New Zealand Banks' Operating Environment

Rising Challenges for New Zealand's Major Banks

Special Report

Fierce Margin Pressure: Competition-driven margin pressure and strong credit growth could hurt operating profitability, asset quality, funding position and, eventually, the capital of New Zealand's major banks. Fitch Ratings takes comfort, however, from solid and consistent profitability, and capital levels which act as solid buffers to absorb potential shocks. In addition, the Reserve Bank of New Zealand (RBNZ) has taken a strong stance on managing the rise in macro-prudential risks.

Systemic Risks Remain: High household leverage and a low national savings rate could pose a risk to the financial system if asset prices decline and/or unemployment rises. But government has the capacity to stimulate the economy and counter-balance macro-economic developments if needed. New Zealand's household debt/GDP ratio and savings rate/GDP ratio have improved since 2007; but at 143% and -0.1%, respectively, they remain weak relative to other developed markets at end-2012.

Stricter Regulation: RBNZ's proposed changes to macro-prudential regulation, and capital adequacy requirements for higher loan/value ratio (LVR) mortgages – those exceeding 80% – should limit the potential risk of asset bubbles. Fitch expects these measures to strengthen the banking system's capital and funding positions, if implemented.

The RBNZ released consultation papers in March 2013 aimed at enhancing the macro-prudential tools available and regulatory requirements within the system. Emphasis was placed on reducing risks associated with strong credit and asset price growth, and reliance on unstable funding sources.

Solid Domestic Economic Recovery: New Zealand's GDP is likely to benefit from the ongoing rebuilding of Christchurch, as well as generally stronger consumer and business confidence. Unemployment remains high by historical standards, although Fitch expects it will ease in 2013. The economy is adequately diversified by industry, but its exports rely heavily on Australia and China which account for more than 30%.

Buoyant Property Market: Risks to the financial system could rise if house-price inflation leads to an overvaluation – due in part to higher LVR mortgages. Property prices have been strong because of a housing shortage – especially in the metropolitan areas of Auckland and Christchurch – and a prolonged period of low mortgage interest rates.

Leveraged Agriculture Sector: Agriculture remains one of the largest industry segments for banks, which are therefore exposed to weather-related risks such as drought. The number of highly leveraged farms has also increased in light of an accelerating trend in farms being converted to profitable dairy businesses – where the extent of debt-funding is significant.

Sound Banking System: New Zealand's "major banks" – ANZ Bank New Zealand (ANZ NZ), ASB Bank Limited (ASB), Bank of New Zealand Limited (BNZ), and Westpac New Zealand Limited (WNZL) – are all rated 'AA−'/Stable Outlook, and owned by the major Australian banks. They held a dominant 85% market share of New Zealand's mortgage assets at end-December 2012.

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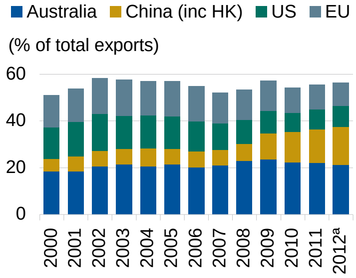
Figure 1

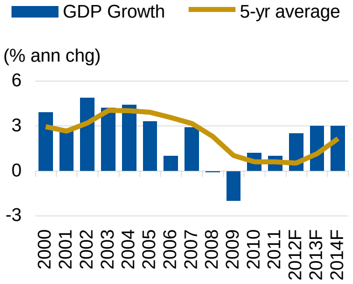
Export Markets



[a] 2012 values are year-to-October
Source: CEIC, Fitch

Figure 2

Real GDP Growth



Source: Fitch

- Consistently profitable banks
- Adequate asset quality amongst major banks
- Improving funding and capital positions

Improving Operating Environment Still Bears Some Risks

New Zealand's GDP increased by 2.5% in the year to September 2012, and Fitch forecasts this at 3% in 2013 – led by the Christchurch rebuilding. Growth may be further enhanced by any improvement in Europe and the US. However, the agency does not expect this before end-2013. New Zealand's GDP is fairly well diversified (see Figure 2).

New Zealand remains a net exporter. Its major market is Australia, which accounted for one-fifth of the country's exports in October 2012. However, in the past five years, Asia – in particular China – has assumed a significantly greater importance. China's share of New Zealand's exports has tripled since 2006. An economic downturn in Australia and China would therefore have a major impact on New Zealand's economic output, and hence lead to higher unemployment. Monetary and fiscal policies could provide some buffer – the official cash rate is 2.5% while government debt/GDP is about 50%.

Unemployment remains above the levels prevailing prior to the 2008 global financial crisis – 6.9% at end-2012, with only a modest improvement since, although it should come down in 2013 as the Christchurch rebuilding accelerates.

New Zealand's property prices hit new peaks in early 2013, recovering from declines in 2008-2009, and with transaction volumes at the highest levels since 2007. National median house prices have risen by 4.2% per year, according to the Real Estate Institute of New Zealand (REINZ) in 2012. This reflects both greater demand and a housing shortage, particularly in Auckland and Christchurch. Auckland's median property prices increased by 8.1% in 2012.

The market is benefiting from a fast-growing population, driven partly by immigration and also by internal migration – as Auckland remains the economic and financial capital. Canterbury's property market – in which Christchurch is located – rose by 5.8%, reflecting the housing shortage due to the earthquakes in 2010 and 2011.

Solid and Consistent Profitability Despite Fierce Competition

The agency expects the banking system to remain one of the more profitable among developed market banking systems, with its strong – albeit decreasing – net interest margin (NIM) and efficient cost management. An improving economy, tight cost-control and generally sound underwriting criteria will remain key to maintaining strong profitability in the financial year 2013 (FY13). However, Fitch expects the major banks to announce margin-compression and higher loan-impairment charges for collective provisioning – given the rapid and competitive loan growth since mid-2012. Loan-impairment charges could rise significantly over the next three years if asset quality were to deteriorate as a result of the strong loan growth. A sound economic environment and softer house price inflation, however, could limit specific loan-impairment charges.

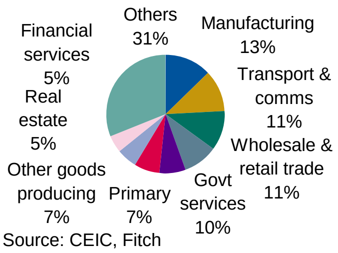
Operating revenue should be supported by stronger loan growth, which could offset some pressure on NIM from fierce pricing competition for quality assets and customer deposits. Fee income may also increase if the banks improve their cross-selling capabilities, eg insurance and wealth management products. Fair-value accounting of derivative instruments used primarily to hedge foreign-exchange risk for debt raised in the non-New Zealand dollar market may add some volatility to revenues, although these movements should net to zero over the life of the instrument.

Cost-management has been a core strength of the major New Zealand banks, and Fitch expects this to continue despite larger investments in technology and distribution infrastructure.

Figure 3

New Zealand Economy

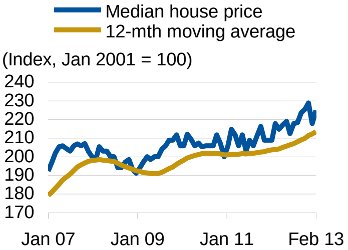
% share of real GDP



Source: CEIC, Fitch

Figure 4

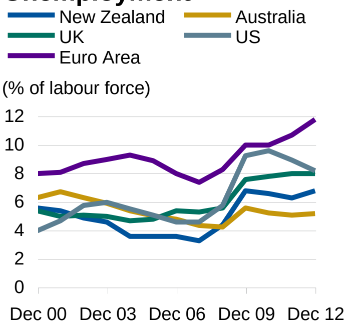
REINZ Median House Price



Source: CEIC, Fitch

Figure 5

Unemployment



Source: CEIC, Fitch

Lending Risks on the Rise

Improving consumer and business confidence, as well as a shortage in housing, have led to a more buoyant property market. All the major banks have increased their loan books – mainly residential mortgages and business loans. Lending into the higher-LVR segment has risen – about one-third of new mortgages had an LVR in excess of 80% at origination at end-2012. This could place pressure on asset quality if house prices decline significantly and unemployment rises. Household debt/GDP remains high relative to other countries, while the household savings rate is weak despite some improvement since 2007 – providing very little cushion for households to absorb financial shocks.

In March 2013, the RBNZ announced the potential temporary introduction of LVR limits on residential mortgages, to limit the effect on the banks in the case of a property price correction. Fitch views these potential macro-prudential requirements as positive, as it strengthens banks' balance sheets. In contrast to their Australian parents, the major New Zealand banks do not use lenders' mortgage insurance (LMI), but instead charge an additional risk premium for higher-risk mortgages. Lower LVR mortgages provide a greater capital buffer in the event of falling prices, especially if the borrower experiences unforeseen financial difficulties.

Agriculture is an important GDP contributor, and makes up a substantial portion of loan books. Exposure ranges from 9% to 16% of the banks' total committed credit exposure at FYE12, with dairy accounting for a significant proportion. Asset quality within the agriculture exposures has improved since FY09, with a reduction in impaired loans and past-due loans. Exposures are generally well collateralised.

Dairy farming fundamentals have generally been sound; but with the increase in the quantum and stability of the milk price, a number of non-dairy farmers transformed their farms into dairy farms, taking on significant leverage in the process. Some of these farmers found themselves in difficulty in 2009, following the sharp fall in the payout from Fonterra Co-operative Group Limited ('AA−' Stable), one of the largest domestic companies that acts as a cooperative for dairy farmers. According to the latest Financial Stability Report of the RBNZ published in November 2012, farmers are reducing their debt, although the proportion of LVR exposures above 70% was larger in 2011 than in 2008.

The industry is exposed to unforeseen risk such as adverse weather conditions, which could influence the debt-servicing ability of highly leveraged farmers. A drought was declared across New Zealand in late 2012, which could clearly have an impact on the industry and the broader economy. Therefore, further reductions in bank exposures to the high LVR segment are being viewed in a positive light.

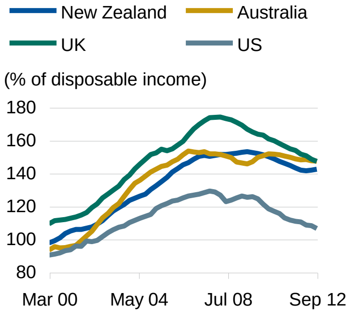
Funding Profile Remains a Weakness Despite Some Improvements

Funding profiles remain weaker than international peers, with the system still reliant on offshore wholesale markets. Loan/deposit ratios are in excess of 130%. Fitch acknowledges the banks' continuing improvements since 2008, helped by the introduction of the core funding ratio (CFR). Since January 2013, the CFR has required a New Zealand bank to fund at least 75% of its loans from stable sources – defined as customer deposits and wholesale funding with a maturity in excess of 12 months. To ensure a sound banking system, the RBNZ is considering an adjustment of the CFR in reaction to the accelerating credit growth.

Fitch expects customer deposit growth to slow in the medium-term. Following the introduction of the CFR, the major banks have increased customer deposits by more than 5% on a compound annual growth rate (CAGR) since 2010, while gross loans' CAGR was less than 2%. The trend of historically strong customer deposit growth was also reflected in an improving savings rate for both households and corporates/businesses since FY07. However, the savings rate has stabilised since early-2012 - most likely the result of the improving property market and consumer and business confidence.

Figure 6

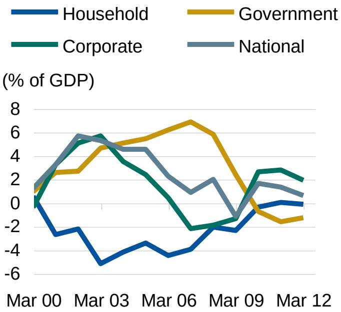
Household Debt



Source: RBNZ, CEIC, Fitch

Figure 7

Savings Rates



Source: StatsNZ, Fitch

The major banks' wholesale funding profiles have benefited from the introduction of covered bond legislation in 2010. Covered bonds provide the major banks with the opportunity to raise long-term debt in a new investor market. Pricing in the wholesale capital markets has improved considerably for New Zealand's banks since late-2012. As a result, some new lending could be funded through long-term offshore wholesale markets. The proportion of short-term wholesale funds maturing within 12 months has declined, and is more than covered by liquid assets at the major banks' respective financial year ends.

Strong Capital Positions

Capitalisation is generally sound, having improved over the past three years. Capital positions benefited from fresh equity injections (BNZ and WNZL), reduced dividend payments, and stable risk-weighted assets (RWA) in FY12. However, further improvements – based on internal capital generation – may be limited in light of recent loan growth and pressure on profitability.

The RBNZ is reviewing the capital adequacy, and all of the proposed changes could lead to an increase in the banks' capital positions – which Fitch views as credit positive. The regulator is considering tougher capital requirements for higher LVR mortgages, and additional counter-cyclical capital buffers (CCB) of up to 2.5% of RWA. The RBNZ also suggested capital requirement adjustments similar to CCB to address rapid credit growth in individual industries.

Fitch Core Capital ratios ranged between 9.4% and 11.7% at FYE12, which is similar to that of their international peers. However, all four banks have stronger non-risk weighted capital ratios than their peers. The difference reflects in part the RBNZ's strong stance on the use of minimum loss given defaults to calculate RWA.

Macro-Prudential Regulations

Fitch views the regulations already implemented as a credit strength, such as the CFR. The RBNZ's suggested measures – which include capping mortgage LVR levels, increasing banks' capitalisation and further strengthening funding positions through a temporary increased CFR limit – could limit the downward pressure on the Viability Ratings of New Zealand's major banks. Consultation closes on 10 April 2013, and implementation is unlikely before end-2013.

The RBNZ has implemented further macro-prudential regulations since 2008. In March 2013, it published two consultation papers discussing additional measures to reduce risks associated with excessive credit and asset price growth, and a reliance on unstable funding sources, as well as strengthening the capital positions when raising the risk profile.