FIPS

Financial Institutions Performance Survey –
Non-banks

Review of 2010

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Contents

The Survey

Welcome to Part 1 of the 2010 edition of the Financial Institutions Performance Survey.

Part 1 focuses on the non-bank financial institutions, while Part 2 to be published in April 2011 will focus on the registered banks. Our Survey captures the annual balance dates between 1 October 2009 and 30 September 2010.

The number of finance companies included in this Survey has reduced from our last Survey published in April 2010. This Survey includes 16 finance companies as compared to our prior year Survey which included 31. This significant reduction is the result of continued finance company failures and receiverships including Allied Nationwide Finance Limited, Equitable Mortgages Limited, North South Finance Limited, St Laurence Limited, Strategic Finance Limited, and most significantly South Canterbury Finance Limited. We have also seen some integration / consolidation such as the Allied Farmers acquisition of the Hanover Finance portfolio. Further, KPMG has lifted the threshold for inclusion in the Survey to $100 million of total assets (previously $50 million).

We see further consolidation of the sector as size and critical mass becomes the focus for the industry. In our opinion, that minimum operating size will be set at a level above where it has been in the recent past and will require at least $100 million in total assets to efficiently run a finance company.

Lifting our threshold has resulted in the following companies now being excluded from the Survey: Canon Finance New Zealand Limited, CIT Group Limited, Dorchester Finance Limited, Farmers Mutual Finance Limited, Geneva Finance Limited, Instant Finance NZ Limited, Oxford Finance Limited and S.H. Lock (NZ) Limited (note that the comparative years of the graphs presented in this Survey include the sector as it was presented in the respective year).

As a result of the failure of the entire Property Development and Commercial Finance segments and continued contraction within the other segments, we have decided that it is no longer practical to track the individual segments (historically being: motor vehicle and vendor financing, property development and commercial finance, diversified finance and consumer finance). We have therefore returned to one overall finance company sector.

The savings institutions sector remained largely consistent with our last Survey, at ten participants. As in our last Survey, Southland Building Society (SBS) has been excluded as it is now a registered bank. However, we note that the savings institutions sector has moved forward on integration somewhat faster than the other sectors. Examples include the approved merger of SBS with Hasting Building Society and the pending amalgamation of CBS Canterbury, Southern Cross Building Society and MARAC's parent, Pyne Gould Corporation.

All the information used to compile this Survey is extracted from publicly available annual reports, disclosure statements and prospectuses for each financial institution with the exception of certain information provided by Survey participants. We thank the Survey participants for their continued valued contribution.

Table 1 Movements	Who's Out
Finance Companies 31 to 16	**In receivership:** Allied Nationwide Finance Limited Equitable Mortgages Limited* North South Finance Limited South Canterbury Finance Limited St Laurence Limited Strategic Finance Limited **Less than $100m total assets:** Canon Finance New Zealand Limited CIT Group Limited Dorchester Finance Limited Farmers Mutual Finance Limited Geneva Finance Limited Hanover Finance Limited Instant Finance NZ Limited Oxford Finance Limited S.H. Lock (NZ) Limited **Financial statements not available:** John Deere Credit Limited
Savings Institutions 11 to 10	**Less than $100m total assets:** Police & Families Credit Union

Footnote
* Still included in sector totals

Industry Overview

Non-bank Sector Overview – Future Proofing

The year 2010 is the first year that the non-bank sector have been able to look forward with a degree of clarity as to what will be required to operate a sustainable business in the future. The last three years have been a period of fundamental change and rationalisation across the whole sector. The catalysts were the collapse of the property development finance companies, domestic recession and flow-on effects of the global financial crisis.

The receivership of South Canterbury Finance on 31 August 2010, in particular, has been an important event from which the sector can now move forward. For much of the previous two years the finance sector was unable to rehabilitate due to continuing bad and doubtful debts (see figures 1 and 2). Ongoing reputational damage, due, in some part, to well-held concerns over the health of South Canterbury Finance has also proved to be an impediment to recovery. In addition, the pricing of money to the wider non-bank sector was negatively impacted by South Canterbury's higher cost government guaranteed debt.

The eventual receivership of South Canterbury Finance and, to a lesser extent, Allied Nationwide Finance, has "cleared the decks". While there may still be some smaller finance companies that fail, the shape of the finance company sector is becoming clearer, in part defined by the Reserve Bank of New Zealand's (RBNZ's) regulatory settings. There are now only six non-bank members in the Extended Retail Deposit Guarantee Scheme (RDGS), of which three are in the process of merging (MARAC Finance's parent Payne Gould Corporation, CBS Canterbury and Southern Cross Building Society). Accordingly, the market will be left to calibrate risk and return for investors in providing funding into the different parts of the bank and non-bank sectors.

Despite pockets of growth, particularly in the export sector, New Zealand's economic activity is subdued. Faced with uncertainty, businesses and consumers are reluctant to take on new debt and, where possible, keen to repay existing debt. In the absence of balance sheet growth and constrained earnings due to bad and doubtful debts, the focus for many in the non-bank sector has been on "future proofing" their businesses. However, surviving the dramatic events of the last three years is still no guarantee of maintaining a long-term position in the market.

> "The last three years have been a period of fundamental change and rationalisation across the whole sector."

We have observed the following strategies being employed by finance companies, building societies and credit unions to future proof their organisations:

- Merge and acquire
- Reduce cost structures and improve systems
- Re-balance funding
- Re-focus on core lending business
- Address capital position
- Consider governance and management

Merge and acquire

The new regulatory environment and the consequent cost structures create considerable incentives for industry participants to look for mergers or acquisitions that will provide scale and loan book diversification. While relatively few transactions have been completed in the finance company sector, the building societies and credit unions have been more successful in completing mergers. In part this reflects the significantly higher price risk attached to finance company assets.

One of the first examples of this trend is the three way merger of MARAC Finance's parent Pyne Gould Corporation, CBS Canterbury and Southern Cross Building Society, which is progressing to plan with the ultimate objective of achieving registered bank status for the merged entity. For the largest non-banks there is an incentive to seek bank registration given the more favourable capital adequacy regime enjoyed by banks and the cost of funds advantage. Consolidation will result in larger individual entities that will have the associated benefit of economies of scale as well as a more prominent market presence.

While the new regulatory settings create incentives to achieve scale there are many smaller financial institutions for whom a better outcome has been to manage down their balance sheet so that total assets are less than $20 million and accordingly they can opt out of many of the requirements including the requirement for a credit rating.

Reduce cost structures and improve systems

The subdued economic environment has meant little, if any, earnings momentum and accordingly the area that management have been able to have most impact on has been operating costs. There have been a range of initiatives undertaken to reduce both direct and overhead costs.

Figure 1

Finance Companies: Gross Impaired and Past Due Assets

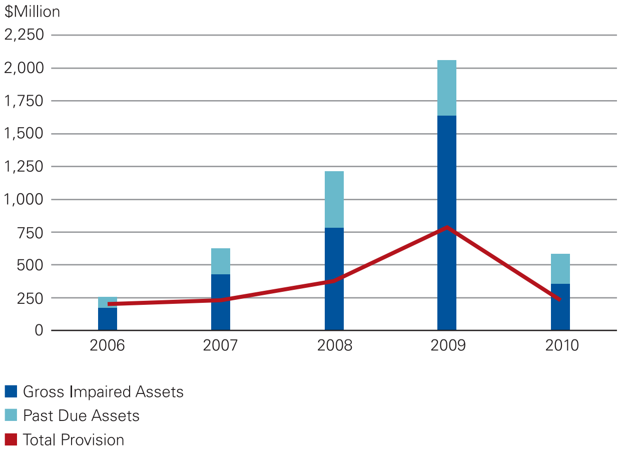
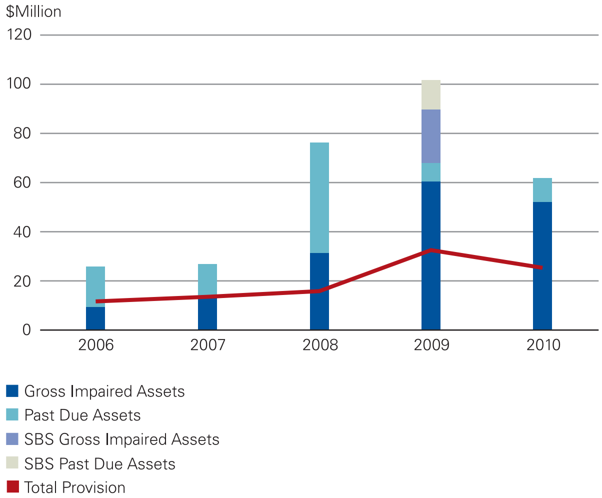


Figure 2

Savings Institutions: Gross Impaired and Past Due Assets



An area of potential cost savings, but requiring increased upfront cost, is information technology – specifically the implementation of new (and better) procedural and operating systems. Following the failure of so many finance companies over the last three years, in-depth investigations were conducted into the procedural and operating systems of these companies. The resounding conclusion of these investigations was that systems were often inadequate and/or compliance with set company policies and procedures was lacking. With larger consolidated companies in the future, and a growing requirement (from the company and customers) for the ability to introduce new products, access to 'real time' information and transactional banking – investment in sound procedural and operating systems will be important.

Another driver for improved lending systems has been the regulatory requirement for all Non-bank Deposit Takers (NBDT) with total assets greater than $20 million to obtain an official credit rating. The rating agencies require access to considerable detail and credit history – those lacking this information have been severely disadvantaged. Improved systems should result in improved credit management.

Re-balance funding

There are three primary issues for non-banks' funding – competition from banks, product diversification and term structure. Less reliance on offshore funding and the RBNZ's liquidity policy have seen the banks competing harder for retail funding over the last year. This has forced the non-bank sector to match pricing and seek ways to differentiate themselves from banks. This competition has been evident in the actions of banks and non-banks to secure the South Canterbury Finance debenture funds once they were paid out to investors by the trustee.

Traditionally, the finance companies have placed a heavy reliance on the debenture funding model. However, with the dual impact of lost investor confidence and a more tightly regulated industry, reliance on this source of funds will further reduce. The future proofed finance company will be required to diversify and access a number of different fund sources, ranging from bank drawn facilities, bonds and notes, and ultimately the securitisation market. The higher risk economic environment (as compared to earlier years) coupled with tighter lending policies imposed by the registered banks is likely to result in a lift in the overall cost of funds as well as restrictions imposed by debt covenants.

In anticipation of the RBNZ's liquidity policy for the non-bank sector, many financial institutions have been seeking to extend the term structure of their debt. In particular many of the building societies and savings institutions have a primary reliance on call money and are now introducing more term debt instruments. A further impact on the finance companies will be that the trustee companies are tasked to set suitable liquidity requirements for the NBDTs via their respective trust deeds, applying the RBNZ's guidance.

Re-focus on core lending business

A theme running across the majority of the non-bank sector, and particularly the finance companies, is the need to review lending activities and focus on areas of core competency. For many finance companies these reviews are resulting in a more risk averse attitude towards lending and a refocus on their core competencies rather than diversifying into markets which have not been 'tried and tested' successfully in the past. A more in-depth understanding of their customers (and their financial stability) is also important as more weighting is placed on performing detailed credit checks. In addition, assessing the underlying quality, value and stability of loan security will become a focal point to ensure that loan impairment is minimised and avoided where possible.

Appropriate price setting is critical to the success of any finance company. In an environment where there is a low level of new business activity and hence new business volume, many financial institutions are taking the opportunity to review loan pricing. Accordingly we have seen price setting policies (on lending) reviewed and adjusted to take into consideration the true underlying risk of an exposure. In setting prices to reflect relative risk, consideration of the full cycle of an exposure must be made, rather than merely considering the immediate and short-term financial position of the borrower and backing security.

An example of this change is the motor vehicle finance market where a new model is emerging whereby the motor vehicle dealers are originating fewer loans as finance companies increasingly originate their own customer base. With a focus on the long-term relationship with the customer, the finance companies are able to justify a higher interest margin on this lending.

Address capital position

The RBNZ's capital adequacy rules for non-banks has caused these financial institutions to pay much more attention to the composition of their balance sheet and re-assess the return achieved on certain asset types. In particular risk weightings for operating leases have caused some companies to exit the leasing market given the return on capital on offer. The RBNZ risk weightings will increasingly impact balance sheet composition as the companies assess the respective return on risk weighted capital and focus on the highest yielding classes.

For many savings institutions there is a need to invest in further product development and systems; but a fundamental constraint exists for mutuals as their only means of generating capital is through retained earnings. In a subdued economic environment earnings are constrained and mutuals are forced to lower the returns to members on their deposits if they are to generate retained earnings and bolster their capital position.

Consider governance and management

The finance company collapses of the last three year period has certainly turned the spotlight towards the past leaders of these companies, and raised questions in relation to ethics, accountability, qualifications and corporate governance. This scrutiny, as well as new regulation which requires directors to be 'fit and proper' is likely to change the profile of the future Board of Directors so that it will comprise a larger proportion of well qualified and independent non-executive board members. In addition, the chairman of the board will also be an independent non-executive member.

We expect there will increasingly be new and specific management and executive roles around risk management, finance and treasury/liquidity functions in the non-bank sector – and these will become critical and focal roles within the company, rather than being perceived as an unimportant 'add on' to an existing (and previously often unrelated) role. In addition, we expect that policies and procedures around corporate governance will be scrutinised, formalised and significantly 'sharpened' in order to align and facilitate compliance with the raft of new legislation and regulation now in force.

A Hypothesis on the Future

Finance Industry Size and Profile

- The future will see a small group of core finance companies that will have an intimate knowledge of their niche markets, strong and capable management teams and appropriate risk management strategies. These companies will need to maintain minimum total assets of $100 million to deliver the earnings base necessary to absorb the operating costs inherent in the new regulatory and business environment.
- The Reserve Bank of New Zealand's (RBNZ's) 'fit and proper' requirement for management and directors of the non-bank deposit takers (NBDT) is likely to see more companies hiring experienced executives, with capable risk management and finance teams who invest in appropriate systems and processes.

Regulators

- The RBNZ oversees the NBDTs sector – and in response to adverse sector trends seen in recent years; has (and will continue to) put sensible and appropriately aligned regulatory measures in place.
- The RBNZ role may be extended from imposing appropriate regulations, to active and rigorous supervision of the sector.

Trustees

- The Trustees are currently the front-line regulators for NBDTs; ensuring the RBNZ's regulatory regime is enforced. This is a different model to that in place for the banks and insurance companies. In the future, the model for non-banks may well be downgraded, such that the role of the Trustee is not much more than a conduit for information destined for the RBNZ.
- The RBNZ has given the Trustees a challenge to reset and redefine the measurement and monitoring of liquidity risk with the issuance of the quantitative liquidity requirements and the new regulations which require companies and trustees to ensure that NBDTs trust deeds include one or more appropriate liquidity requirements. This is a test which may be determinative of the future model.

The Media and Financial Analysts

- To date, the analysis of the performance and safety of the NBDTs sector has been largely undertaken by financial brokers, some of whom, based on anecdotal evidence have been shown to be less than independent. The future might hold a sectorial funded group to perform regular and detailed financial analysis and recommendations on the performance and safety of the non-bank sector.

Rating Agencies

- The rating agencies may begin to use the entire spectrum of available ratings to appropriately differentiate the non-bank sector. It could be possible that a well run small deposit taker, investing wisely into a known market, with established and capable management could be rated investment grade, while at the same time, the rating agencies would be constantly monitoring the market and downgrading companies who were underperforming. Timely downgrades have not been the norm over the last two years, most notably and with regard to South Canterbury Finance.

Investors

- The future will likely see investors moving money far more regularly than that experienced historically. While reinvestment rates will fall, the market will be more price sensitive and consequently seek a real return on funds invested.
- Currently the premium from the AA rated banks to the BB rated finance companies appears to be between 150-300 basis points. The future may see a BB+ rated instrument demanding a return of 300-500 basis points but a BB- rated instrument would require an additional 150-200 basis points to reflect the additional risk.

Auditors

- The auditors of NBDTs may be required to be local New Zealand auditing firms: individuals who actually operate in and understand the market and are of such a size that they have the necessary scale and skills to handle complex and sophisticated businesses. The fining and censuring of the long standing previous auditor of South Canterbury Finance, who signed off a clean opinion, points to a past environment where companies have been able to select an auditor who potentially had insufficient experience and expertise.

Brokers and Advisers

- The future may see brokers no longer paid by the companies they recommend but rather by the customers for whom they invest. This will eliminate the inherent conflict that currently exists whereby brokers could be influenced in the referrals they make. While the new securities law investment advisor disclosure requires the transparent disclosure of such fees, we can see a time when the removal of these fees will eliminate the potential that they are seen as an influencing factor in the decision making process of the broker.

Regulatory Change and Challenges

Non-bank Deposit Takers

During the current year, Non-bank Deposit Takers (NBDT) have had to adopt and implement a significant amount of new legislation.

The Deposit Takers (Liquidity Requirements) Regulations 2010 was gazetted on 7 October 2010 and came into effect on 1 December 2010. The legislation stipulates that every NBDT and Trustee must include at least one quantitative liquidity requirement in their Trust Deed. For both the individual entity as well as the borrowing group as a whole (where applicable), the requirement must take into consideration the individual characteristics of the businesses as well as their unique liquidity profiles. The regulations are a step back from the specific liquidity requirements imposed on the registered banks, and as such, might be seen as an opportunity for the Trustee Companies to show they have learnt from the issues/failures of the last few years and will implement effective and real limits/parameters on the activities of the non-bank sector.

To complement the Deposit Takers (Liquidity Requirements) Regulations 2010, the Reserve Bank of New Zealand (RBNZ) have published non-binding quantitative liquidity guidelines for NBDT's. The guidelines encourage the use of specific quantitative risk metrics to assist in meeting the liquidity requirements of the legislation. Two such recommended risk metrics include the liquidity coverage ratio and the mismatch ratio. The coverage ratio measures the extent to which the NBDT holds sufficient liquid assets to meet withdrawals from its liabilities; and the mismatch ratio measures the extent to which the maturity profile of the NBDT's funding matches the maturity profile of its lending.

In conjunction with the new liquidity requirements, regulations have been imposed in respect to credit ratings, capital ratios and related party exposures (i.e. the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010) including a number of additional prudential requirements with effect from 1 December 2010. These include specific requirements around governance structures such as stipulating the need for an independent chairman of the Board, at least two independent directors as well as providing guidance on the content of the entity's constitution. These changes will give a greater level of independent oversight of the entities, although finding appropriately qualified people willing to take on such roles may be a challenge for some entities.

> "Non-bank deposit takers (NBDT) have had to adopt and implement a significant amount of new legislation."

A minimum capital ratio must now be included in NBDT's Trust Deed. Where the entity holds a credit rating (from one of the approved agencies being Standard and Poor's, Moody's or Fitch), this ratio is set at 8%, while those NBDT's without a credit rating must comply with a 10% ratio. While the headline limits are consistent with those of the banks, the underlying methodology includes a number of significantly more conservative settings than those set for the banks. These include particularly conservative risk weightings on a number of asset classes including loans secured over qualifying moveable machinery (one assumes motor vehicles) at 100% only if it remains under a 70% loan to value ratio (LVR). Exceed that limit and the risk weighting jumps to 350%. One might speculate that in such a situation, it would be better to classify the loan as a personal loan with no Personal Property Security Act registration and take the relevant 150% risk weighting.

Other conservative risk weightings include a 175% against operating leases which has resulted in a number of companies looking to exit their operating lease businesses. Property development lending has seen some improvement from the first consultative document, but a 200% risk weighting on loans with a greater than 60% LVR will see finance companies in the future needing to hold a far higher level of capital.

So while the headline capital adequacy ratios will look very similar to the banks (i.e. 8%), the amount of capital being held to achieve this ratio is likely to be the better part of 50% higher for some entities than an equivalent calculation under the Registered Bank regime.

Finally, limits have been imposed on related party exposures, so that such exposures should not exceed 15% of the entity's tier-one capital, a limit consistent with those assigned to the Banks.

Although the legislation applies to all NBDT's – the RBNZ have granted a number of specific class and individual exemptions. Class exemptions (from various different provisions of the legislation) have been granted to charitable and religious organisations, funding conduits, entities in moratorium, payment facility providers, entities in receivership/liquidation, non-trustee entities and small entities.

Individual exemptions have been granted where individual companies have proven that certain provisions of the legislation are either not relevant or where the ability to surpass the set requirements of the legislation via compliance with existing internal policies can be demonstrated. Some of the more noteworthy individual exemptions currently in place include:

- Fisher & Paykel Finance Limited has been granted an exemption from governance requirements, provided the company maintains alternative governance arrangements;
- Forsyth Barr Cash Management Limited has been granted an exemption from the obligation to have a credit rating, comply with minimum capital ratio, related party exposures, liquidity and governance requirements;
- Public Trust has been granted a partial exemption in relation to various trustee elements of the regime, the liquidity requirements and the 8% minimum capital ratio. The exemption is subject to the Trust making alternative capital requirements; and
- UDC Finance Limited has been granted an exemption (to 31 May 2011) from the capital ratio, related party and governance requirements and then a long-term exemption for credit ratings, capital ratios and related party exposure, subject to the condition that alternative measures are met.

As a general theme, individual exemptions seem to have been granted to companies who have the support and structure of a large parent company (or governing body) – where strong liquidity and governance policies are already in place, and in most cases, easily surpass the specific requirements set out by the new NBDT legislation.

As of October 2010, the RBNZ has released a consultation paper which addresses the remaining NBDT regulatory requirements set out in the original Cabinet paper in 2007, but which have not yet been implemented. The remaining elements include: licensing of NBDT's, fit and proper requirements for directors and senior officers, controls on changes of ownership, distress and failure management powers of the RBNZ and further refinements to part 5D of the Reserve Bank of New Zealand Amendment Act 2008. The intention is that this legislation will come into effect during early 2011 although the exact form of these final regulations is still to be determined.

Retail Deposit Guarantee Scheme

The Crown Retail Deposit Guarantee Scheme (RDGS) which covered all retail deposits of participating banks, building societies, credit union and finance companies expired on 12 October 2010. The onus of performing risk assessment has now returned to individual depositors and the Rating Agencies.

> "The onus of performing risk assessment has now returned to individual depositors and the Rating Agencies."

The general consensus is that the RDGS was successful as a temporary measure designed to give assurance to depositors and facilitate the continued functionality of the New Zealand financial markets. The Governor, Alan Bollard, recently stated that *"The scheme was set up in response to exceptional circumstances, at a time of international financial market turbulence. That crisis is now well past us."* No one would debate that the scheme wasn't without flaws; however, with the expiry of the initial scheme and with the exception of South Canterbury Finance's failure in September 2010 – for which the total cost is yet to be determined, the ultimate cost to the Government has been limited.

An extended scheme has been put in place and is effective from 13 October 2010 to 31 December 2011. The participant eligibility terms of this extended scheme are significantly tighter than those of its predecessor – with key changes including:

- Fees of participating institutions will be amended to reflect the relative risk profile of the entity;
- Deposits will be covered only to a maximum of $250,000 per depositor per institution (as compared to a maximum of $1,000,000 in the previous scheme);
- Only deposit-taking institutions with a credit rating of BB or higher will be eligible to participate in the extended scheme; and
- Collective Investment Schemes are not eligible to participate in the extended scheme.

The majority of institutions have been actively discouraged from entering the extended scheme – with only six participants registered to date:

- Canterbury Building Society
- Fisher & Paykel Finance Limited
- MARAC Finance Limited
- PGG Wrightson Finance Limited
- Southern Cross Building Society
- Wairarapa Building Society

This provides a stark contrast to the ninety odd participants of the original scheme. Most notably, the Registered New Zealand Banks have opted out of the extended scheme as the New Zealand financial markets have moved out of the crisis period.

Finance Companies Sector Performance

Table 2		Total
Increase in Total Assets		-5.1%
Increase in Net Profit After Tax		213.5%
Movement in Impaired Asset Expense (% of Loans and Advances)	bp	19
Movement in Interest Margin	bp	198

Performance of the finance company sector during the 2010 year has been volatile. A number of large and high profile finance companies that originally survived the early fallout from the global financial crisis (GFC) lost the battle during 2010 and joined the ever growing list of finance companies now in receivership. These companies include: Allied Nationwide Finance (Allied's parent had acquired Hanover Finance in a debt for equity swap), North South Finance, Equitable Mortgages, St Laurence, Strategic Finance and, on 31 August 2010 New Zealand's largest finance company, South Canterbury Finance. The common denominator amongst these companies was the heavy reliance on property development lending. As a consequence in the short to medium term, the property development lending market (for the finance companies) no longer exists.

For those finance companies that have survived, the picture is a little brighter with a notable recovery in profitability since 2009. Across the sector, there have been reports of 2010 generally being a good year, during which the surviving finance companies have 'cleaned up' their loan portfolios, rid themselves of non-core exposures (often property related) and refocused on their original core capabilities and skills.

Overall, the majority of finance companies have recovered to a point where, despite elevated doubtful debts, profitability has returned – with a total sector profit after tax of $162 million in the current year as compared to a loss after tax of $143 million in the prior year. All 16 companies captured by our Survey reported a net profit result in the 2010 year. This is a stark contrast to the prior year, where seven companies from the same pool reported a net deficit result. One key factor contributing to this positive result is the boost to earnings resulting from a 198 basis point increase in the average interest margin between 2009 and 2010 as funding costs fell but the finance companies were able to hold their interest rates on lending.

Asset quality remains a focus of concern for many of the finance companies, with increased past due and gross impaired assets in the current year as compared to the prior. As anticipated, impaired asset expenses have remained relatively consistent between years as legacy issues continue to be worked through. We expect this trend to continue before past due and impaired assets start to decrease.

A 5.1% reduction in total assets across the sector is reflective of a slowing economy and an industry which continues to be cash constrained with funding still tight. While many of the companies would have liked to reduce their reliance on the debenture funding model, the banks have shown limited interest in providing funding to the finance company sector. Even those that have bank funding have found it comes with certain covenants and restrictions which have made growth difficult.

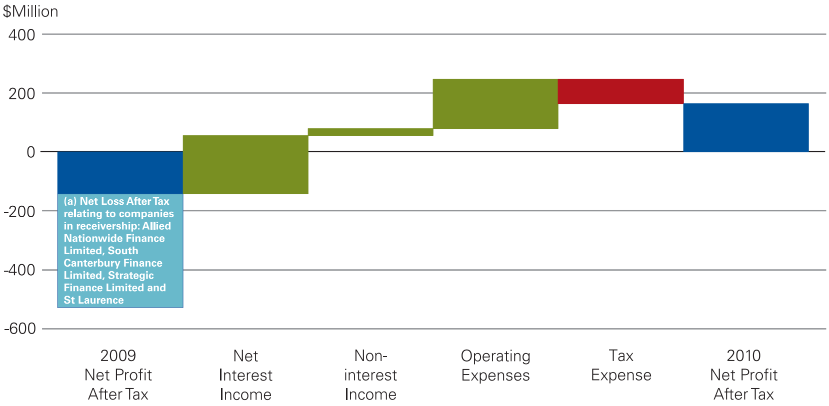
The profitability of the sector combined with the overall contraction in lending assets has helped to improve the average gearing ratio of the sector, from 8.18 in 2009 to 11.57 in 2010.

Two factors which have caused significant disruption and distortion in the finance company sector are the Crown Retail Deposit Guarantee Scheme (RDGS) (and Extended Scheme (ERDGS)) and the new Non-bank Deposit Taker (NBDT) regime introduced by the RBNZ. Although the original RDGS provided a level of much needed security and certainty to investors at a time of crisis, it has also had the effect of distorting the market and taking the onus of risk assessment from the consumer and transferring it to the Crown. The finance companies participating in the RDGS have essentially had license to offer guaranteed products sporting interest rates well in excess of bank and sovereign interest rates and have had the consequent ability to attract a substantial amount of investment funds with no reference to the risk of the underlying business.

The introduction of the NBDT regime will have also had a significant impact on the finance companies and the way in which they operate. The provisions of the regime will make it challenging for small finance companies to be able to operate in the market. The standards and requirements placed on the sector are such that this is likely to impose a high cost of compliance, which combined with the difficultly in sourcing funding, will in our view, force many of the smaller finance companies to consolidate or merge to achieve scale. We expect to see continued consolidation of the sector in coming years, as evidenced in the proposed "Heartland Bank" merger of MARAC's parent Pyne Gould Corporation, CBS Canterbury and Southern Cross Building Society.

Figure 3

Finance Companies: Movement in Net Profit After Tax



Finance Companies in Receivership

Strategic Finance was the first high profile finance company to be placed into receivership for the 2010 year. The inability to meet scheduled investor repayments under its moratorium agreement and breach of financial covenants the Trustee set out in the Trust Deed provided sufficient reason to place Strategic Finance into receivership on 12 March 2010. Strategic Finance owed its investors approximately $417 million although it was not covered by the RDGS as the company did not qualify for the scheme.

St Laurence was placed into receivership by its Trustee on 29 April 2010 following the declaration that it was insolvent and no longer able to make scheduled payments under its moratorium agreement. St Laurence owed its investors approximately $245 million, again not covered by the RDGS.

North South Finance was placed in receivership on 8 July 2010 when it too had trouble meeting the terms of its debt moratorium.

Allied Nationwide Finance was placed into receivership on 20 August 2010. Allied's parent Allied Farmers had acquired the Hanover Finance portfolio in a debt for equity swap, but had struggled with increasing loan impairment expenses over the period. With total outstanding debentures of $130 million, the Crown crystallised a significant liability under the RDGS.

On 31 August 2010, despite significant efforts to put together a recapitalisation or 'rescue deal', South Canterbury Finance (SCF) was placed in receivership. With both bonds, debentures and notes issued to the market, this was by far the most significant failure of the year. While the Crown settled all liabilities (approximately $1.6 billion) to debenture holders and other guaranteed instruments in mid-October 2010, the Receiver is working hard to continue to operate SCF (the first finance company to continue to operate post receivership). Deutsche Bank has been appointed to act as sale advisor for the SCF business with a goal to minimise the potential loss of value which has been estimated by some observers to be as high as $600 to $700 million.

Most recently, on 26 November 2010, Equitable Mortgages (Equitable) was placed into receivership after the Board of Directors deemed the company to be no longer viable. Under the RDGS, deposit holders will be repaid circa $178 million. As this receivership occurred after the last 31 March 2010 reporting date, Equitable's financial results have been included in our 2010 Survey.

Profitability of the Sector

The finance company sector has made a remarkable recovery in the current year – moving from an overall net deficit after tax of $143 million in 2009 to a strong profit of $162 million in 2010 (see figures 3 and 6). The remaining finance company sector is a combination of the internationally supported entities or the strongest of the other entities who have now returned to a more normalised,

Figure 4

Finance Companies: Gross Impaired and Past Due Assets

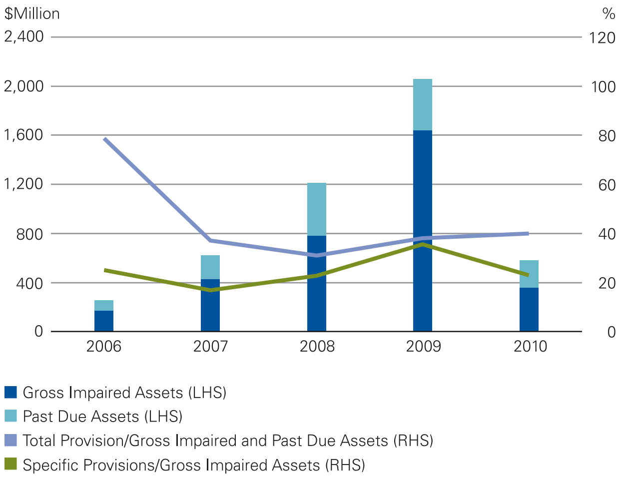
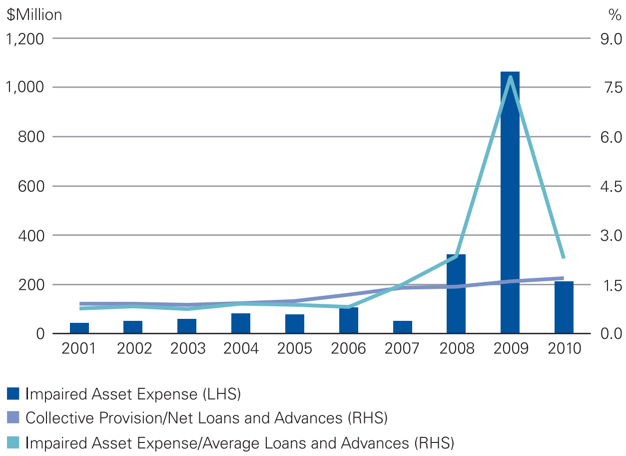


Figure 5

Finance Companies: Impaired Asset Analysis



if not still somewhat cautious, level of business. Amongst the better performers for the 2010 year are UDC Finance, Custom Fleet NZ, Fuji Xerox Finance and GE Finance and Insurance (GE Money) – who have seen net profit after tax increase by 576%, 229%, 142%, and 119% respectively.

Across the sector, the primary drivers of increased profitability include increased interest rate margins, gaining control over impaired asset expenses and the benefit of reduced market interest rates (as compared to 2009). As the largest player in the market, UDC Finance has performed particularly well in the current year with asset growth in 2010 of 13.3% after a five year period of contraction in total assets. The wider failures in the sector, combined with the 'AA' rated/ANZ National Bank supported strength of UDC, has allowed UDC to target growth, and new lending opportunities.

GE Money also performed well in the year to December 2009 compared to the prior year. Results improved due to the absence of significant investment and intangible asset write-offs which were present in the prior year due to the business restructuring. GE Money also saw an improvement in interest rate margins as rates have fallen and funding has been repaid.

Specific contributing factors to the performance recorded by Custom Fleet and Fuji Xerox Finance in the current year include the absence of costs associated with Custom Fleet's acquisition in 2009 and a significant ($25 million) intercompany service fee incurred by Fuji Xerox during 2009.

MARAC Finance, Motor Trade Finance and Equitable Mortgages (Equitable was subsequently placed into receivership on 26 November 2010) reported reduction in net profit after tax of 25.0%, 39.5% and 83.7% respectively.

MARAC Finance's loan book has stabilised somewhat as a result of its restructure, which saw a significant portion of the underperforming property loans transferred out of the finance company. This was the precursor to MARAC Finance, Southern Cross Building Society and Canterbury Building Society progressing their merger with the aim of achieving the scale, product and geographical reach considered necessary for a subsequent bank registration.

Motor Trade Finance's profitability has been particularly impacted by the GFC and associated recession which resulted in a significant reduction in car sales across New Zealand, and MTF's decision to exit the car leasing business.

Asset Quality and Impairment Expense

Despite the recovery of the finance sector in terms of profitability, margins and volume growth, the legacy asset quality issues continue to persist. Although impairment expenses to average loans and advances have remained at largely similar levels to 2009 at 2.28% (see figure 5), past due assets and gross impaired assets continue to steadily creep up (see figure 4). We expect this trend to continue into the foreseeable future until such time as impaired assets are recovered or written off.

Although the average impairment expense ratio across the sector has increased to 2.28%, up from 2.09% in the prior year, individual results have been somewhat varied. The performance of the three largest finance companies reflect these varied results with UDC Finance seeing a significant improvement in impaired asset expense – even after allowing for a $7.6 million reduction in collective provisions, the level of write-offs was down 51% on the prior year. However, GE Money and MARAC both experienced increases in impaired asset expense with GE Money rising to 6.71% (from 4.95% in the year to December 2008) and MARAC Finance to 1.95% (up from 1.02% in 2009). The high level of write-offs in the GE Money

Figure 6
Finance Companies: Underlying Profit and Net Profit After Tax

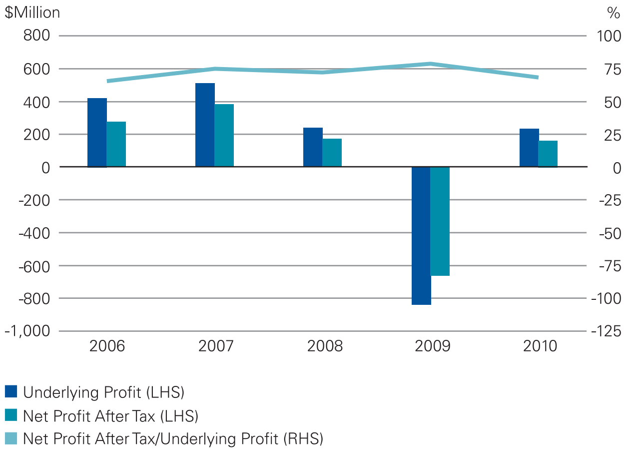
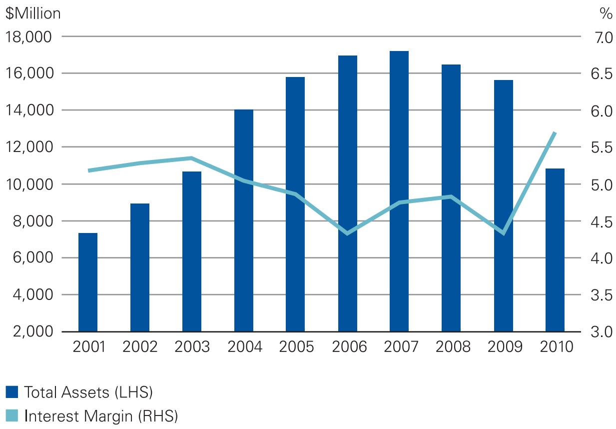


Figure 7
Finance Companies: Total Assets vs Interest Margin



portfolio reflects the retail and personal loan nature of the portfolio, while the MARAC result points to a 'clean up' in the book prior to any amalgamation/merger as part of the "Heartland Bank" proposal. Between 2009 and 2010, average past due assets have increased by 22.9% and similarly gross impaired assets by 39.1%. The increase in past due assets has been largely driven by increases in two entities and a reduction by one. Equitable Mortgages and PGG Wrightson Finance had a combined increase in past due assets of $103 million, while MARAC Finance with its non-performing loan restructure saw a reduction of $59 million. Across the sector a net increase in past due assets from $181 million to $223 million points to the fact that while the recession might technically be over, there are still large numbers of customers who are struggling to make payments.

Gross impaired assets have followed a broadly similar trend; increasing 39.1% from $236 million to $329 million (see figure 4). While several entities have seen improvements in gross impaired loans, four companies experienced significant deterioration. Equitable Mortgages (now in receivership), MARAC Finance, PGG Wrightson Finance and UDC Finance between them reported a $111 million increase in impaired loans, essentially doubling the level of such loans from the prior year. While the four companies operate in somewhat different segments of the industry (including automotive and equipment financing, property funding, rural exposures and general asset financing) the trend across these four companies, represented 39% of the total finance companies sector's assets, points to a legacy of problem loans which are proving difficult to dispose of or recover.

Interest Margins

Contrary to trends seen in the prior year, interest margins have improved in the current year by a significant 198 basis points (i.e. almost 2%) across the sector (see figure 7). One would need to look back to the year 2000 to see an average interest margin for the sector at this level (5.71%). The falling interest rate environment through 2009, combined with a market which has been particularly tight on new lending has allowed the remaining finance companies to more appropriately price for risk. However, not all the finance companies experienced this improvement with only 12 of the 16 companies experiencing an increase. Amongst those companies reporting decreased margins are Equitable Mortgages and NZF Money.

The three largest companies UDC Finance, GE Money and MARAC, all experienced improvements in their margins, although it was GE Money who recorded the most significant increase, largely driven off the back of reduced interest rates and reduced funding requirements due to business restructuring. Other significant movements during the year were Customfleet, who returned to a more normal 5.70% margin after integrating the GE Money portfolio in 2009, and GMAC who had experienced a blowout in its cost of funds in 2009. As the finance company sector continues to adapt and change to fit into the new economic environment, a key change which we expect to see in the future is an increasing move for investors to price for risk. With the new NBDT regulations requiring credit ratings, the information is in place for the investor to more appropriately assess the risk and to require an appropriate return on the invested funds.

Non-interest Income

Non-interest income for the sector increased from 1.51% of total assets in 2009 to 1.79% in 2010. Non-interest income comprises all other income including gains on sale, income of associates, and IFRS revaluations. This improvement is largely the result of a number of negative financial instrument/interest rate swap revaluations which occurred in the prior year but which have not recurred in the current since interest rates have once again started to rise. These include: NZF Money ($4 million), Medical Securities ($5 million) and GMAC Financial Services ($7 million). Other significant improvements in other income were Orix who recorded a $7.7 million gain on disposal of vehicles.

Among the three largest finance companies, non-interest income remained largely static.

Operating Expenses

Across the sector, operating expenses as compared to operating income have decreased from 73.0% in the prior year to 45.6% in the current year. There are a number of key changes in the current year which have contributed to this result including:

- a number of significant one-off events which were unique to the prior year – including: Fuji Xerox incurring a $25 million inter-company service charge and $21 million of commission paid out by Motor Trade Finance for the separation of owners from dealers; and
- a significant reduction in operational costs in GE Money which reflected a refocus of the business around its products, platforms and operating model bringing significant reductions in costs during the year to December 2009.

The improvement in overall operating expenses occurred despite finance companies experiencing increased costs related to compliance with the new NBDT regime which was introduced during the current year.

Finance Companies

Analysis of Consolidated Accounts of Finance Companies[(a), (b)]	Rank by Total Assets	Location of Head Office	Approved Institution – Extended Retail Deposit Guarantee Scheme	Balance Date	Year	Size & Strength Measures: Total Assets $'000	Net Assets $'000	Gearing %	Net Loans and Advances[(m)] $'000	Number of Employees[(n)]	Growth Measures: Increase in Net Profit After Tax %	Increase in Underlying Profit %	Increase in Total Assets %
BMW Financial Services New Zealand Limited	14	Auckland		31-Dec	2009	234,647	23,338	9.95	193,244	17	529.12	287.37	2.85
					2008	228,150	20,656	9.05	192,423	17	-118.67	-145.15	-1.45
Custom Fleet NZ [(c)]	4	Auckland		31-Dec	2009	1,056,595	n/a	n/a	492,014	n/d	228.51	202.00	-8.70
					2008	1,157,248	n/a	n/a	510,154	n/d	-133.89	-301.94	82.56
Equitable Mortgages Limited [(o)]	13	Auckland	✓	31-Mar	2010	252,924	64,930	25.67	190,216	6	-83.72	-104.04	56.12
					2009	162,002	19,109	11.80	0	7	969.26	25.23	-8.58
Fisher & Paykel Finance Group [(j)]	6	Auckland	✓	31-Mar	2010	677,929	n/a	n/a	640,620	229	66.34	43.42	5.58
					2009	642,118	n/a	n/a	609,691	231	-37.29	-13.81	-1.27
Fuji Xerox Finance Limited	15	Auckland		31-Mar	2010	212,702	39,618	18.63	207,804	11	141.61	138.63	8.93
					2009	195,271	27,880	14.28	193,760	11	-574.55	-514.43	-1.89
GE Finance and Insurance [(g)]	2	Auckland		31-Dec	2009	1,543,240	109,572	7.10	1,451,800	n/d	118.84	169.35	-18.67
					2008	1,897,445	80,340	4.23	1,820,468	n/d	-1,056.18	-215.18	-23.19
GMAC Financial Services NZ Limited	16	Auckland		31-Dec	2009	132,095	25,941	19.64	109,316	11	122.53	115.87	-57.27
					2008	309,106	21,242	6.87	252,255	25	-235.30	-228.87	-28.16
MARAC Finance Limited [(h) (i)]	3	Auckland	✓	30-Jun	2010	1,294,556	206,468	15.95	1,114,698	176	-24.96	-25.55	-8.37
					2009	1,412,795	152,961	10.83	1,300,159	156	-26.33	-29.49	4.48
Medical Securities Limited	12	Wellington		31-Mar	2010	259,281	42,666	16.46	251,367	31	549.83	593.02	-33.91
					2009	392,298	38,874	9.91	376,959	39	-132.36	-129.20	-14.20
Mercedes-Benz Financial Services	9	Auckland		31-Dec	2009	338,788	22,441	6.62	323,288	27	134.98	54.79	-4.62
					2008	355,212	17,869	5.03	329,955	31	208.47	170.94	10.78
Motor Trade Finances Limited	8	Dunedin		30-Sep	2010	462,447	66,244	14.32	420,302	52	-39.46	-43.60	-13.78
					2009	536,368	63,473	11.83	494,365	52	-64.99	-67.01	-14.03
NZF Money Limited	11	Auckland		31-Mar	2010	276,314	16,369	5.92	260,361	16	262.19	263.34	4.35
					2009	264,796	11,596	4.38	255,144	16	-146.86	-144.33	3.34
ORIX New Zealand Limited	10	Auckland		31-Mar	2010	317,451	67,525	21.27	50,691	71	140.57	161.71	-3.68
					2009	329,593	55,888	16.96	71,375	71	-10.14	11.70	-3.75
PGG Wrightson Finance Limited	7	Christchurch	✓	30-Jun	2010	549,662	100,375	18.26	530,119	58	14.85	14.80	-4.49
					2009	575,475	66,816	11.61	559,659	58	33.67	28.34	13.40
Toyota Finance New Zealand Limited	5	Auckland		31-Mar	2010	1,017,912	129,786	12.75	620,759	n/d	37.96	33.57	2.65
					2009	991,628	118,117	11.91	590,345	61	-15.26	11.64	35.50
UDC Finance Limited	1	Auckland		30-Sep	2010	2,127,431	250,043	11.75	1,997,678	199	575.93	2,024.13	13.31
					2009	1,877,578	231,874	12.35	1,865,588	215	-90.48	-104.95	-7.66
Finance Sector Total [(k)]					**2010**	**10,753,974**	**1,165,316**	**11.57**	**8,854,277**	**904**	**213.53**	**657.40**	**-5.06**
					2009	**11,327,083**	**926,695**	**8.18**	**9,422,300**	**990**	**-225.17**	**-126.90**	**-3.59**
2009 Including companies in receivership					**2009**	**14,498,557**	**1,157,682**	**7.98**	**11,750,103**	**1,152**	**-392.43**	**-329.21**	**0.72**
2009 Financial Statements not available [(l)]													
John Deere Credit Limited				31-Oct	2009	152,945	3,766	2.46	109,077	1	164.38	163.74	7.33
Truck Leasing Limited				30-Sep	2009	102,507	55,181	53.83	672	120	-54.82	-91.45	-70.06
In Receivership													
Allied Nationwide Finance Limited [(d)]		Wellington		30-Jun	2009	361,960	30,212	8.35	309,814	48	-397.92	-334.07	89.34
South Canterbury Finance Limited [(d)]		Timaru		30-Jun	2009	2,335,774	200,775	8.60	1,643,530	95	-334.83	-318.60	18.53
St Laurence Limited [(d)]		Wellington		31-Mar	2009	132,873	0	0.00	48,756	0	-448.06	-1,763.17	-53.08
Strategic Finance Limited [(d)]		Wellington		30-Jun	2009	340,867	0	0.00	325,703	19	-1,012.78	-726.09	-35.92

Key: n/a = not available/applicable; n/d = not disclosed.

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(a) Where comparatives have been restated in the latest financial statements, we have restated the tables accordingly.

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(c) As at their respective balance dates, Custom Fleet NZ and Fisher & Paykel Finance Group, had goodwill and other intangible assets which exceeded their equity. In accordance with the Survey definitions, total assets and net assets are adjusted to exclude goodwill intangibles. We do not believe it is appropriate to present negative net tangible assets or gearing ratios and therefore sector net assets have been adjusted to exclude Custom Fleet NZ.

(d) Allied Nationwide Finance Limited, South Canterbury Finance Limited, Strategic Finance Limited, and St Laurence are all in receivership and are therefore excluded from all sector totals.

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(f) Canon Finance New Zealand, CIT Group Limited, Dorchester Finance Limited, FAI Money Limited (formerly FAI Finance Limited), Farmers Mutual Finance Limited, Geneva Finance Limited, Hanover Finance Limited, Instant Finance NZ Limited, North South Finance Limited, Orange Finance Limited, Oxford Finance Limited, Primus Financial Services Limited, Structured Finance (NZ) Limited, United Finance Limited and The Warehouse Financial Services all have Total Tangible Assets of less than $100 million and are therefore excluded.

(g) GE Finance and Insurance results include $34 million (2009: $20 million) of management income from their parent company.

(h) MARAC Finance Limited amalgamated with Nissan Finance New Zealand Limited during the financial year ended 30 June 2009.

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(k) Where information is not available for 2010, 2009 or 2008, sector averages have been adjusted. The 2010 sector totals include companies with financial reporting periods ended 1 October 2009 to 30 September 2010.

(l) Current financial results for Truck Leasing Limited and John Deer Credit Limited were not available at publication date. The financial data for 2009 has been included for reference only and is not included in the sector totals.

(m) Net loans and advances exclude operating lease assets.

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(o) Equitable Mortgages Limited entered into receivership on 26 November 2010.

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					2009	*1,877,578*	*231,874*	*12.35*	*1,865,588*	*215*	*-90.48*	*-104.95*	*-7.66*
Finance Sector Total [(k)]					**2010**	**10,753,974**	**1,165,316**	**11.57**	**8,854,277**	**904**	**213.53**	**657.40**	**-5.06**
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Truck Leasing Limited				*30-Sep*	*2009*	*102,507*	*55,181*	*53.83*	*672*	*120*	*-54.82*	*-91.45*	*-70.06*
In Receivership													
Allied Nationwide Finance Limited [(d)]		*Wellington*		*30-Jun*	*2009*	*361,960*	*30,212*	*8.35*	*309,814*	*48*	*-397.92*	*-334.07*	*89.34*
South Canterbury Finance Limited [(d)]		*Timaru*		*30-Jun*	*2009*	*2,335,774*	*200,775*	*8.60*	*1,643,530*	*95*	*-334.83*	*-318.60*	*18.53*
St Laurence Limited [(d)]		*Wellington*		*31-Mar*	*2009*	*132,873*	*0*	*0.00*	*48,756*	*0*	*-448.06*	*-1,763.17*	*-53.08*
Strategic Finance Limited [(d)]		*Wellington*		*30-Jun*	*2009*	*340,867*	*0*	*0.00*	*325,703*	*19*	*-1,012.78*	*-726.09*	*-35.92*

Key: n/a = not available/applicable; n/d = not disclosed.

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(a) Where comparatives have been restated in the latest financial statements, we have restated the tables accordingly.

(b) Where applicable, consolidated Group numbers have been used.

(c) As at their respective balance dates, Custom Fleet NZ and Fisher & Paykel Finance Group, had goodwill and other intangible assets which exceeded their equity. In accordance with the Survey definitions, total assets and net assets are adjusted to exclude goodwill intangibles. We do not believe it is appropriate to present negative net tangible assets or gearing ratios and therefore sector net assets have been adjusted to exclude Custom Fleet NZ.

(d) Allied Nationwide Finance Limited, South Canterbury Finance Limited, Strategic Finance Limited, and St Laurence are all in receivership and are therefore excluded from all sector totals.

(e) Companies with Total Tangible Assets less than $100 million are excluded from all sector totals.

(f) Canon Finance New Zealand, CIT Group Limited, Dorchester Finance Limited, FAI Money Limited (formerly FAI Finance Limited), Farmers Mutual Finance Limited, Geneva Finance Limited, Hanover Finance Limited, Instant Finance NZ Limited, North South Finance Limited, Orange Finance Limited, Oxford Finance Limited, Primus Financial Services Limited, Structured Finance (NZ) Limited, United Finance Limited and The Warehouse Financial Services all have Total Tangible Assets of less than $100 million and are therefore excluded.

(g) GE Finance and Insurance results include $34 million (2009: $20 million) of management income from their parent company.

(h) MARAC Finance Limited amalgamated with Nissan Finance New Zealand Limited during the financial year ended 30 June 2009.

(i) MARAC Finance Limited's results include securitisation vehicles.

(j) Fisher & Paykel Finance Group comprises Fisher & Paykel Finance Limited and Fisher & Paykel Finance Holdings Limited (and their respective subsidiaries).

(k) Where information is not available for 2010, 2009 or 2008, sector averages have been adjusted. The 2010 sector totals include companies with financial reporting periods ended 1 October 2009 to 30 September 2010.

(l) Current financial results for Truck Leasing Limited and John Deer Credit Limited were not available at publication date. The financial data for 2009 has been included for reference only and is not included in the sector totals.

(m) Net loans and advances exclude operating lease assets.

(n) Employee numbers are on a full time equivalent basis (including casuals and contracting staff) at the annual balance date and the prior balance date.

(o) Equitable Mortgages Limited entered into receivership on 26 November 2010.

Performance Rankings

Finance Companies

	Rank by Total Assets	Increase in Total Assets %	Gearing $000's	Net Profit After Tax $000's	Interest Margin %	Impaired Asset Expense/ Average Loans & Advances %	Operating Expenses/ Operating Income %
BMW Financial Services New Zealand Limited	14	2.85	9.95	2,682	4.53	1.52	35.43
Custom Fleet NZ Limited	4	-8.70	n/a	23,929	5.70	0.81	48.33
Equitable Mortgages Limited (unrated)	13	56.12	25.67	382	2.22	0.00	58.45
Fisher & Paykel Finance Group	6	5.58	n/a	15,586	9.63	3.11	42.52
Fuji Xerox Finance Limited	15	8.93	18.63	11,738	7.59	1.46	23.26
GE Finance and Insurance	2	-18.67	7.10	28,555	8.97	6.71	44.50
GMAC Financial Services NZ Limited	16	-57.27	19.64	980	5.06	1.71	58.29
MARAC Finance Limited	3	-8.37	15.95	14,299	4.89	1.95	36.23
Medical Securities Limited	12	-33.91	16.46	3,792	3.73	0.44	55.90
Mercedes-Benz Financial Services New Zealand Limited	9	-4.62	6.62	3,849	4.36	1.57	40.91
Motor Trade Finances Limited	8	-13.78	14.32	5,306	7.33	0.61	78.66
NZF Money Limited	11	4.35	5.92	3,560	2.08	-0.08	46.52
ORIX New Zealand Limited	10	-3.68	21.27	8,634	9.19	1.62	60.89
PGG Wrightson Finance Limited	7	-4.49	18.26	8,933	5.14	1.62	25.05
Toyota Finance New Zealand Limited	5	2.65	12.75	11,669	3.75	0.83	44.14
UDC Finance Limited	1	13.31	11.75	18,169	3.84	0.89	43.24
Sector Total		**-5.06**	**11.57**	**162,063**	**5.71**	**2.28**	**45.63**

gold silver bronze

Savings Institutions

	Rank by Total Assets	Increase in Total Assets %	Gearing $000's	Net Profit After Tax $000's	Interest Margin %	Impaired Asset Expense/ Average Loans & Advances %	Operating Expenses/ Operating Income %
CBS Canterbury	2	-1.63	7.91	1,910	1.47	0.14	79.03
Credit Union Baywide	6	8.80	17.57	1,488	7.07	1.72	76.81
First Credit Union	10	-0.76	18.57	1,035	5.70	1.42	74.62
Credit Union North	8	-0.05	14.32	644	7.00	2.43	83.14
Credit Union South	9	4.78	15.32	714	11.23	2.51	83.16
Hastings Building Society	5	0.75	9.20	1,005	1.74	0.48	49.99
Nelson Building Society	4	9.76	6.12	1,470	2.63	0.10	68.29
PSIS Limited	1	5.17	8.37	13,120	3.71	0.29	70.80
Southern Cross Building Society	3	-2.19	11.81	-4,702	2.48	2.11	77.13
Wairarapa Building Society	7	2.36	13.99	45	1.52	0.51	78.70
Sector Total		**2.90**	**9.92**	**16,729**	**3.50**	**0.70**	**74.60**

gold silver bronze

Savings Institutions Sector Performance

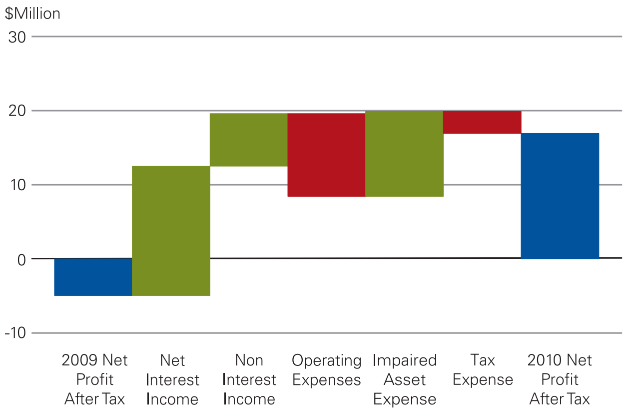
Recent media reports have referred to the savings institutions as being New Zealand's "best kept secret". Although the savings institutions have certainly not been immune to the effects of the global financial crisis (GFC); prudent lending policies and reliance on domestic funding sources has meant that the impact has been less severe (than that experienced by the finance companies) and recovery quicker when compared to that of the registered banks.

Performance results presented in the current year in terms of asset growth and profitability are testament to the overall recovery of this sector. Although the challenges of a soft economy and competitive industry continue, this sector certainly appears to be stepping forward and considering future changes needed to succeed in the future environment.

The savings institutions have weathered the GFC, the adverse economic conditions have provided a catalyst for significant and continued change within the sector. Even more so than the prior year, the sector has been characterised this year by contraction and consolidation. In many cases, consolidation has been the saving grace for a number of institutions for who survival into the future on a stand-alone basis may have been far more difficult than as part of a larger group.

Perhaps the most noteworthy merger presently on the cards is that of the so-called "Heartland Bank" – where Southern Cross Building Society (SCBS), Canterbury Building Society (CBS) and MARAC Finance's parent Pyne Gould Corporation (PGC) aim to merge in early January 2011 and become a registered bank in due course. This merger has recently moved one step closer to completion with shareholders of SCBS, CBS and PGC voting in favour of the proposal. While merging the entities will achieve the first hurdle in the path to bank registration, there will continue to be further hurdles including integration of the businesses, showing a track record, convincing rating agencies that the combined entity warrants an upgrade and finally getting RBNZ approval. These hurdles will take time and while the merger is not without risk, the risk profile of the consolidated group must be lower than the individual entities. One particular risk reducing factor to note is that these three are among the last entities to still carry the Extended Crown Retail Deposit Guarantee.

Figure 8
Savings Institutions: Movement in Net Profit After Tax



Other key integration and rationalisation events which have occurred within this sector in the current year include:

- Hastings Building Society completing the process to approve an amalgamation with Southland Building Society effective 1 October 2010; and
- As a group, the credit unions have continued a rationalisation/aggregation process that has seen the number of credit unions drop significantly over the last few years.

An additional change present in the current year is the expiry of the Crown Retail Deposit Guarantee Scheme, on 12 October 2010. Although an Extended Scheme has been implemented, the number of approved participants is much reduced – with the only participants from the savings institution sector being: CBS, SCBS and Wairarapa Building Society (WBS). Although participation in the Extended Scheme provides scope for members to offer both guaranteed and non-guaranteed products, the costs of participation and compliance are likely to be significant.

Results for the Sector: Key Trends

The overall picture painted by the savings institutions for the current year is generally a positive one. This is reflective of recoveries across the New Zealand economy as a whole as well as a number of entities working through a number of individually significant prior year issues/adjustments. Specifically, total assets and net profit after tax have grown in the current year, with average total assets growing by 2.9% and average net profit after tax increasing by a considerable 436.3% (see figure 8). Interest margins have strengthened – reaching 3.50% in the current year as compared to 3.02% in the prior (see figure 9).

As compared to operating income, average operating expenses (to operating income) have decreased slightly on the prior year, with 75.97% in 2009 to 74.60% in 2010 (see figure 11). This reduction is attributable to the absence of a number of significant one-off costs in the prior year and strong income growth over the period.

Credit quality has also improved with a 38.4% reduction in the total impaired asset expense and a 12.1% reduction in gross impaired assets (see figure 10). Despite these improvements, total past due assets for the sector have increased by 14.5% between 2009 and 2010 and a more cautious approach to provisioning by the saving institutions has resulted in a higher average provision for doubtful debts against gross loans and advances in the current year as compared to last, with a 0.95% provision in the current year against 0.77% in the prior.

Profitability

As compared to results presented in the prior year, the change in profitability is perhaps the most striking – with a total loss after tax result of $5.0 million across the sector in the prior year to a profit result of $16.7 million in the current year. This improved result has been driven by the results of a number of individual institutions including: CBS, Credit Union Baywide (CUB), Credit Union North (CUN) and Hastings Building Society (HBS). In addition, as the largest player in the industry, the 66.3% increase in profit after tax of PSIS has contributed significantly to the average results of the sector.

The key drivers to this positive trend are improved interest margins, reduced impaired asset expenses and the work through of the prior year fair value movements (losses) on derivatives and financial instruments.

In the prior year, it was CUB and HBS that were hurt most by the IFRS fair value adjustments (typically on their interest rate swaps), however the passing of time and movements in interest rates have seen a dramatic improvement in profitability between years – from a loss result in the prior year to a strong profit result in the current. CUB recorded a net loss after tax of $0.98 million during 2009 as compared to a profit after tax of $1.49 million for 2010. HBS recorded a net loss after tax of $1.14 million during 2009 as compared to a profit after tax of $1.01 million for 2010.

The significant change in profit result for CBS from a $3.48 million loss after tax in 2009 to a $1.91 million profit after tax in the current year is mainly due to the absence of a once-off extraordinary expense recognised during 2009 for the write off of $4.10 million goodwill (arising on the LBS merger). The 2010 profit result is therefore more reflective of 'business as usual' rather than an extraordinary turnaround in performance.

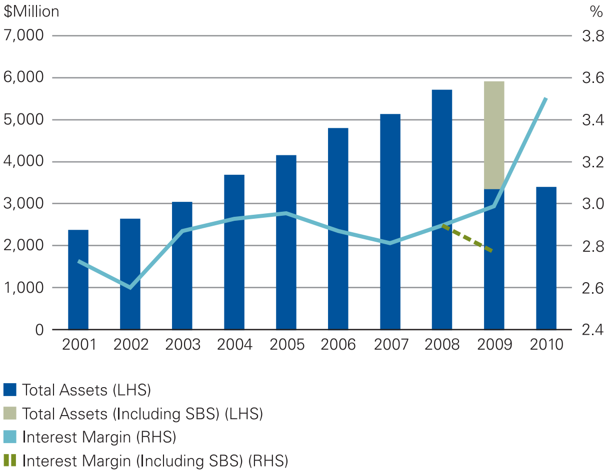
Bucking the positive profit growth trend of the current year is Credit Union South (CUS) and WBS, whom have reported reduced profit results of 10.2% and 79.0% respectively. In addition, while current performance has improved against the $8.75 million loss after tax of the 2009 year, SCBS continues to record a loss after tax of $4.70 million in the current year. The common denominator across these entities is continued asset impairment. CUS recorded a significantly higher impaired asset expense in the current year, with an increase from the prior year of 89.4%. While SCBS has significantly reduced the impaired asset expense in the current year (down by 60.6%) – it continues to be high when compared to industry average (impaired asset expense ratio of 2.11% vs. an industry average of 0.70%). These results are reflective of the continued effect of the GFC as individual borrowers' losses are now being crystallised or customers who previously were able to withstand the financial pressures are starting to default.

Interest Margins

In line with the current year profit results, average interest margins across the sector have increased in comparison to previous years – with an average interest margin of 3.50% in the current year, as compared to 3.02% in the prior year (see figure 9). This trend is consistent when analysing the building societies and credit unions separately – with the average interest margin for building societies increasing from 2.43% in 2009 to 2.75% in 2010 and credit unions increasing from 6.26% in 2009 to 7.19% in 2010. The credit unions seemingly have been better at lagging any reductions in interest rates charged through to their customers than the building societies, perhaps reflecting the more personal lending nature of their

Figure 9

Savings Institutions: Total Assets vs Interest Margin



lending against the very competitive residential market.

All but three of the savings institutions included in this report have seen equal or higher margins in the current year.

As the savings institutions generally do not obtain funding via wholesale sources, the cost of funds is driven in the main by domestic deposit interest rates and reinvestment rates. The registered banks have been chasing retail deposits to help their core funding ratios. This has caused fierce competition amongst the financial institutions and forced deposit interest rates up. While the credit unions have been able to manage this cost increase with recoveries on the lending side, the building societies have struggled, resulting in a reduced interest spread for the building societies.

From discussions held, we understand that in general reinvestment rates have remained stable across the period even as the Crown Retail Deposit Guarantee Scheme expired, allaying fears that a 'wall of money' might flow out of non-guaranteed entities.

In conjunction with re-pricing, an additional factor which has contributed to increased interest margins is a change to the typical lending portfolio profile – so that a greater focus and reliance is placed on personal lending as opposed to mortgages.

Impaired Asset Expense

As a sector, the total impaired asset expense attributable to the current year has almost halved as compared to the prior year, with an $18.4 million expense in the current year as compared to $29.9 million in the prior (see figure 10). In line with this trend, total gross impaired assets have decreased by 12.1% between 2009 and 2010.

Conversely, past due assets have increased by 14.5% between 2009 and 2010 and the average provision for doubtful debts over gross loans and advances has increased from 0.77% in 2009 to 0.95% in 2010. These results indicate that although the savings institutions have weathered the worst of the GFC, the effects of a fragile and softening economy continue to permeate. The savings institutions continue to act with caution and have generally adopted prudent lending and provisioning policies.

When analysing individual institutions, the most noteworthy recoveries of the current year in terms of reducing impairment expenses and gross impaired assets include CBS and SCBS who between them record an $11.6 million reduction in impairment charges/expenses down from $18.0 million to $6.4 million. In contrast, the credit unions (CUB, FCU, CUN and Credit Union South (CUS)) have seen gross impaired assets increase 12.9% between 2009 and 2010 with a corresponding increase in impaired asset expenses of 34.7%. These results seem to point to the fact that the personal lending from the credit unions has performed worse in 2010 than the more heavily mortgage focused building society portfolios.

Figure 10
Savings Institutions: Impaired Asset Analysis

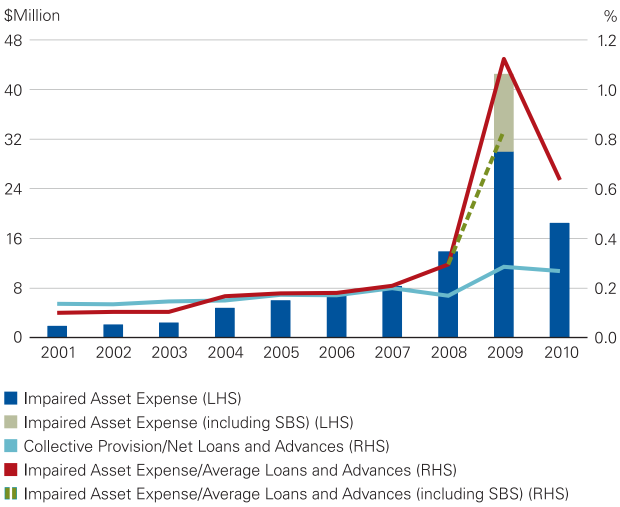
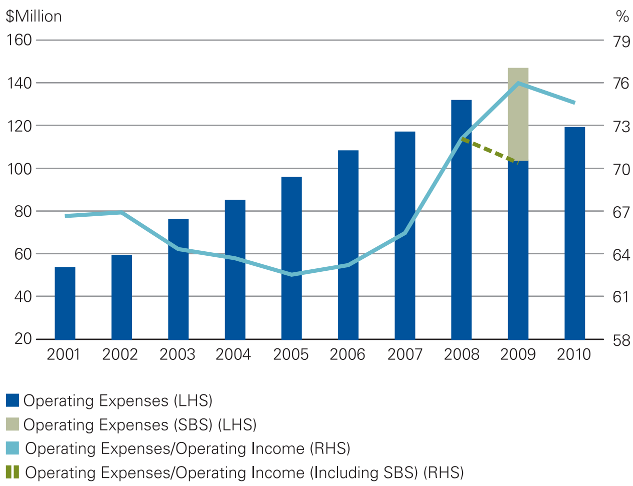


Figure 11
Savings Institutions: Operating Expenses



Savings Institutions

Analysis of Consolidated Accounts of Savings Institutions	Rank by Total Assets	Approved Institution – Extended Retail Deposit Guarantee Scheme	Balance Date	Year	Size & Strength Measures: Total Assets $'000	Net Assets $'000	Gearing %	Net Loans and Advances $'000	Number of Employees	Growth Measures: Increase in Net Profit After Tax %	Increase in Underlying Profit %	Increase in Total Assets %
CBS Canterbury [a]	2	✓	31-Mar	2010	531,321	42,028	7.91	445,298	62	154.87	-61.54	-1.63
				2009	*540,125*	*39,070*	*7.23*	*417,423*	*54*	*-493.78*	*-6.02*	*-1.45*
Credit Union Baywide	6		30-Jun	2010	148,965	26,170	17.57	116,537	n/d	252.62	252.62	8.80
				2009	*136,918*	*24,462*	*17.87*	*119,079*	*n/d*	*-194.20*	*-194.20*	*26.01*
First Credit Union	10		30-Jun	2010	106,008	19,688	18.57	73,775	46	238.24	238.24	-0.76
				2009	*106,823*	*18,653*	*17.46*	*74,827*	*47*	*-79.78*	*-79.76*	*7.62*
Credit Union North [b] [c]	8		30-Jun	2010	114,607	16,414	14.32	83,695	120	n/d	n/d	-0.05
				2009	*114,669*	*15,661*	*13.66*	*94,184*	*114*	*n/d*	*n/d*	*-1.34*
Credit Union South [d] [c]	9		31-Mar	2010	112,644	17,254	15.32	89,372	84	n/d	n/d	4.78
				2009	*107,506*	*17,104*	*15.91*	*88,959*	*75*	*-14.24*	*-14.33*	*2.95*
Hastings Building Society [e]	5		31-Mar	2010	184,791	17,003	9.20	141,176	16	188.31	188.35	0.75
				2009	*183,412*	*15,948*	*8.70*	*134,825*	*15*	*-159.39*	*-157.64*	*-5.47*
Nelson Building Society	4		31-Mar	2010	272,724	16,687	6.12	218,089	30	94.96	84.83	9.76
				2009	*248,484*	*17,264*	*6.95*	*193,018*	*30*	*-6.57*	*-20.13*	*10.90*
PSIS Limited	1		31-Mar	2010	1,395,542	116,872	8.37	1,125,321	292	66.31	55.64	5.17
				2009	*1,326,953*	*103,737*	*7.82*	*1,065,910*	*288*	*319.44*	*244.72*	*6.52*
Southern Cross Building Society [a]	3	✓	30-Jun	2010	402,996	47,606	11.81	251,422	49	46.23	68.98	-2.19
				2009	*412,012*	*52,198*	*12.67*	*276,692*	*53*	*-269.21*	*-218.64*	*-9.63*
Wairarapa Building Society	7	✓	31-Mar	2010	115,440	16,152	13.99	99,297	8	-78.97	-98.98	2.36
				2009	*112,778*	*16,087*	*14.26*	*99,148*	*8*	*-76.91*	*-62.67*	*5.90*
Sector Total				**2010**	**3,385,038**	**335,874**	**9.92**	**2,643,982**	**706**	**436.26**	**205.62**	**2.90**
				2009	***3,289,680***	***320,184***	***9.73***	***2,564,065***	***684***	***-150.97***	***-223.43***	***0.67***

Analysis of Consolidated Accounts of Savings Institutions	Year	Credit Quality Measures: Impaired Asset Expense $'000	Provision for Doubtful Debts/Gross Loans and Advances %	Past Due Assets $'000	Gross Impaired Assets $'000	Impaired Asset Expense/Average Loans and Advances %	Profitability Measures: Interest Margin %	Interest Spread %	Non-interest Income / Average Total Assets %	Net Profit After Tax $'000	Net Profit After Tax/ Average Total Assets %	Underlying Profit $'000	Efficiency Measures: Operating Expenses/Average Total Assets %	Operating Expenses/ Operating Income %
CBS Canterbury [a]	2010	589	0.13	393	511	0.14	1.47	1.13	0.49	1,910	0.36	1,591	1.53	79.03
	2009	*3,363*	*0.00*	*531*	*5,404*	*0.78*	*1.99*	*1.42*	*0.22*	*-3,481*	*-0.64*	*4,137*	*0.81*	*36.95*
Credit Union Baywide	2010	2,057	1.65	n/d	4,111	1.72	7.07	6.18	3.74	1,488	1.04	1,488	8.22	76.81
	2009	*1,541*	*1.03*	*n/d*	*3,499*	*1.47*	*6.96*	*5.80*	*2.08*	*-975*	*-0.79*	*-975*	*8.47*	*94.84*
First Credit Union	2010	1,061	1.45	n/d	4,710	1.42	5.70	5.00	2.21	1,035	0.97	1,035	5.79	74.62
	2009	*1,422*	*1.49*	*n/d*	*3,518*	*1.84*	*5.53*	*4.52*	*1.95*	*306*	*0.30*	*306*	*5.68*	*77.19*
Credit Union North [b] [c]	2010	2,175	1.76	280	3,668	2.43	7.00	6.44	7.80	644	0.56	644	12.13	83.14
	2009	*1,357*	*1.47*	*121*	*3,555*	*1.43*	*5.68*	*4.94*	*6.10*	*-594*	*-0.51*	*-594*	*10.93*	*94.30*
Credit Union South [d] [c]	2010	2,254	2.31	n/d	3,575	2.51	11.23	10.44	4.87	714	0.65	714	13.31	83.16
	2009	*1,190*	*1.83*	*n/d*	*3,657*	*1.32*	*7.94*	*6.96*	*3.41*	*795*	*0.75*	*795*	*9.36*	*83.33*
Hastings Building Society [e]	2010	671	0.77	0	2,442	0.48	1.74	1.25	0.60	1,005	0.55	1,456	1.15	49.99
	2009	*1,025*	*0.70*	*313*	*1,773*	*0.73*	*1.74*	*0.91*	*-0.84*	*-1,138*	*-0.60*	*-1,648*	*1.21*	*137.64*
Nelson Building Society	2010	197	0.12	405	411	0.10	2.63	2.36	0.23	1,470	0.56	2,120	1.91	68.29
	2009	*813*	*0.37*	*124*	*1,435*	*0.42*	*2.40*	*1.93*	*0.38*	*754*	*0.32*	*1,147*	*1.91*	*69.67*
PSIS Limited	2010	3,154	0.30	n/d	1,943	0.29	3.71	3.28	1.33	13,120	0.96	16,585	3.52	70.80
	2009	*4,308*	*0.30*	*n/d*	*1,549*	*0.41*	*2.84*	*2.28*	*1.78*	*7,889*	*0.61*	*10,656*	*3.41*	*74.54*
Southern Cross Building Society [a]	2010	5,765	4.76	3,426	31,579	2.11	2.48	2.02	0.01	-4,702	-1.15	-3,538	1.84	77.13
	2009	*14,625*	*3.18*	*1,033*	*35,668*	*4.67*	*2.54*	*1.80*	*0.10*	*-8,745*	*-2.02*	*-11,406*	*1.79*	*70.76*
Wairarapa Building Society	2010	508	0.92	113	150	0.51	1.52	1.00	0.71	45	0.04	5	1.66	78.70
	2009	*265*	*0.42*	*31*	*342*	*0.27*	*2.32*	*1.61*	*0.52*	*214*	*0.20*	*489*	*1.97*	*74.08*
Sector Total	**2010**	**18,431**	**0.95**	**8,656**	**53,100**	**0.70**	**3.50**	**3.05**	**1.35**	**16,729**	**0.50**	**20,742**	**3.57**	**74.60**
	2009	***29,909***	***0.77***	***7,557***	***60,400***	***1.14***	***3.02***	***2.35***	***1.21***	***- 4,975***	***-0.15***	***-19,638***	***3.16***	***75.97***

Key: n/a = not available/applicable; n/d = not disclosed.

Footnotes

(a) CBS Canterbury and Southern Cross Building Society are currently going through the voting process to approve an amalgamation with Pyne Gould Corporation.

(b) The trading name of Credit Union North is NZCU North. Credit Union North's 2009 financial year was for an 11 month period.

(c) Where comparatives are not for the equivalent period, the increase in net profit after tax and underlying profit has not been provided.

(d) Credit Union South's balance date was changed to 30 June for the 2010 period end in order to align the financial year with the majority of Credit Unions in New Zealand. Credit Union South's 2010 financial year is for a 15 month period.

(e) Subsequent to their 2010 year end, Hastings Building Society merged with Southland Building Society (registered bank) on 1 October 2010.

Definitions

Terms and Ratios used in this Survey[a]	Definitions used in this Survey
Gearing	Net assets divided by total assets.
Gross Impaired Assets	Includes all impaired assets, restructured assets, assets acquired through the enforcement of security, but excludes past due assets.
Impaired Asset Expense	The charge to the Profit and Loss Account for bad debts and provisions for doubtful debts, which is net of recoveries (where identifiable).
Interest Bearing Liabilities	Customer deposits (including accrued interest payable where identifiable), balances with banks, debt securities, subordinated debt and balances with related parties.
Interest Earning Assets	Cash on hand, money on call and balances with banks, trading and investment securities, net loans and advances (including accrued interest receivable where identifiable), leased assets net of depreciation and balances with related parties.
Interest Expense	Includes all forms of interest or returns paid on debt instruments.
Interest Margin	Net interest income divided by average interest earning assets.
Interest Spread	Difference between the average interest rate on average interest earning assets, and the average interest rate on average interest bearing liabilities.
Loans and Advances	Includes loans and advances, lease receivables (net of unearned income) and accrued interest receivable (where identifiable), but excludes amounts due from banks, marketable securities, loans to related parties, sundry debtors and prepayments.
Net Assets	Total assets less total liabilities.
Net Interest Income	Interest income (including net income from acting as a lessor) less interest expense.
Net Loans and Advances	Loans and advances, net of individual provisions for doubtful debts.
Net Profit After Tax	After minority interests, adjusting for the impact of subvention payments.
Operating Expense	Includes all expenses charged to arrive at net profit before tax (excluding interest expense, impaired asset expense, subvention payments, depreciation of leased assets where a lessor and amortisation/write-off of goodwill and other intangibles).
Operating Income	Net interest income and income from all other sources net of depreciation of leased assets, but excludes subvention receipts.
Past Due Assets	Includes any asset which has not been operated by the counterparty within its key terms for 90 days and which is not an impaired or restructured asset.
Provision for Doubtful Debts	Includes both collective and individual provisions for bad and doubtful debts.
Total Assets	Excludes goodwill assets.
Total Liabilities	Includes subordinated debt, but excludes minority interest.
Ultimate Shareholding	Identifies the ultimate holding company rather than any intermediate holding companies.
Underlying Profit	Operating income less operating expense and impaired asset expense. Items of a non-recurring nature, unrelated to the ongoing operations of the entity, are excluded.

Footnote

(a) This Survey includes only those institutions whose financial statements were available at the time of publication. Comparatives have been adjusted for each institution where reclassifications and/or adjustments were made by that institution. To facilitate comparisons between these financial institutions, we have presented the information in their financial statements under standardised classifications.

Credit Ratings

Finance Company/Savings Institutions	Credit Rating Agency	Rating Outlook
AA+		
GE Finance and Insurance	Standard & Poor's	-
AA		
UDC Finance Limited	Standard & Poor's	Stable
AA-		
Fuji Xerox Finance Limited	Standard & Poor's	-
A3		
BMW Financial Services New Zealand Limited	Moody's Investors Service	-
A-		
Medical Securities Limited	Standard & Poor's	Stable
ORIX New Zealand Limited	Standard & Poor's	-
BBB+		
Mercedes-Benz Financial Services New Zealand Limited	Standard & Poor's	Stable
BB+		
Canterbury Building Society	Standard & Poor's	Stable
MARAC Finance Limited	Standard & Poor's	Credit watch positive
Nelson Building Society	Fitch Rating International	Stable
PSIS Limited	Standard & Poor's	Positive
Wairarapa Building Society	Fitch Rating International	Stable
BB		
Credit Union Baywide	Standard & Poor's	Stable
Credit Union North	Standard & Poor's	Stable
Credit Union South	Standard & Poor's	Stable
First Credit Union	Standard & Poor's	Stable
Fisher and Paykel Finance Group	Standard & Poor's	Stable
PGG Wrightson Finance Limited	Standard & Poor's	Stable
Southern Cross Building Society	Standard & Poor's	Stable
B		
GMAC Financial Services NZ Limited	Standard & Poor's	-
NZF Money Limited	Standard & Poor's	Negative

Long-term Credit Ratings Grades Assigned by Standard & Poor's	Description of the steps in the Standard & Poor's credit rating grades for the rating of the long-term senior unsecured obligations payable in New Zealand, in New Zealand dollars.
AAA	Extremely strong capacity to meet its financial commitments. Highest issuer credit rating assigned.
AA	Very strong capacity to meet its financial commitments. It differs from the highest rated obligors only to a small degree.
A	Strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than those in higher rated categories.
BBB	Adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to meet its financial commitments.
BB	Less vulnerable in the near term than other lower rated borrowers. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to the borrower's inadequate capacity to meet its financial commitments.
B	More vulnerable than those rated BB, but currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the capacity or willingness to meet its financial commitments.
CCC	Currently vulnerable, and is dependent upon favourable business, financial, and economic conditions to meet its financial commitments.
CC	A borrower rated CC is currently highly vulnerable.
Plus (+) or Minus (-)	The ratings from AA to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.
BB, B, CCC, and CC	Borrowers rated BB, B, CCC, and CC are regarded as having significant speculative characteristics. BB indicates the least degree of speculation and CC the highest. While such borrowers will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.
Moody's Investors Service	Moody's Investors Service applies numerical modifiers 1, 2 and 3 in each generic rating classification from Aaa through Caa. The modifier 1 indicates the obligation ranks in the higher end of its generic category; the modifier 2 indicates a mid range ranking; and the modifier 3 indicates the lower end of that generic category.

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