FIPS Quarterly

Financial Institutions Performance Survey

FINANCIAL SERVICES

October 2010

JUNE QUARTER

Subdued growth but an improving credit environment

Results from the Major Banks to 30 June 2010

Overview for the quarter

The overarching theme for the June 2010 quarter is one of steady but subdued growth or recovery. Although the New Zealand economy continues to recover from the Global Financial Crisis, the recovery has been termed 'fragile' by a number of commentators in recent weeks. The state of the banking sector is returning to a more normalised level, with the dissipation of the exceptional events of the last year, which included soaring net bad debts and tax settlements.

The evidence of recovery has translated directly into the major banks financial results with strong margins, significantly reduced impairment charges and accordingly a strong increase in reported net profits during the quarter.

The significant changes over the June 2010 quarter were:

- Lending growth is occurring with almost all banks recording positive lending figures – after almost a year of contraction.
- Interest margins have recovered to over 2%, back to levels consistent with June 2009, reflecting significant repricing of lending to offset deposit competition.
- Impairment expenses are significantly reduced for the June 2010 quarter, down to levels not seen since March 2008.

Refer to the table below for a summary of interest margins at June 2010 as compared to six and twelve months ago.

	30 Jun 10	Movement for the 6 months	Movement for the 12 months
	Interest margins		
ANZ Banking Group[a]	2.25	0.20	0.14
Bank of New Zealand	2.12	0.09	(0.03)
Commonwealth Bank of Australia[a]	1.67	0.15	0.06
Kiwibank Limited	1.13	(0.00)	(0.72)
Southland Building Society	2.23	(0.07)	(0.15)
TSB Bank Limited	2.16	(0.54)	(0.86)
Westpac Banking Corporation[a]	2.24	(0.06)	(0.07)
Total/Average	2.06	0.10	0.00

	30 Jun 10	Movement for the 6 months	Movement for the 12 months
	Impaired asset expense/average gross loans		
ANZ Banking Group[a]	0.34	(0.28)	(0.36)
Bank of New Zealand	0.34	0.03	(0.00)
Commonwealth Bank of Australia[a]	0.02	(0.22)	(0.46)
Kiwibank Limited	0.19	(0.02)	0.01
Southland Building Society	0.56	(0.08)	0.15
TSB Bank Limited	0.06	(0.28)	0.27
Westpac Banking Corporation[a]	0.05	(0.79)	(0.78)
Total/Average	0.21	(0.30)	(0.38)

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Global

As discussed in further detail below, the full impact of the new global bank capital rules ("Basel III") announced following the G20 talks is likely to be significantly tougher than the headline ratio suggests (estimates suggest up to 30%), according to regulators and industry participants who have studied private banking data. The impact of earlier rule changes approved by the Basel Committee on Banking Supervision narrows the definition of what banks can count towards their core Tier 1 capital ratio. The banks will also have to subtract items such as goodwill, some tax credits and minority investments from equity and retained earnings. The aim is to make this key measure of capital reflect the equity that would be available to absorb losses in a crisis. The data submitted to the Committee suggests the real impact of the change could be equivalent to raising the minimum capital requirement to 10% for many banks. The deductions are likely to cut many banks' equity totals by between 30% and 40%.

In addition to the new global bank capital rules, following on from the G20 talks and EU Member Statement Agreement in June 2010, a number of Governments, namely France, Germany, Hungry, Sweden, the US and the UK, have announced plans for the introduction of ongoing bank levies (applied to targeted liabilities). While there are inconsistencies in the exact schemes being implemented, the wider methodology and approach seems broadly consistent.

New Zealand environment

Since the March 2010 quarter, the official cash rate (OCR) has been increased twice by 25 basis points to bring it up to 3%. In the Reserve Bank media release on 16 September 2010, Reserve Bank Governor Alan Bollard stated: "While the global and domestic economies continue to recover, the outlook has weakened since our June Statement. We consider it appropriate at this point to keep the OCR on hold".

A specific event which has contributed to weakening the current economic outlook for the country was the earthquake which struck Christchurch on 4 September 2010. The result of which has been to cause significant disruption to economic activity as a consequence of major damage to homes, businesses and local infrastructure. The 'silver lining' to this disaster is that reconstruction and repair work to be performed over the next 24-month period will provide a significant boost to a number of industries such as the construction industry, although determination of the ultimate winners and losers could take a year or more.

The impact of the earthquake on the major banks is being mitigated somewhat by the Earthquake Commission natural disaster fund and support from the Government to ensure the region is given the best prospect for recovery. The Major Banks have taken steps to assist local Canterbury residents and businesses by offering a raft of different relief packages, including: loan repayment holidays, access to temporary overdraft limits and waiving fees on restructuring business loans.

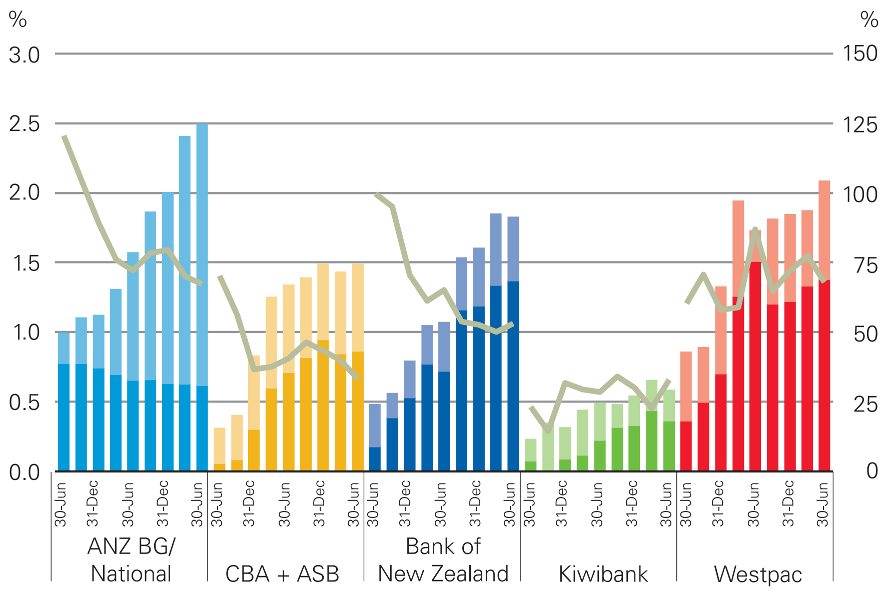
In September, the boards of Pyne Gould Corporation (PGC), MARAC, CBS Canterbury (CBS) and Southern Cross Building Society (SCBS) signed a binding Merger Implementation Agreement. The Agreement represents formalisation of the merger plan to form a New Zealand listed financial services group and with plans to move towards ultimate banking registration.

Results for the quarter

Profitability of the Major Banks is strengthening in line with the recovery of the economy. Overall, average net profit after tax (NPAT) for the June 2010 quarter was $737 million, an increase of 38% on the March 2010 quarter. The biggest jumps in profit were from ANZ and Westpac who increased 76% and 67% respectively over the previous quarter. Kiwibank offset the average improvement in profitability by way of a 16% reduction in NPAT reflecting a continued hit to interest margin from the funding and deposit war.

The major factors contributing to the improvement of profitability in the June quarter include general strengthening of core earnings which is visible through improved interest margins, reduced bad debt and impairment expenses, stable operating expenses

Major Banks: Past Due and Gross Impaired Assets vs Gross Loans and Advances



■ Gross Impaired / Gross Loans and Advances (LHS)
■ Past Due / Gross Loans and Advances (LHS)
■ Total Provisions / Past Due and Gross Impaired Assets (RHS)

and the absence of significant one-off costs such as the settlement of the previous tax disputes.

Overall, interest margins for the June quarter have improved, with an average rate in excess of 2% for the first time in a year. The average margin has increased by a 13 basis points from the March quarter. This improvement has been driven by a recovery in the margins recorded by the four largest majors. Although more significantly, the domestic New Zealand banks (Kiwibank, Southland and TSB Bank) have seen significant pressure with a reduction in margins over the last six to twelve months, reflecting their greater reliance on domestic funding and lower useage of offshore funds. In particular, TSB Bank is seeing a significant reduction, although this is probably more related to strong hedging income earned in 2009.

The margin improvements in the majors, in light of the fierce competition amongst the Banks for domestic retail deposits, reflects a strong drive to reprice and reset existing lending.

Kiwibank continues to report the lowest margin of all the Major Banks at just 1.13% for the quarter, almost half the margin earned by ANZ and Westpac. This is reflective of continued competition for domestic deposits and limited scope for re-pricing.

In line with the general trend of slow economic recovery and improved stability, the growth of gross loans and advances is now showing a positive pace. Kiwibank continued to grow faster than any of the other majors (who reported only slight growth) with 3.5% growth for the quarter, but this is well down on the 10% plus growth experienced in 2009. This reflects Kiwibank's funding pressures as well as greater competition from the majors who have responded to the pressures Kiwibank has imposed in the market.

Impaired asset expense continues to show a rapid improvement since its peak in March 2009, with the current level of charge now being only a quarter of those seen during March 2009. The impaired asset expense ratio to gross loans for the June 2010 quarter has halved from that of the March 2010 result, reducing from 0.48% to 0.21%. Impaired asset expense for the quarter was only $148 million for the sector, down from $340 million in March and $360 million in December 2009. The June 2010 quarterly result was improved by a $56 million reduction in collective provision balances held, and a stabilisation of the level of individual impairment provisions being recorded. Anecdotally, banks are referring to improvement in retail books and a stabilisation in the corporate sector which is enabling banks to begin unwinding the collective provision balances that were built up during the GFC.

While impaired asset expense ratios have fallen, the level of gross impaired and past due loans actually increased over the quarter to just under $4 billion impaired (up $138 million in the quarter) and $1.451 billion past due (up $94 million in the quarter).

To what extent this has been influenced by the rural sector is unknown, although generally it is recognised that a number of rural customers have faced significant and serious liquidity constraints over the last year. Whether this eases following Fonterra's announcement that the forecast dairy payout rate for the coming season is expected to be $7.00 – $7.10, up from this season's $6.37 per kg of milk solids is yet to be seen. This forecast should assist a number of farms in the dairy sector to record positive operating results in the coming year.

Regulatory developments

On 12 September 2010, the Basel Committee on Banking Supervision, announced a strengthening of the existing capital requirements for banks – to be known as "Basel III". The measures are likely to represent significant increases in minimum capital amounts. The key changes announced included:

- Modifying the definition of capital;
- Introducing a leverage ratio cap as a non-risk weighted backstop to the risk-based minimum capital requirements; strengthening the capital requirements for counterparty credit risk; and
- Introducing a global liquidity standard – which would increase the minimum common equity requirement from 2% to 4.5%, and the minimum total Tier 1 capital requirement from 4% to 6%. Additionally, two capital buffers made up of common equity would be required: a 2.5% conversion buffer and a 2.5% counter cyclical buffer.

The proposals are required to be translated into national laws and regulations in time for each member country's banking institutions to begin the transition period starting 1 January 2013. In some areas the Reserve Bank of New Zealand is already ahead of the game with the introduction in April this year of the new liquidity policy (core funding ratio and one week/one month scenarios).

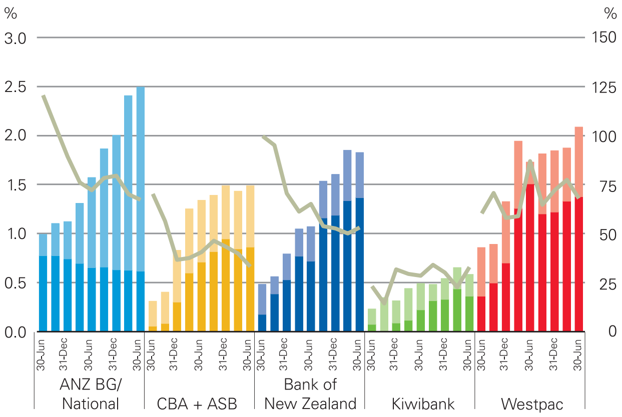
In other regulatory news:

- The Reserve Bank has recently taken submissions on the disclosure regime for Registered Banks in New Zealand with a view to reducing the compliance costs and providing clearer and more user friendly information to the public. The outcome of this consultation will be closely watched by many who either prepare or audit such information.
- The Retail Deposit Guarantee Scheme expired on 12 October 2010, and was extended for a small group of entities on new tighter conditions. This group included Canterbury Building Society, Equitable Mortgages, F&P Finance, Marac Finance, PGG Wrightson Finance, Southern Cross Building Society and Wairarapa Building Society.
- The latest round of consultative documents was released on the non-bank sector including new liquidity proposals, and the fit and proper tests.

Retail banks – quarterly analysis

Quarterly Analysis	Size & Strength Measures							
	30 Sep 08	31 Dec 08	31 Mar 09	30 Jun 09	30 Sep 09	31 Dec 09	31 Mar 10	30 Jun 10
	Total Assets							
ANZ Banking Group[(a)]	119,598	128,799	129,651	122,905	122,992	121,210	119,944	118,797
Bank of New Zealand	64,130	76,004	73,214	70,080	69,760	67,629	67,171	67,905
Commonwealth Bank of Australia[(a)]	69,522	72,263	72,524	71,662	71,062	70,161	70,309	69,550
Kiwibank Limited	8,146	9,370	9,700	10,328	10,743	11,974	12,030	12,190
Southland Building Society	2,488	2,562	2,538	2,562	2,609	2,658.00	2,625	2,578
TSB Bank Limited	3,403	3,650	3,831	3,924	4,055	4,299	4,404	4,417
Westpac Banking Corporation[(a)]	70,255	77,109	77,230	73,642	72,821	71,789	71,538	70,705
Total/Average	337,542	369,757	368,688	355,103	354,042	349,720	348,021	346,142
	Total Risk Weighted Assets							
ANZ Banking Group[(a)]	75,449	77,260	83,826	82,421	81,181	86,744	79,856	79,461
Bank of New Zealand	45,555	45,749	46,075	48,537	43,838	42,838	41,922	42,959
Commonwealth Bank of Australia[(a)]	43,893	44,892	45,177	42,829	44,626	43,234	43,428	43,057
Kiwibank Limited	3,815	4,341	4,639	4,966	5,241	5,607	5,858	5,997
Southland Building Society	1,637	1,667	1,654	1,664	1,687	1,699	1,710	1,701
TSB Bank Limited	1,494	1,562	1,689	1,766	1,900	1,984	2,053	2,071
Westpac Banking Corporation[(a)]	49,163	51,065	50,798	49,163	48,877	47,710	47,734	47,524
Total/Average	219,369	226,536	233,858	231,346	227,350	229,816	222,561	222,770
	Capital Adequacy							
ANZ Banking Group[(a), (b)]	11.72	11.68	11.00	12.40	13.70	13.40	13.00	12.60
Bank of New Zealand	10.78	10.68	10.80	10.00	10.88	11.79	12.03	11.63
Commonwealth Bank of Australia[(a), (b)]	11.60	11.40	11.40	10.40	10.50	11.63	11.60	11.30
Kiwibank Limited	10.40	10.00	10.00	10.10	9.80	9.60	9.40	11.70
Southland Building Society	9.63	9.57	12.46	13.43	13.40	13.52	13.35	13.45
TSB Bank Limited	18.36	18.15	16.71	17.05	16.46	16.38	15.90	16.18
Westpac Banking Corporation[(a), (b)]	10.80	11.20	11.40	11.00	10.80	11.10	10.80	10.80
Average								
	Net Profit After Tax							
ANZ Banking Group[(a)]	203	210	212	56	-284	253	133	234
Bank of New Zealand	188	260	140	-583	2	271	144	161
Commonwealth Bank of Australia[(a)]	86	109	66	84	-122	164	117	132
Kiwibank Limited	10	16	14	24	14	10	12	10
Southland Building Society	5	2	4	3	2	3	5	2
TSB Bank Limited	13	9	9	15	14	13	9	9
Westpac Banking Corporation[(a)]	144	220	19	66	-802	340	114	190
Total/Average	643	826	465	-335	-1,176	1,054	534	737

Major Banks: Past Due and Gross Impaired Assets vs Gross Loans and Advances



■ Gross Impaired / Gross Loans and Advances (LHS)
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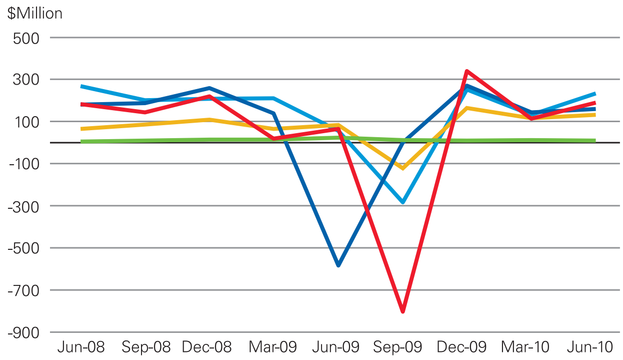
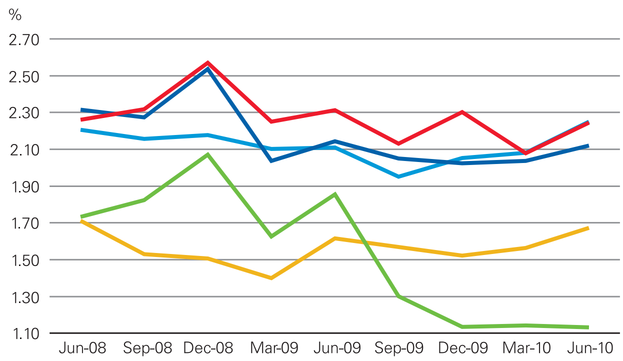
Major Banks: Net Profit After Tax



Major Banks: Interest Margins



■ ANZ BG/National ■ CBA + ASB ■ Bank of New Zealand ■ Kiwibank ■ Westpac

Footnotes

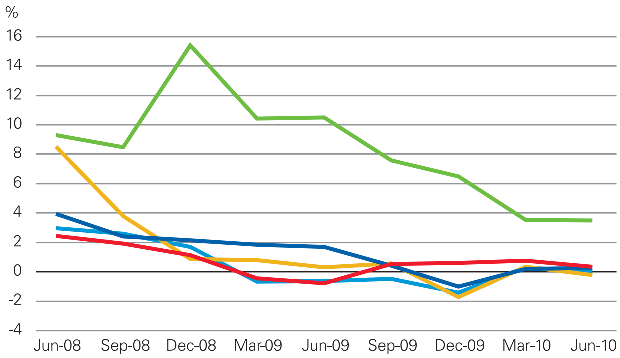
(a) The results for ANZ Banking Group (ANZ BG), Commonwealth Bank of Australia and Westpac Banking Corporation relates to the New Zealand banking group division of these entities.

(b) The capital adequacy ratio's reported are for the overseas banking group.

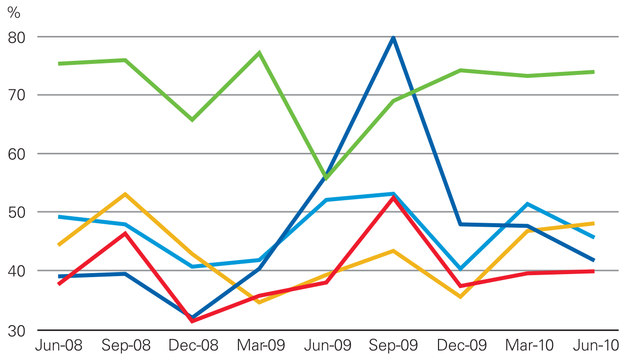
n/a = not available/applicable

Quarterly Analysis	Profitability							
	30 Sep 08	31 Dec 08	31 Mar 09	30 Jun 09	30 Sep 09	31 Dec 09	31 Mar 10	30 Jun 10
	Interest Margins							
ANZ Banking Group[(a)]	2.16	2.18	2.10	2.11	1.95	2.05	2.08	2.25
Bank of New Zealand	2.27	2.54	2.04	2.14	2.05	2.02	2.04	2.12
Commonwealth Bank of Australia[(a)]	1.53	1.51	1.40	1.61	1.57	1.52	1.56	1.67
Kiwibank Limited	1.82	2.07	1.63	1.85	1.30	1.13	1.14	1.13
Southland Building Society	9.77	2.68	2.26	2.38	2.19	2.30	2.45	2.23
TSB Bank Limited	2.87	2.62	2.21	3.02	2.73	2.70	2.40	2.16
Westpac Banking Corporation[(a)]	2.32	2.57	2.25	2.31	2.13	2.30	2.08	2.24
Total/Average	2.11	2.19	1.96	2.06	1.91	1.96	1.93	2.06
	Non-interest Income / Total Assets							
ANZ Banking Group[(a)]	0.94	1.06	0.84	0.32	0.62	1.16	0.49	0.82
Bank of New Zealand	1.13	1.20	0.68	0.12	-0.33	0.71	0.59	0.89
Commonwealth Bank of Australia[(a)]	0.40	0.82	1.03	0.60	0.67	0.98	0.44	0.61
Kiwibank Limited	1.60	2.02	1.14	1.88	1.90	1.34	1.37	1.29
Southland Building Society	1.09	0.12	1.86	0.78	0.62	0.76	0.76	0.70
TSB Bank Limited	0.57	0.13	0.74	0.31	0.50	0.29	0.28	0.34
Westpac Banking Corporation[(a)]	1.00	1.05	0.91	0.76	0.54	0.90	0.65	0.66
Total/Average	0.89	1.05	0.87	0.48	0.46	0.98	0.56	0.77
	Impaired Asset Expense/Average Gross Loans							
ANZ Banking Group[(a), (b)]	0.55	0.38	0.78	0.98	1.42	0.62	0.71	0.34
Bank of New Zealand	0.16	0.26	0.47	0.31	0.35	0.31	0.33	0.34
Commonwealth Bank of Australia[(a), (b)]	0.13	0.45	0.79	0.70	0.60	0.24	0.07	0.02
Kiwibank Limited	0.05	0.33	0.21	0.20	0.23	0.21	0.12	0.19
Southland Building Society	1.49	0.63	0.61	0.49	0.65	0.64	0.80	0.56
TSB Bank Limited	0.19	0.02	0.31	0.07	0.11	0.34	0.17	0.06
Westpac Banking Corporation[(a), (b)]	0.60	0.69	1.70	1.61	0.89	0.84	0.72	0.05
Average	0.39	0.43	0.89	0.88	0.88	0.51	0.48	0.21
	Operating Expenses/Operating Income							
ANZ Banking Group[(a)]	48.06	40.82	41.99	52.21	53.25	40.50	51.52	45.76
Bank of New Zealand	39.60	32.21	40.45	56.37	79.84	48.04	47.80	41.89
Commonwealth Bank of Australia[(a)]	53.14	42.96	34.75	39.48	43.56	35.73	46.92	48.19
Kiwibank Limited	76.03	65.87	77.25	55.91	69.05	74.29	73.33	73.97
Southland Building Society	64.99	63.96	61.69	55.00	61.11	55.00	47.62	57.89
TSB Bank Limited	33.81	44.76	50.44	31.25	34.38	41.94	37.93	33.19
Westpac Banking Corporation[(a)]	46.48	31.55	35.86	38.18	52.53	37.52	39.73	40.04
Total/Average	47.43	38.15	40.31	46.95	55.14	41.46	48.00	45.03

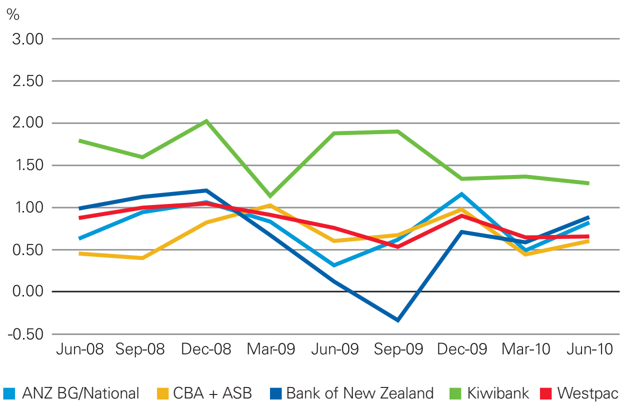
Major Banks: Quarterly Increase in Gross Loans and Advances



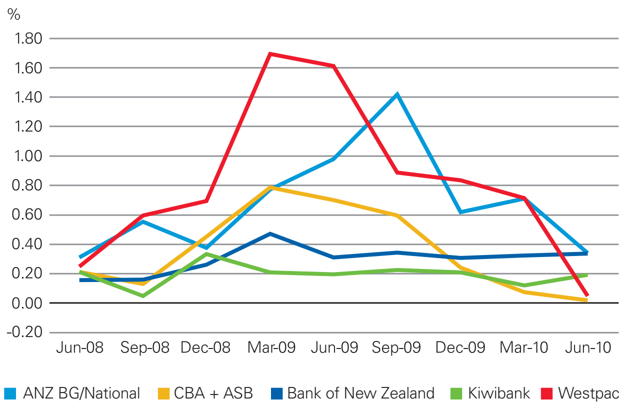
Major Banks: Operating Expenses vs Operating Income



Major Banks: Non-interest Income vs Average Total Assets



Major Banks: Impaired Asset Expense vs Average Gross Loans and Advances



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