08
Loan loss reserves/gross nonperforming assets (%)	60.42	41.49	64.46	60.55	50.35	75.83	154.53
Total adjusted capital/total assets (%)	6.25	6.28	6.08	7.07	8.28	4.88	7.75
Tier 1 Capital ratio	10.85	11.70	9.59	11.70	17.20	10.40	15.42

Domestically Owned Banks Are Small Players With Limited Competitive Advantage

New Zealand's financial system is dominated by four major banks, who account for about 91% of total assets of all incorporated banks. The remaining small share of the market is made up by a large number of bank and non-bank financial service providers. New Zealand's domestically owned and locally incorporated banks are small market share players who largely compete across commoditized product and service segments in which they have limited competitive advantage over major banks. This provides limited scope for domestic banks to compete on factors other than price and underwriting standards, with customer service losing its luster as a compelling area of competitive advantage for retail-branch-focused local banks, particularly with respect to the technology-savvy younger customer set. Although the locally owned banks are able to generate sound net interest margins, which benefit from good levels of low cost deposits, and their favorable asset-quality experience, which is positively influenced by their predominate focus of low-risk residential mortgage lending, core earnings are materially lower when compared to the major banks, who enjoy greater economies of scale.

Despite their limited competitive advantage, New Zealand's domestically owned banks have established sound and viable business franchises that leverage good customer demand for locally owned and incorporated financial service providers.

Banking System's Reliance on Wholesale Funding Remains A Ratings Sensitivity

Similar to Australia, the New Zealand banking system has a material reliance on offshore wholesale funding, although the position has progressively improved since 2009 on the back of increased retail deposit levels (an outcome supported by an increase in consumer savings levels). Although the banks are maintaining good levels of liquidity, any prolonged disruption in offshore wholesale borrowing markets is likely to escalate funding pressure on the banks and put pressure on them meeting minimum core funding ratio (CFR) requirements, with the minimum set to increase to 75% from Jan. 1, 2013.

New Zealand Banks Well Placed to Meet New Basel III Capital Requirements

Regulatory capital ratios for New Zealand's banks remain robust, and position the banks well to meet new Basel III capital requirements. Similar to their trans-Tasman neighbor, the Reserve Bank of New Zealand (RBNZ) has opted for the early adoption of Basel III by Jan. 1, 2013, with the Common Equity Tier 1 (CET1) and Tier 1 ratios set at 4.5% and 6%, respectively, from Jan. 1, 2013, and the capital conservation buffer of 2.5% to come in full force from Jan. 1, 2014 (two years earlier than in Australia). The RBNZ has indicated that although the quantitative impact assessments have shown that most banks should be able to comply with the new ratios, some banks may have to replace their Basel III non-complaint hybrid debt instruments. With the Basel III policy finalized, the RBNZ is currently consulting with the industry on how the policy translates into the detailed capital-adequacy requirements in its Banking Supervision Handbook.

Although New Zealand banks will continue to actively manage their capital positions, we do not expect them to raise material levels of new capital after the implementation of Basel III. Additionally, projected Risk Adjusted Capital ratios (RAC) for most New Zealand banks under Standard & Poor's Risk-Adjusted Capital Framework, which fundamentally drive our capital and earnings assessment, are expected to remain comfortably within the ranges set for their current capital and earnings assessments.

Asset Quality Supporting Earnings Outlook

The asset quality profile of New Zealand banks is robust when assessed against key quality metrics such as credit losses, nonperforming loan levels, and loan loss reserving levels--a position supported by the sector's high focus on low-risk residential mortgage lending and complemented by robust risk-management systems, policies, and practices. The adequacy and sophistication of the enterprise-wide risk-management capability of the four major New Zealand banks are superior to those maintained by New Zealand's locally owned banks, reflecting their ability to leverage parent group-wide risk-management systems and practices, and the significantly higher level of resources available to them. This said, risk-management systems and practices are adequate at the locally owned banks that generally have a lower risk profile than the major banks, due to their higher focus on low-risk residential lending.

Residential mortgage lending represents about 55% of the total loan portfolio of the major banks compared to more than 80% for locally owned financial institutions. The domestically owned banks have also been investing significant time and resources in developing enterprise-wide risk-management capabilities that are expected to strengthen further over time. A decline in property prices from a peak in 2008, together with an increase in the saving rate in New Zealand, which has helped reduce private-sector indebtedness, has helped reduce but not eliminate the prospect of a material deterioration in asset quality from an unexpected sharp drop in property prices. The strong asset-quality position is also positively influencing the earnings outlook for New Zealand's banks.

Rating Impact Of Higher Core Funding Ratio Requirement Is Neutral

We are of the opinion that New Zealand banks are well positioned to meet the higher core funding ratio requirements effective Jan. 1, 2013, and that the favorable funding market conditions that prevailed in 2012 have helped New Zealand banks to build comfortable buffers above the minimum core funding ratio requirements. In addition, we do not expect that the RBNZ's intention to not adopt the Basel III minimum liquidity standards in the near term would have a negative impact on our ratings. In this regard we have noted that the net one week and one month run-off mismatch and core funding ratio achieve similar outcomes compared to the liquidity coverage ratio and net stable funding ratio.

Open Bank Resolution Framework Is Not Expected To Negatively Impact New Zealand Bank Ratings

New Zealand bank ratings will not themselves be negatively affected by progression of an Open Bank Resolution (OBR) policy. The potential for a negative impact on the ratings is also moderated because explicit government support is not factored into most bank ratings. Resolution regimes, such as New Zealand's OBR policy, are generally established by governments to lessen the damage to the economy and the cost for the taxpayer of a distressed systemically important bank. The OBR policy, which requires all banks with retail funding of more than NZ$1 billion to position their systems such that customers would have access to accounts the day after an insolvency event, does in theory raise the prospect that government support for different classes of creditor could vary.

Although the OBR policy does in some way signal that the New Zealand government might not fully support a distressed bank in the future, this policy does not eliminate the option for the government to extend extraordinary support to a bank. Furthermore, the existence of a resolution regime is not indicative, in our view, that a government would let a highly systemically important bank fail in the future, particularly if the economic spillover would be great. All this said, the existence of a resolution regime might make it more difficult for authorities to defend the use of public funds to support distressed banks.

New Zealand's Banking Sector Well Placed To Meet Challenges

Like banking systems all over the world, New Zealand's will continue to face a range of existing and new credit issues that emerge in its domestic operating environment, or those brought on by the escalation or emergence of new external pressures. We believe that despite these pressures, New Zealand's banking sector is well placed to deal with any issues. We see the sector's overall operating-performance outlook as being reasonably sound, supported by a stable level of repeatable net interest revenue generated by the banks, and the good asset-quality experience currently being enjoyed.