New Zealand
Perspectives
Major banks analysis
September 2010

Major banks start down the road to recovery

New Zealand's five major banks (ANZ National, ASB, BNZ, Kiwibank and Westpac) have weathered recent turbulent times caused by the global financial crisis, our domestic recession and the settling of the conduit tax disputes to record respectable, if unspectacular, profits for the first six months of their 2010 financial year (1H10).

Specifically, core earnings have strengthened, reported bad debt charges have eased, and the settlement of the conduit tax disputes with the Inland Revenue have now been fully reflected in the results for 1H10. Alongside these results, there has been a decrease in net loans and advances to customers and with the increase in deposits from customers showing up in the banks, holdings of liquid assets have also increased.

This publication focuses on the major banks' performance for the first half of their 2010 financial year with reference to their 2009 financial year. The financial results illustrate a sound performance for the major banks when compared to the previous six months which is reflective of the New Zealand economy emerging from a recession, but the results were also influenced by the reversal of the conduit tax dispute provisions following the agreed settlement with the Inland Revenue in December 2009. The net effect of this contributed to an overall statutory earnings profit of $1,320m, compared to an overall statutory earnings loss of $1,351m reported in the second half of their 2009 financial year (2H09).

Accordingly, one could argue the major banks have begun down the road to recovery. However, when comparing these sound results to results for the same time last year, we observe core earnings are still down $335m and aggregated profits before tax are down $287m.

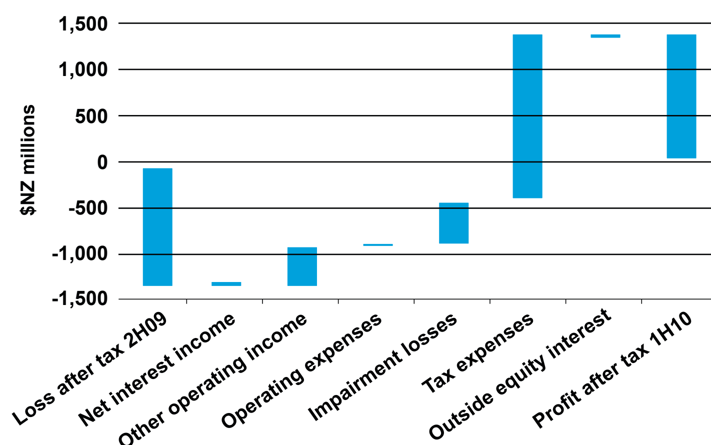
This suggests that, while the financial improvement over the last six months is noticeable, the banks' performance has not returned to the former days, and with foreseen and unforeseen changes in the economic and regulatory landscapes likely, the question remaining is "are we nearly there yet?"

Potential potholes on the road ahead are the fragile Northern Hemisphere recovery, potential increases in funding costs and the possibility of further bad debts which could all cause the journey to take longer than expected or to experience a few more bumps along the way.

Looking back to 2009, the major New Zealand banks along with the broader New Zealand economy have navigated their way well through the Global Financial Crisis (GFC) and its aftermath, including the significant bad debt write-offs experienced in 2H09 and the debris from the unexpected collision with Inland Revenue. This has left them in a place where, while not yet pushing the pedal to the metal, they can once again begin to focus on making good progress.

As Figure 1 below demonstrates, the drivers for the improvement in results for 1H10 are the non-repeats of one-off costs passing through other operating income and tax expenses combined with significant bad debt expenses recognised in 2H09. Underneath these one-offs, the results are remarkably similar with both net interest income and operating expenditure staying fairly flat, period on period. If the growth in the banks' balance sheets continues to stall, then the only likely improvement in the results will be further reductions in bad debt expenses.

Figure 1: Majors banks: changes is profit after tax - 2H09 to 1H10



Looking down the road we expect further growth to come from an increase in the net interest margin as loans continue to reprice on more favourable margins. However, there is possible congestion in the distance. Over the coming year, for example, we expect the wholesale funding markets will continue to be volatile. While we do not foresee any difficulty in the banks being able to fulfil their immediate wholesale funding requirements, we do expect the cost for this form of funding to remain high. Together with the ongoing retail deposit war, this will push up bank funding costs and hence we do not expect to see the recent cuts in lending interest rates to continue.

Looking beyond FY10, there is a risk funding will not only get more expensive but possibly more scarce. Factors contributing to this view include: governments and central banks deleveraging and lessening their direct support of banks; competition globally as banks renew/roll their debt programs as they expire; and the impact of potential new regulatory rules that require banks to hold more capital and high-quality liquid assets.

We have seen the banks trying new products in order to generate funding from new sources, such as the recent covered bonds issue. However, in the New Zealand market, the major banks only have a limited local investment pool from which to draw and internationally the markets are still very cautious and expensive.

Needless to say, regulatory developments remain a significant uncertainty of the road ahead. From a global perspective, there have been particular concerns the combination of political pressure for change and a failure to see the collective impact of a diverse range of reforms (any one of which might look sensible in isolation) would generate a suite of changes which could stifle the industry's ability to support economic recovery in a sustainable way.

While the 2010 PwC Banking Banana Skins survey confirmed Australasian banks see their number one risk being over-regulation, at a global level the top threat is considered to be political risk. Banks in the Northern Hemisphere remain unpopular.Proposed political responses range from new taxes and levies to restricting banks' trading activities to curtailing the size of too-big-to-fail institutions. All of these have negative connotations for the returns on capital achievable globally by regulated banks in the future.

New Zealand banks may be advantaged in some ways as they are unlikely to be caught by some of the regulations, such as those relating to Systemically Important Financial Institutions, and in many ways the existing policies of the Reserve Bank could be considered to be ahead of the global reform agenda minimising the impact on the local banks here.

Five majors combined performance

Figure 2: Five majors' combined performance ($NZ millions)

	1H10	2H09	1H09	1H10 v 2H09	1H10 v 2H09
Interest income	9,117	9,652	12,336	-5.5%	-26.1%
Interest expense	-6,062	-6,587	-9,094	8.0%	33.3%
Net interest income	3,055	3,065	3,242	-0.3%	-5.8%
Other operating income	1,302	822	1,433	58.4%	-9.1%
Operating expenses	-1,961	-1,974	-1,944	0.7%	-0.9%
Core earnings	2,396	1,913	2,731	25.2%	-12.3%
Bad debt expenses	-768	-1,266	-816	39.3%	5.9%
Profit before tax	1,628	647	1,915	151.6%	-15.0%
Tax expenses	-298	-1,981	-614	85.0%	51.5%
Outside equity interest	-10	-17	-20	41.2%	50.0%
Statutory profits	1,320	-1,351	1,281	197.7%	3.0%

The banks' core earnings have been somewhat resilient at $2.4bn in 1H10, 25.2% up from $1.9bn in 2H09, but 12.3% down from $2.7bn in 1H09 (see Figure 2). The key elements when comparing the first half of the 2010 financial year with the second half of the 2009 financial year are:

- Net interest income has remained steady reflecting the stable interest rate environment and the lack of growth seen in their lending books.
- Other operating income has risen post the timing loss on financial instruments held at fair value through profit or loss that were recognised at the end of the 2009 financial year.
- Operating expenses have remained stable highlighting the efforts the major banks have made in cutting their costs whilst dealing with increasing compliance costs.
- Bad debt expenses have reduced in line with the improvements in the economic environment and also the banks taking a lot of the bad debt pain in 2H09 (as predicted in the previous issue of Banking Perspectives where the Everest of bad debt expenses was experienced).
- Tax expenses have reduced post the settlement of the conduit tax dispute with the Inland Revenue.

When comparing the results from 1H10 with those in 1H09, we can see the combined statutory profits for the major banks has increased by 3%. However, the driver for this lift is primarily attributable to the large one-off impact of releasing the conduit tax provisions and favourably assisted by an improvement in bad debt expenses. This improvement in the bottom line is in spite of a drop in net interest income and other operating income.

Income and expenditure

Net interest income

The banks' net interest income has remained fairly consistent with 2H09 decreasing only by 0.3% or $10m, but down 5.8% when compared to 1H09.

Overall, the small decrease seen in the net interest income is in line with the general reduction seen in the loans and advances to customers which were offset by a flat to slight increase in net interest margin (NIM) in the current period as predicted in our previous Banking Perspectives publication. This slight increase differs to the results of the banks in Australia, although for the Australian banks, this is the first such reduction in NIM since the beginning of the GFC.

On a combined basis we have seen a small NIM expansion in the period with the net interest income largely flat on a decreasing balance sheet. However, the major banks have experienced huge variability in their reported NIMs for the period. While comparison across the banks is very difficult because each bank calculates NIM differently, we observed reported NIMs varying between 15 basis points down, 1 basis point down, 6 basis points up, and 12 basis points up when comparing 1H10 to 2H09. This suggests the pressure on margins in previous periods as a result of competition on retail deposit rates and wholesale funding, has been offset to varying degrees by the repricing of risk on commercial lending in the less competitive lending environment.

On the expense side, the banks have been impacted by higher funding costs due to the ongoing deposit war and continued high wholesale funding costs. On the income side, the banks are seeing some respite with repricing continuing at more sustainable interest margins as the banks continue to be more aware of risks than prior to the GFC.

The overall improvement in the repricing of NIM has been offset by a decrease in break fees in the period and the ongoing obligations of the related hedging swaps for the broken mortgage contracts. These swaps were transacted as hedges for the fixed rate mortgages when they were originated and will have the banks paying interest fixed at origination, which is higher than current interest rates. With the mortgages no longer paying these higher interest rates, the related hedging swaps will have a negative impact on the NIM of the banks until they mature in line with original terms of the loan.

Going forward, we expect the NIM to continue to increase with assets continuing to reprice at more favourable interest margins and the further maturity of the hedging swaps of broken mortgages. However, this may be offset by increases in the cost of funding due to the pricing premium seen in the global debt markets and the continuance of the fierce deposit war.

An interesting dynamic in the New Zealand market will be the decision borrowers make in relation to fixed or floating interest rates for their residential mortgages. Many fixed rate borrowers clearly felt hard done by as mortgage interest rates fell dramatically during the second half of 2008 and the early part of 2009 and they either had to pay fees to break the term of their contract or continue paying interest at rates well above market. With the current volatility in interest rates, residential borrowers face a tough decision around if and when they lock in fixed mortgage interest rates and for how long.

Other operating income

Other income has increased overall by 58.4% comparing 1H10 with 2H09, mainly driven by the reversal of losses on financial instruments held at fair value through profit or loss recognised in 2H09.

Other operating income has returned to a level consistent with that historically seen after significant one-off losses recognised against financial instruments held at fair value through profit or loss in the 2H09. Underlying this return, we can see the following movements:

- Fees earned by the banks returning to levels seen in 2008, down roughly $100m per half from those seen in 2009. This reflects less loan establishment fees as well as fee reductions introduced by the banks as predicted in our previous Banking Perspectives publication. Fees brought in $965m for the five major banks in the 1H10 but could potentially be an area of further pressure for the banks as the Commerce Commission continues its review of various fees. With reviews of credit card foreign exchange fees, credit card interchange fees and mortgage break fees completed and a review of credit card late fees announced, the extent of further reviews in this area could continue to impact the banks results.
- Trading income almost doubled from $88m in 2H09 to $167m in 1H10. This reflects the subdued performance experienced in 2H09 with the lack of volatility in the financial markets. While confidence is returning to businesses in this area through improved customer flows, the results are still below those seen during the GFC from 2H07 to 1H09. Our expectation is there will be continued growth in this area as trading levels and therefore, income for the major banks returns to historical levels.
- Financial instruments held at fair value through profit and loss have shown gains of $87m in 1H10 compared with losses of $394m in 2H09. This change is mainly due to one-off items in 2H09 with the 1H10 performance being more consistent with historically experience.

Operating expenses

Operating expenses are broadly consistent over the last two periods, with operating costs down by 0.7% from 2H09, reflecting the cost-cutting efforts of the banks are effective, not-with-standing the impact of increased regulatory and compliance costs as the major banks deal with the implementation of regulations the Financial Advisers Act and anti-money laundering. Going forward, the banks will be doing well if they are able to maintain a flat cost structure in light of these rising compliance costs and the impending GST rate rise which will be largely non-recoverable for the banks.

Tax expenses

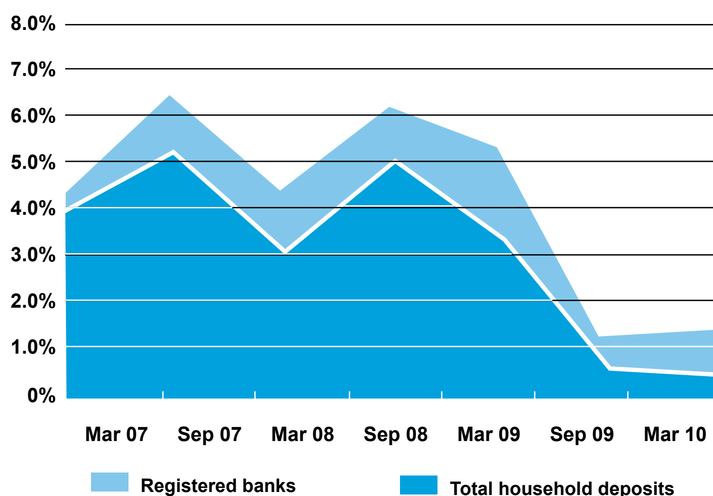
The aggregated effective tax rate for the banks in 1H10 was 18% compared to a whopping 306% in 2H09 and a recent average of around 32%. This large effective tax rate in 2H09 was due to three of the Australian owned banks providing for their exposure in the conduit tax cases. The remaining Australian owned bank provided for its exposure in 1H10, due to it having an earlier reporting date, but this was more than offset by the release of the other banks' provisions when the cases were settled at 80% of the core tax in dispute. Going forward we expect the effective tax rate return to just above the corporate tax rate, which will further reduce in time as a result of the 20 May budget announcement. This drop will likely be beneficial for the banks due to the extra money in the economy as a result in the reduction in the income tax rates but will also cause one-off expenses in the current year due to the re-measurement of any deferred tax assets held by the banks.

Funding and liquidity

The cumulative funding book of the five major banks continues its slow drop from the high seen in 1H09 of $307bn. The drop seen in the current period from $303bn to $288bn demonstrates the continuing stagnation of the lending to customers by the banks.

The banks are continuing to fight hard in the deposit market, among other reasons in order to keep their compliance with the Reserve Bank's liquidity policy. However, total system growth in household deposits continues to be weak, showing the lowest six month growth since the dot-com bubble burst. As demonstrated in Figure 3, the banks continue to grow their share of the deposit market more than the system growth as a whole, mainly due to the continued flight to quality as well as their aggressive pricing strategy.

Figure 3: Semi-annual growth in household deposits



Source: Reserve Bank of New Zealand

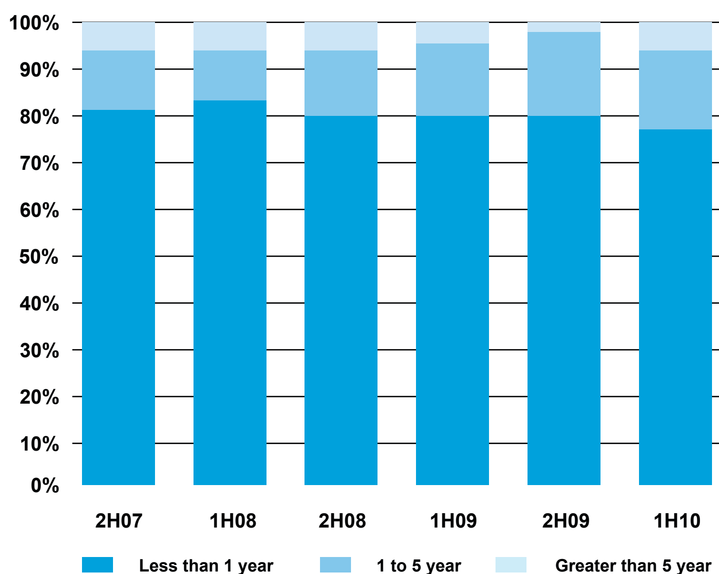
Underlying this, the banks have been making some changes both in the constituents and the tenor of their funding in order to aid compliance with the Reserve Bank's Liquidity Policy which came into effect on 1 April 2010:

- Deposits from customers continue their steady incline with the major banks gaining an extra $4bn funding during the period from their retail customers. This incline has come at a price as referred to in our interest section, but due to the liquidity advantages it offers when measuring the banks' core funding ratio under the Reserve Bank's Liquidity Policy, this source of funding will continue to remain attractive to the banks.
- Bonds and notes and subordinated debt have also increased by around $3bn each. This funding has been used to replace shorter-term funding. Again, this form of funding will have been sourced in order to aid compliance with the core funding ratio in the Reserve Bank's liquidity policy which applies haircuts to funding with residual maturities of less than twelve months, making short term funding less attractive when determining a bank's compliance against the Reserve Bank's liquidity ratios.

These funding haircuts have also driven a change in the funding roll strategy of the banks. Whereas previously the banks may have rolled funding in the last three to six months depending on the size of the roll, there now appears to be trend to roll earlier in order to maintain the contractual maturities greater than twelve months wherever possible.

These changes are demonstrated in Figure 4. We can see a trend to funding greater than twelve months in maturity in the last six months as expected. Due to the large amount of retail funding the banks have, there will always be a significant amount of the funding portfolio with a maturity of less than one year. This does not receive the same haircuts as non-retail funding because of its perceived stickiness (i.e. low depositor churn).

Figure 4: Relative maturities of funding for the NZ major banks



We anticipate further changes to the banks' funding strategies over the medium term as the Reserve Bank is expected to graduate increases in the prudential threshold in the core funding ratio from 65% to 75% over the next two years.

The existing Crown Retail Deposit Guarantee Scheme ends on 12 October 2010. An extension scheme is available which runs until 31 December 2011. Currently, only eight institutions have successfully applied for inclusion in the extension, compared with the 96 institutions covered under the original scheme. None of the major five banks have entered into the extension scheme to date, and looking forward, it appears this will not change. The Reserve Bank reported in the May 2010 Financial Stability Report ,"The Crown's retail deposit guarantee scheme has been extended but it is not likely that banks will continue to participate, given the costs of the scheme and because of the strong level of public and market confidence in the banking system".

Following the maturity of the current Crown Retail Deposit Guarantee Scheme in October 2010, we predict a second flight to quality to the banks may occur. However, this second flight for quality is likely to be less significant than previously as investors are now more aware of the risk differentials between the various deposit taking institutions and these risks are more appropriately priced.

As anticipated in the last Banking Perspectives, the Wholesale Funding Guarantee Facility ended on 30 April 2010 after only being used once in calendar year 2010, reflecting the improvement in funding conditions at that time.

The other quantitative elements of the Reserve Bank's Liquidity Policy (on top of the core funding ratio previously mentioned) are the two run-off limits over one week and one month. These requirements stipulate the minimum holding of certain liquid assets need to be held based on the contractual maturities and committed facilities over the relative period. Again, this is likely to have two impacts on the marketplace:

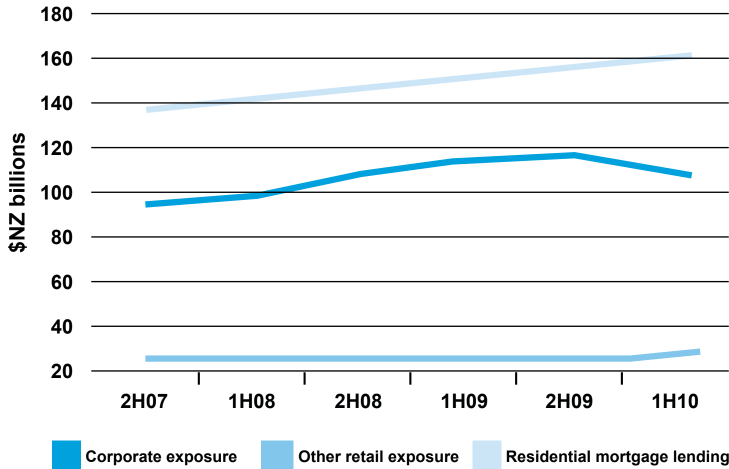
- The banks will change the mix and amount of liquid assets they hold in order to meet the requirements of the policy in the most cost efficient manner. A lot of this occurred in 2009 with the trading securities held increasing from $16bn to $23bn, but a further increase to $26bn was seen in the current period, possibly due to holding onto funds obtained from term raisings which have not been immediately deployed through advances to customers. Alongside this, there has been a switch to the primary and secondary liquid assets as defined in the policy.
- The primary and secondary liquid assets are typically sovereign or government and related securities. These requirements have placed some stress on the markets that exist for these securities due to the demand this has now caused. Further stress is expected on these markets from the Australian liquidity policy recently announced and in anticipation of other international policies in this area. These pressures may result in price inflation in these markets leading to even higher costs for banks which will inevitably have to be passed on to their customers.

A useful pressure valve for the funding market may be successful forays by the banks in to alternative types of funding. One of the major banks, subsequent to 1H10, was successful in raising funding through the covered bond market - effectively a type of on-balance-sheet securitisation. It would not be surprising to see further similar debt raisings going forward given there are no regulatory restrictions to banks developing this type of funding product (unlike in Australia where the Australian banks cannot launch a covered bond programme due to Australian Prudential Regulatory Authority restrictions in order to maintain the deposit preference) and the Reserve Bank has publicly supported the development of this instrument and has confirmed they are developing a specific policy on covered bonds (source: Reserve Bank of New Zealand Financial Stability Report May 2010).

Lending

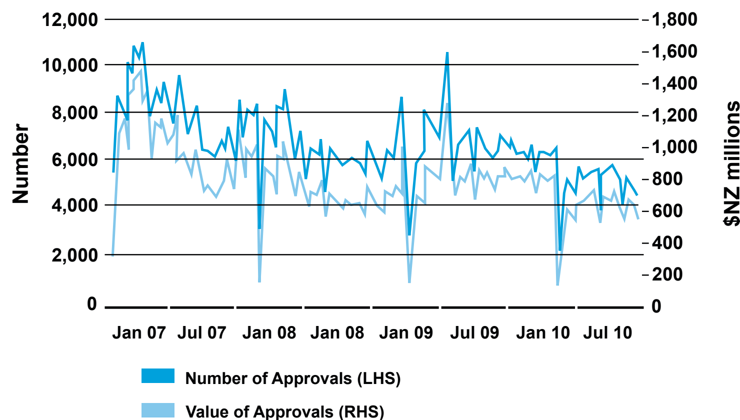
The banks are facing new challenges in their lending books. While their residential lending book is still chugging away with growth of between 2% and 3% every six months, their corporate lending has stalled and has started rolling back down the hill. These two factors have offset in 1H10 to leave the overall gross advances to customers largely unchanged at $277.2bn compared to $277.1bn at the end of the 2009 financial year. The trend seen by the banks is mirrored in the total systems growth in lending which saw a dramatic 6% decrease in business lending but a modest 2% increase in housing lending in the six months ending March 2010.

Figure 5: NZ major banks lending portfolios



While still growing, the retail book is not without its potential problems. New Zealand has escaped many of the problems faced in Northern Hemisphere but is still facing a potentially long tail coming out of the recession combined with a weak housing market. As can be seen in Figure 6 below, both the number and value of mortgage approvals have continued their downward trend seen since 2007 despite some resistance seen in 2009. This is likely to be a function of both the weaker housing market as well as lending policies which better price risk.

Figure 6: NZ mortgage approvals



Source: Reserve Bank of New Zealand

The security of the new loans advanced continues to be a focus for the banks with the proportion of loans with Loan to Value Ratios (LVRs) of less than 80% continuing to grow. With the worst of the GFC and its hangover hopefully behind us and interest margins improving, we expect to see some relaxing of these lending criteria over the next twelve months. While there are signs more recently the credit policies have started to be relaxed, there is still an element of conservative practices when you look at the banks' approach to lending. This combined with the lower interest environment will hopefully stimulate further growth in the economy.

Figure 7: NZ major banks' LVR

	1H10	2H09	1H09
0%-80%	81.2%	80.1%	78.9%
80%-90%	11.2%	11.9%	12.6%
>90%	7.6%	8.0%	8.5%

In the corporate lending world, there is a feeling both within this market and the investment banking market that FY09 was the year where corporates got their houses in order, making sure they had sufficient funding and liquidity. This was a difficult job in a market with limited supply and high margins and fees were paid. Now corporates have refinanced their operations, there is little appetite to reopen these wounds while the GFC is still fresh in their minds. The feeling is many corporates want a year of stability without any major projects or acquisitions.

In 2H10, further reductions in corporate borrowings are expected where debt is continued to be paid down. However, as memories of the GFC fade in the medium term, we would expect corporate lending to increase again as business confidence returns to normal and projects and acquisitions that were delayed during the GFC recommence.

As reported in our previous Banking Perspectives publication, we still believe there will be further corporate debt market offerings (e.g. bonds, capital notes and the like) which will further reduce corporates' dependency on the banks and give them an appropriate diversification of funding sources.

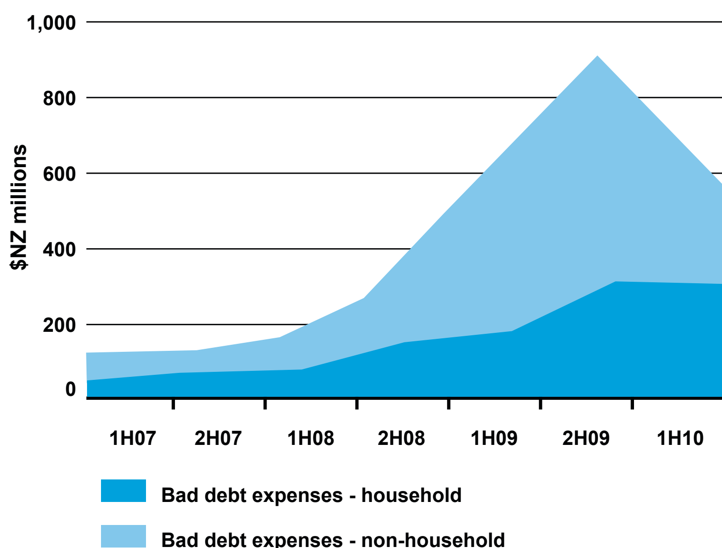
A positive note for many corporate borrowers and therefore the banks is the reduction in corporate tax rates in the 20 May Budget. This should generally help ease the burden on many businesses and improve their cash flow.

Asset quality

The bad debt charges recognised by the banks peaked in the 2H09 with a significant reduction seen in 1H10 by 39% or $498m. This huge drop shows the fall away from the peak of Everest described in the last edition of Banking Perspectives.

The drop in bad debt expense is due to the large impairments seen in FY09 in the corporate sector which have caused the corporate bad debt expense to drop from $806m in 2H09 to $315m in 1H10. As expected, the retail sector lags behind corporate sector and does not show a similar level of decline. This is due to the smaller typical loan size within retail, meaning significant one-off write-offs are less likely for this class of lending. However, an improving trend, while only being modest, is also seen in retail with the bad debt expenses dropping from $460m in 2H09 to $453m in 1H10.

Figure 8: NZ major banks: composition of bad debt expenses

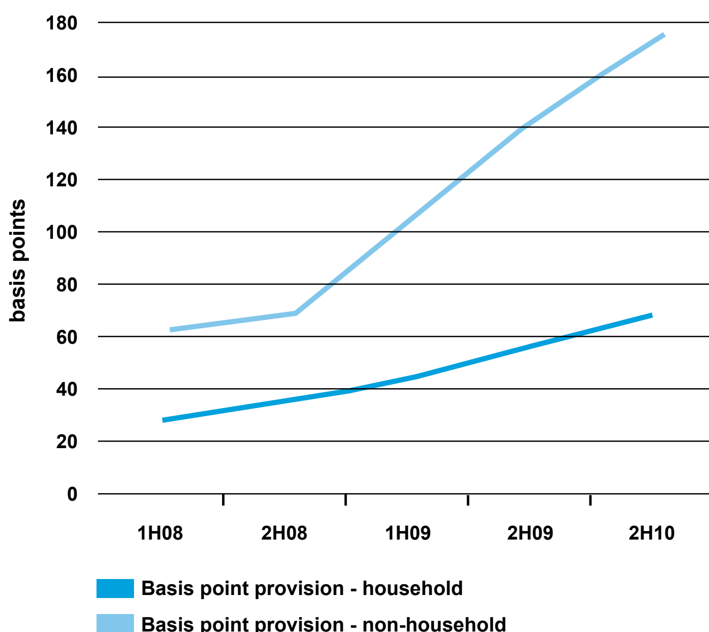


While the bad debt expenses may have peaked for the banks' corporate lending, the balance sheet loan loss provisions continue to grow in both the corporate and retail books. Again, we see the trend as more positive in the corporate book with the curve beginning to flatten (see Figure 9). The basis point provision for the retail book, while still much lower than its corporate counterpart, does not demonstrate any signs of a top being near.

The loan loss provisioning has grown in the corporate portfolio from $1.7bn at 2H09 to $1.8bn at 1H10, although with the decline in the corporate lending book, the growth is more significant in basis point terms rising from 147bps to 171bps. We expect 2H10 to continue the improving trend with a possible absolute decrease in loan loss provisioning, as New Zealand's economy continues to improve. Yet, we do acknowledge the risk of one-off large corporate write-offs could skew these results.

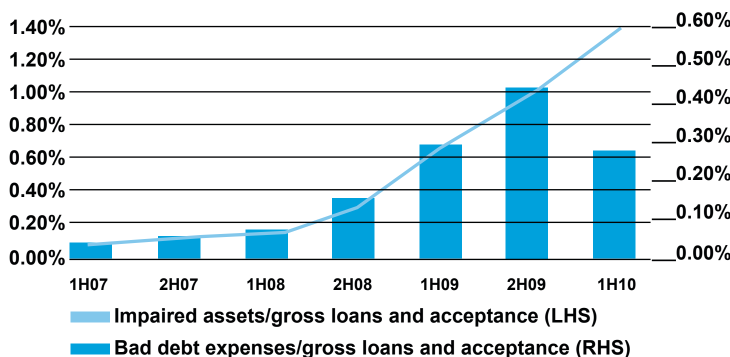
The loan loss provisioning on the retail book has continued its steady climb, growing from $0.9bn at 2H09 to $1.1bn at 1H10. In basis point terms, this is from 54bps to 67bps, still significantly behind the corporate book due to lower risk presented by residential mortgages in New Zealand which make up the majority of the banks' retail book composition.

Figure 9: NZ major banks: basis point loan loss provisions



The trends reflected above continue to reflect the points made in the previous Banking Perspectives edition with regard to the protection that has been afforded to local households through a lower interest rate environment as result of the easing in monetary policy, a concerted effort to cut-back in discretionary consumer spending but also a more favourably employment environment under the GFC than originally forecast. We are not yet out of the woods with continuing uncertainty and a weak housing market meaning we expect the basis point provision for both households and non-households to remain consistent at best in 2H10.

Figure 10: NZ major banks: impaired assets and bad debt expenses



An area of focus, in terms of asset quality, for the major banks will continue to be the rural sector. Although the outlook for this sector appears to be more positive than it was twelve months ago, there is still much uncertainty and the banks will no doubt be concerned about the high level of gearing of many participants in this sector. The likely improvement in the dairy payout is certainly positive, but reports there is likely to be more volatility in the quantum of future payouts will certainly cause concern to those looking a cash flow forecasts for these rural businesses.

We can see the 90-day past due assets have stabilised and have continued the small reductions seen in FY09, dropping from $1,399m at 2H09 to $1,304m at 1H10.

With the change in the credit environment, the banks have increased their collections resources and the improvement seen in this area is likely to be driven by improvements in the banks' internal policies rather than improvements in the economy as a whole.

Of more concern is the increase seen in the impaired assets with a continuation of their almost exponential growth since FY07 growing from $2,783m at 2H09 to $3,810m at 1H10. These are assets which are being managed on an individual basis and are significant enough to calculate a specific provision for. Typically, these impaired assets will be in the non-household sector. The quantum of impaired assets continue to grow at a fast pace and, while the provision held against them has dropped from 35.5% in 2H09 to 33.9% in 1H10, this causes some concern that the number of businesses being managed in this way continues to grow. This adds further weight to the fact while we may have navigated the peak of Everest, there are still several dangerous crossings to make until we are safely back to greener pastures.

Capital adequacy

The capital ratios of the major banks has generally seen an improvement in 1H10 with the average Tier 1 Capital increasing from 8.9% to 9.1% and the average Total Capital ratio increasing from 11.7% to 11.9%. While this suggests the banks are trying to grow their capital bases, the reasons are more likely to be concerns about regulatory changes rather than environmental factors. These regulatory changes are discussed further in the "Regulatory Change" section.

Figure 11: NZ major banks: capital ratios

	Tier 1 Capital Ratio	Total Capital Ratio
ANZ National	9.5%	13.2%
ASB	10.0%	12.4%
BNZ	9.0%	12.0%
Wespac	9.5%	12.4%
Kiwibank	7.4%	9.6%
Minimum	*4.0%*	*8.0%*

*Kiwibank is calculated under the standardised approach.

The major banks' annualised return on equity in 1H10 returned to 13.3% similar to the 13.4% experienced in 1H09 after the understandably poor return of -14.4% seen in 2H09. The return seen in 1H10 is still far below the average of 16.4% seen in FY07.

Regulatory change

G20 Summit

At the June 2010 G20 Summit in Toronto, the world's leaders evaluated progress in the regulatory reform agenda. With much still to be done, they pledged to continue to act together to achieve the reform agenda although some flexibility of the timelines have been introduced through the use of transitional provisions. While accepted as necessary to protect the ongoing economic recovery, this does raise the prospect of inconsistent application of the new standards between countries in the early years. The reforms are being appraised against four pillars:

Pillar 1: Strong regulatory framework

This pillar is to be achieved by raising the quality, consistency and transparency of the capital and strengthening the liquidity risk management framework. The key discussions were around the strength of these reforms, striking the balance between effective regulation and damaging the economic recovery.

A lot of proposed changes in relation to capital revolve around making the figures produced more comparable internationally. This will be achieved through internationally consistent capital definitions and the introduction of a non-risk based leverage ratio. However, some of the capital definitions have recently been relaxed, allowing banks to have up to 10 per cent of Tier 1 Capital composed of investments in minorities, and deferred tax assets.

According to recent reports, the proposed leverage ratio is three per cent. This ratio would require banks to keep a minimum level of capital against total assets, in conjunction with the traditional approach where capital is set aside against risk-weighted assets. It is proposed the leverage ratio will be phased in slowly, with full implementation in 2017. In the global discussions on the leverage ratio, the concern has been for banks with highly secured books. Therefore, we would expect New Zealand banks to be impacted under this proposed regulation. However, based on their positions at 1H10, the leverage ratios of four of the major banks would be between 5.2% and 6.0%, with one at 3.5% which has subsequently raised capital. This once again demonstrates the capital strength of the New Zealand banks.

Another significant change is the proposed introduction of forward-looking provisioning although this may have limited impact in New Zealand, as the Reserve Bank would argue they have already achieved some element of this with their through-the-cycle probabilities of default. The key changes globally with regard to liquidity are to introduce quantitative standards for liquidity and restricting which assets are eligible. Again, the Reserve Bank's Liquidity Policy effective from April 2010 covers the majority of the proposals. The Reserve Bank of Australia and Australian Prudential Regulation Authority have persuaded the Basel Committee that Australian banks receive an exemption from the requirement to keep enough government bonds on hand to meet 30 days of cash withdrawals. This is due to the fact that there are not enough government bonds to satisfy this requirement in Australia. It is currently unknown whether this exemption will be extended to New Zealand.

A new stable income ratio is also being introduced, which will require banks to achieve a closer matching of the term to maturity of their assets and liabilities. This will not now be introduced until 2018, with further work done before a final proposal is announced. New Zealand and Australian banks, with a large proportion of their assets in mortgages and their liabilities in wholesale funding, would have struggled to reach the originally proposed required ratio.

Pillar 2: Effective supervision

The Financial Stability Board (FSB) is going to make recommendations at the next Summit on the operational mandate, capacity and resourcing of supervisors and specific powers to be adopted to proactively identify and address risks including early intervention.

Pillar 3: Systemically important financial institutions (SIFIs)

One critical objective of the global reform initiative is to mitigate the risk of shocks being transmitted across the financial system through SIFIs without tax payers bearing the burden. While the FSB will be presenting final policy recommendations in November 2010, these are unlikely to have a significant impact on New Zealand as the New Zealand banks are unlikely to be considered systematically important on a global level. Any impact is likely to be indirect and positive as capital and liquidity surcharges could be places on global SIFIs.

Pillar 4: Transparent international assessment and peer review

The Summit pledged its continuing support for robust and transparent peer reviews.

New Zealand

The focus continues to be on Pillar 1 and on credit risk in New Zealand. One of the requirements of Reserve Bank's accreditation of the major four banks under the Advanced Internal Rating Based Approach for Basel II was for the banks to improve the way its housing probability of default models differentiate risk by appropriately including structural risk drivers. The carrot for implementing these improvements was the removal of the 15% scalar on housing risk weighed assets. This carrot is being supplemented with a stick from December with the Reserve Bank proposing to increase this 15% scalar to 30% for banks who have not had an improved model approved by the Reserve Bank.

With these changes and the changes to the international Basel II framework, the capital requirements for New Zealand banks are expected to continue growing. This means the significant buffers the New Zealand banks currently hold will either be much reduced or we should expect further capital raisings over the next two years. Realistically if the capital ratios were to drop significantly then New Zealand banks could face problems raising money overseas and therefore we should expect further capital raisings going forward.

Key Banking Statistics - Half Year 2010

$NZ millions

	BNZ			WBC			CBA			ANZ			Kiwibank		
	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths	6 mths
	Mar 10	Sept 09	Mar 09	Mar 10	Sept 09	Mar 09	Dec 09	Jun 09	Dec 08	Mar 10	Sept 09	Mar 09	Dec 09	Jun 09	Dec 08
Income statement															
Interest income	1,688	1,729	2,345	1,995	2,062	2,560	2,094	2,329	2,836	3,072	3,246	4,233	268	286	362
Interest expense	-1,066	-1,082	-1,641	-1,301	-1,353	-1,789	-1,568	-1,816	-2,334	-1,925	-2,134	-3,047	-202	-202	-283
Net interest income	622	647	704	694	709	771	526	513	502	1,147	1,112	1,186	66	84	79
Other operating income	221	-36	337	279	247	369	293	295	214	421	241	439	88	75	74
Operating expenses	-404	-405	-372	-375	-425	-383	-323	-299	-340	-748	-740	-739	-111	-105	-110
Core earnings	439	206	669	598	531	757	496	509	376	820	613	886	43	54	43
Impairment losses on credit exposures	-88	-91	-99	-220	-352	-338	-125	-220	-85	-325	-595	-288	-10	-8	-6
Total operating profit before income tax expense	351	115	570	378	179	419	371	289	291	495	18	598	33	46	37
Income tax expense	64	-696	-170	77	-908	-178	-320	-123	-78	-109	-246	-176	-10	-8	-12
Net profit to minorities	0	0	0	-1	-1	-2	-9	-16	-18	0	0	0	0	0	0
Net profit attributable to shareholders	415	-581	400	454	-730	239	42	150	195	386	-228	422	23	38	25
Balance sheet															
Trading securities	3,221	3,662	5,371	6,854	5,442	7,529	5,616	6,773	6,487	8,216	5,679	3,162	1,769	1,424	1,840
Loans and advances to customers	54,647	55,142	54,047	56,215	55,592	55,730	58,121	58,846	58,278	95,689	97,024	98,490	9,726	8,492	6,984
Derivative financial instruments	4,770	5,918	9,832	4,938	6,328	8,968	1,979	2,517	4,224	9,087	11,015	15,072	52	49	69
Total assets	67,268	69,862	73,301	72,159	73,444	77,850	70,554	72,056	72,647	123,504	126,314	132,972	12,018	10,371	9,430
Due to central bank and other financial institutions	1,786	3,892	3,057	597	485	239	396	312	90	1,045	3,228	3,632	581	317	587
Other money market deposits / bonds and notes	20,293	18,345	20,616	19,236	15,837	15,561	19,626	20,267	20,906	27,151	27,140	34,128	884	913	716
Deposits from customers	27,909	27,233	26,171	34,508	32,944	32,726	30,541	29,376	29,614	59,270	59,931	59,553	9,740	8,266	7,298
Derivative financial instruments	5,489	7,643	10,394	4,938	6,970	10,704	2,706	4,239	4,187	9,109	10,974	13,080	216	304	321
Amounts due to related parties	6,744	7,149	7,906	6,708	9,463	10,475	10,551	13,404	13,490	15,729	14,096	10,797	-1	38	1
Subordinated debt	373	375	357	796	0	0	3,053	608	620	1,783	1,785	1,782	142	144	145
Total liabilities	63,293	66,117	69,214	67,772	69,539	73,781	66,882	68,631	69,447	116,119	118,999	125,455	11,597	10,016	9,138
Total shareholders equity	3,975	3,745	4,087	4,387	3,905	4,069	3,672	3,425	3,200	7,385	7,315	7,517	421	355	292
Asset quality & provisioning															
Gross loans and advances	55,029	55,428	53,907	56,982	56,203	56,335	58,489	59,114	58,372	96,976	97,861	98,497	9,742	8,505	6,991
Gross other individually impaired assets	727	636	414	759	675	710	556	355	178	1,736	1,188	609	32	19	6
Gross impaired assets as a % of loans and advances	1.32%	1.15%	0.77%	1.20%	1.20%	1.26%	0.95%	0.60%	0.30%	1.79%	1.21%	0.62%	0.33%	0.22%	0.09%
Gross restructured assets	3	1	0	0	1	0	200	65	0	8	2	20	0	0	0
Gross other assets under administration	8	8	6	0	0	0	37	34	29	0	0	4	0	0	0
90 day past due assets	284	210	152	312	346	386	318	374	309	369	446	547	21	23	16
Allowance for impairment losses on individual financial assets	249	222	119	233	152	235	119	124	58	608	477	269	0	0	0
Individual assessed provision as a % of impaired assets	34.25%	34.91%	28.74%	22.52%	22.52%	33.10%	21.40%	34.93%	32.58%	35.02%	40.15%	44.17%	0.00%	0.00%	0.00%
Allowance for impairment losses on groups of financial assets	263	237	231	597	510	410	259	199	120	867	804	610	15	12	7
Bad debt charge as a % of loans and advances	0.16%	0.16%	0.18%	0.63%	0.63%	0.60%	0.21%	0.37%	0.15%	0.34%	0.61%	0.29%	0.10%	0.09%	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.

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