MOODY'S
INVESTORS SERVICE

BANKING SYSTEM OUTLOOK

New Zealand

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Average Ratings

RATINGS	
Weighted Average Bank Financial Strength:	C+
Weighted Average Long-term Bank Deposits, Local Currency:	Aa2
Weighted Average Long-term Bank Deposits, Foreign Currency:	Aa2
Country Ceiling for Local Currency Deposits:	Aaa
Country Ceiling for Foreign Currency Deposits:	Aaa
Country Ceiling for Local Currency Debt:	Aaa
Country Ceiling for Foreign Currency Debt:	Aaa

Summary Opinion

The outlook[1] for the New Zealand banking system is stable, reflecting (i) the country's steady recovery from a mild recession between January 2008 and March 2009, (ii) improved economic factors, such as gross domestic product (GDP) growth occurring earlier than previously forecasted and lower revised unemployment forecasts, (iii) the four major banks solidifying their market positions, and (iv) improved risk-adjusted profitability, which has assisted capital generation.

The outlook was changed to stable from the negative on 26 January 2010. The industry outlooks for 12 of the banking systems in Asia Pacific, including New Zealand, were changed to stable upon improving local economic prospects and stabilizing global conditions; and improving access to international debt and money markets.

The New Zealand banking sector's average banking financial strength rating (BFSR) of C+ has a mostly stable outlook, representing the capacity of the four major banks' entrenched positions (with a combined market share above 90%) to withstand further price competition, rising funding costs, or a further downward turn in the credit cycle.

We expect the fundamental credit conditions for the New Zealand banking sector to stabilize as economic indicators improve, which, in turn, will usher in the return of consumer and business confidence.

[1] Outlooks for industries or sectors represent Moody's view on the likely future direction of fundamental credit conditions in that sector over the next 12-18 months. They do not represent our projection of rating upgrades versus downgrades.

Economic forecasts in 2010 are markedly better than those reported when New Zealand endured a shallow but long recession from 2008 to early 2009. New Zealand Treasury's more recent forecasts point to a recovery occurring sooner than earlier projections, bringing higher annual GDP growth of 3.2% for March 2011 from March 2012. Unemployment rates are also set to fall. They are likely to have peaked at 7.1% in March 2010 and will drop to 4.6% by March 2014.

Non-performing loans (as a percentage of gross loans and defined as non-accrual loans that are more than 90 days past due) continue to improve, most visibly in the business/corporate segment. A recovery in dairy prices this year should ease farm cash flow pressures, leading to a greater portion of performing rural loans. With improved economic forecasts, asset impairment levels should also improve; however, we will watch for signs of new exposures becoming delinquent.

Borrower concentrations still exist, particularly in the property sector, where developments have slowed and final completions or settlements have been delayed owing to factors such as a drop in market values. Rural lending has also become a problem sector for banks in recent years because of farm conversions and overleveraging during the boom years. Inactivity in that sector has led to extended delinquency periods for those exposures awaiting asset sales for the purposes of curing impairments.

The major banks remain vulnerable to funding disruptions, given that wholesale funding accounts for around 40% of total funding. While the government guarantee for wholesale funding closed for new issuances after 30 April 2010, the banks had been able to access the non-government guaranteed markets during the financial crisis, albeit at reduced volumes as lending growth was intentionally slowed. However, as indicated, with approximately two-thirds of their wholesale funding coming from offshore, the major banks remain exposed to the volatility of overseas markets.

A new liquidity policy introduced by the Reserve Bank of New Zealand (RBNZ) and effective 1 April 2010 now forms part of the conditions of registration for banks registered with the RBNZ to operate in New Zealand. The policy includes three financial metrics, a one-week mismatch ratio, a one-month mismatch ratio, and a one-year core funding ratio. All the major banks are expected to be compliant.

The new Basel proposals for global regulatory reforms are likely to lead to structural changes in the local financial system. The proposal by the Basel Committee on Banking Supervision to require increased "stable funding" and liquid asset holdings[2] directly address the issue of New Zealand banks' heavy reliance on wholesale funding.

The issue clearly affecting New Zealand banks under the proposed Basel liquidity ratios is the pool of available "liquid assets" under the Basel definition. New Zealand banks may not be able to meet the liquidity ratios because of an insufficient supply of eligible assets under the current definition.

This is driven by a limited supply of New Zealand government debt (reflecting a prudent fiscal policy), as well as the country's relatively small domestic capital markets. The revisions to the proposals in July 2010 may aid the liquidity coverage and net stable funding ratios through lower haircuts on customer deposits and residential mortgages. However, additional liquid assets are still required by New Zealand banks to meet those requirements.

[2] "International framework for liquidity risk measurement, standards and monitoring - consultative document", Basel Committee on Banking Supervision, December 2009

While the proposed changes would negatively affect profits, our initial analysis -- from a ratings perspective -- suggests the possibility that (absent other profit pressures, such as an increase in competition), the margin loss would be offset by the improvement in bank funding/liquidity.

Generally, the impact of the Basel Committee's capital proposals would appear to be far less significant than elsewhere in the world because New Zealand banks are already well capitalized. The RBNZ requires them to hold additional capital under capital adequacy calculations that are more conservative than those of Australia's Australian Prudential Regulation Authority (APRA) and the UK's Financial Services Authority (FSA).

Key Drivers

Strengths

» Steadily improving economic outlook, with strong ties to its nearest neighbor, Australia, its largest export destination. Exports are also reliant on high growth countries in Asia, such as China, and recovering nations, such as the US and Japan

» The four major New Zealand banks are subsidiaries of the four major Australian banks and receive strong parental support owing to their significance to overall group operations

» Banks have very little exposure to crisis-affected asset classes, with lending consisting of prime residential mortgages and moderately leveraged businesses/corporates

» Banks increased their liquid assets, capital, and long-term funding during the recent crisis

» Supportive regulatory environment underpins bank deposit and debt ratings

» New Zealand's central bank was proactive in the recent crisis, broadening its open market operations, including repos, and introducing a retail deposits guarantee scheme and a wholesale funding guarantee facility

» Close cooperation between the New Zealand and Australian bank regulators focuses on maintaining financial system stability through the Trans Tasman Banking Regulation

» New Zealand government debt remains very low at around 30% of GDP, allowing for future support/stimulus, if required

Weaknesses

» The banking system remains heavily reliant on wholesale funding, with a large offshore component, increasing the system's sensitivity to external shocks

» The country's four major banks are all subsidiaries of Australian banks, making the New Zealand system intrinsically vulnerable to systemic or name-specific credit developments in its neighbor's banking system

» Funding costs have risen substantially and new liquidity proposals from the Basel Committee could require major system re-adjustments, although only likely over an extended period

» Competition for deposit funding has driven up interest-expense margins

» Household leverage is high by global standards, increasing system sensitivity to rises in interest rates and unemployment

- » Major banks generally have moderate-high borrower concentration levels
- » Large industry concentration in rural lending, which is susceptible to fluctuations in agricultural prices and climate conditions

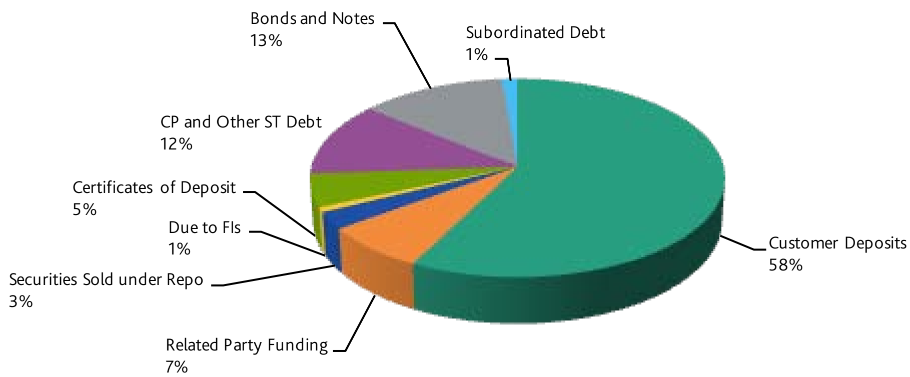
Key Issues

Major Banks Have A Structural Reliance On Wholesale Funding

Like their Australian parent banks, the major New Zealand banks enjoy a high level of wholesale funding as a proportion of total funding. This reflects low deposit savings behavior because tax incentives favor property ownership as a more attractive way for individuals to generate wealth for retirement. Superannuation is not compulsory in New Zealand as it is in Australia. New Zealand also has a persistent current balance of payments deficit, which is largely funded by the major banks' offshore borrowings.

FIGURE 1

Major 4 New Zealand Banks - Funding Profile at FY2009



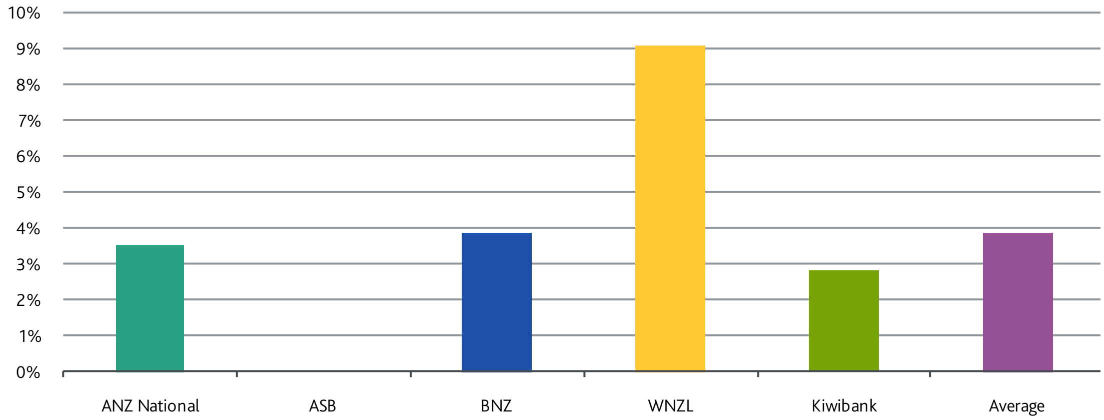
Source: Bank General Disclosure Statements, at FY2009

While customer deposits comprise roughly 60% of the major four banks' combined funding profiles, wholesale funding sources have been sufficiently diversified among traditional debt market instruments, including commercial paper, certificates of deposit, bonds, notes, and subordinated debt. Related-party funding (such as intercompany loans from related parties, debt issued to related parties, deposits from related parties, etc) – and which we include in the definition of wholesale funding -- now comprises about 7% of the four majors' total funding needs.

The major banks in New Zealand tapped the wholesale funding markets during the recent financial crisis, with a combination of government-guaranteed and non-government-guaranteed issuance. To date, approximately NZD11 billion of wholesale funding was raised by ANZ National, BNZ, Westpac New Zealand, and Kiwibank using the government guarantee, and averaging nearly 4% of each bank's total funding. Government-guaranteed issuance has lengthened their funding maturity profiles, with each transaction generally having tenors of two to five years.

FIGURE 2

Government Guaranteed % Total Funding



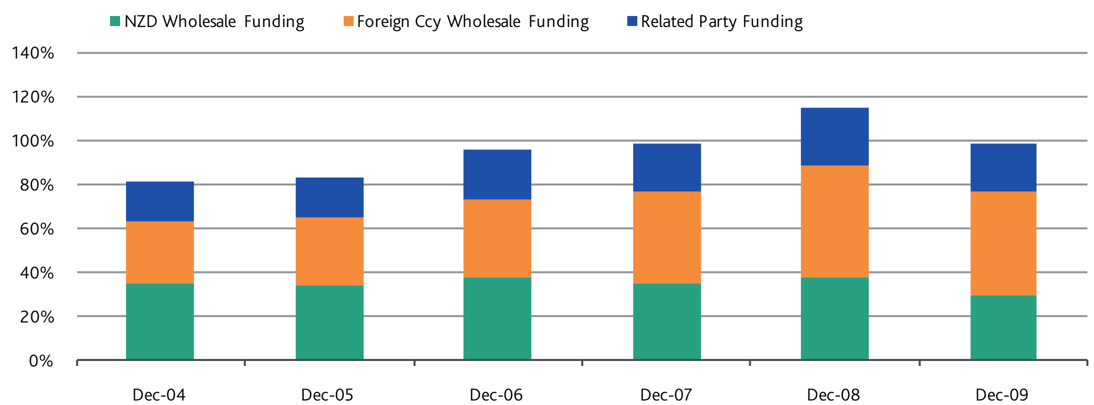
Source: Bank General Disclosure Statements, at March 2010

With the wholesale funding guarantee closed to new issuance after 30 April 2010, our focus has now turned towards the banks' ability to continue accessing the wholesale funding markets without the government guarantee.

Bank debt -- as a percentage of New Zealand GDP is high -- peaked at close to 120% in December 2008, but fell to just under 100% in December 2009. This was due to the banking industry being mainly responsible for funding growth in business investment and in residential mortgage lending.

FIGURE 3

New Zealand - Bank Debt % GDP



Source: RBNZ Statistics

The volume of foreign currency bank debt remains larger than domestic bank debt, driven by a more diverse investor base offshore than domestically. Offshore investors, familiar with the risk of the four major Australian banks, have felt comfortable with their New Zealand subsidiaries.

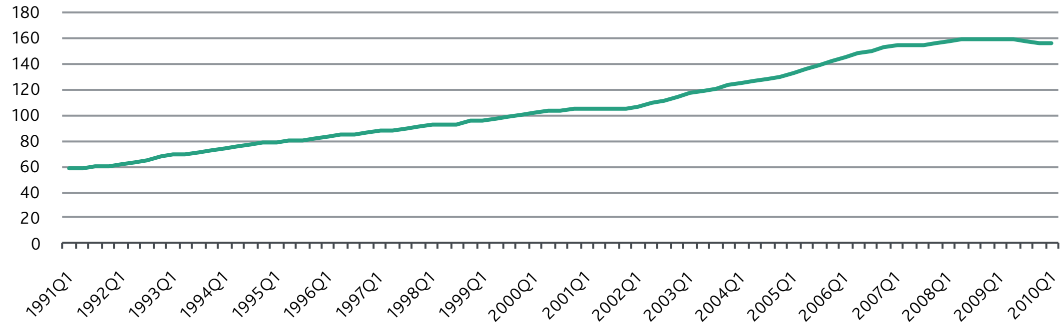
However, a large offshore wholesale funding component is also a risk, making the major New Zealand banks vulnerable to shocks in the offshore debt markets, and which could later impact their ability to get funding. This is one of the key risks to New Zealand bank ratings.

Household Leverage Is Off Its Peak, But Remains High

Consumer leverage ratios in New Zealand are high on a global basis, although similar to Australian levels, and reflect the large residential mortgage debt held by the country's households.

FIGURE 4

New Zealand - Household Claims as % Nominal Disposable Income



Source: RBNZ Statistics

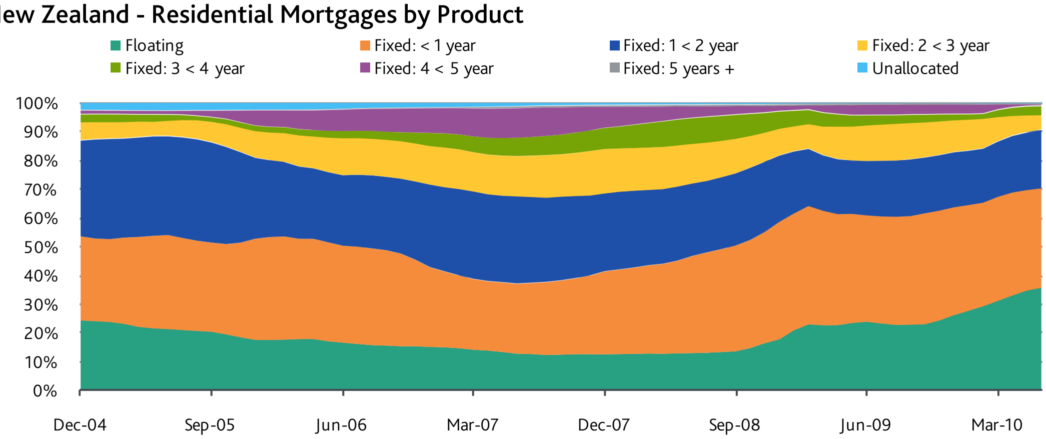
The dramatic rise in household debt over the past two decades has been driven by a similar rise in house prices.

But since the financial crisis began in 2007, the growth in household debt -- as a percentage of disposable income -- has fallen, to 155% in the first quarter of 2010 from its peak of 159% in the third quarter of 2008. Residential mortgage holders were able to repay their housing debt more rapidly as interest rates began to fall from July 2008 onwards. But their ability to repay ahead of schedule is limited by the significant portion of residential mortgages locked in at fixed rates.

Variable rate mortgages now account for 36% of all residential mortgages (at June 2010), an increase from 13% three years ago. With an increasing proportion of residential mortgages moving to floating rate since mid 2008, borrowers have been able to keep the dollar value of their repayments steady as interest rates fell, resulting in faster principal reductions.

FIGURE 5

New Zealand - Residential Mortgages by Product

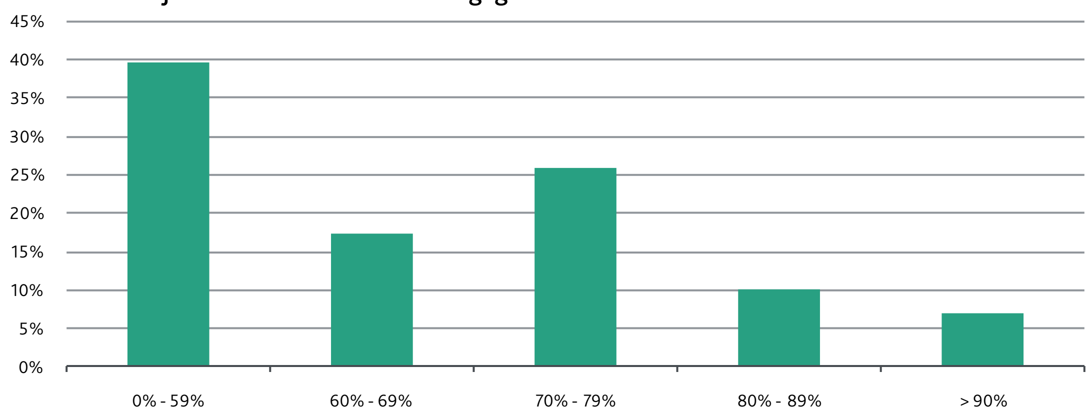


Source: RBNZ Statistics

Loan-loss rates in the banks' residential mortgage portfolio have been very low because of the buffer present in the loan-to-value (LVR) ratio of an average loan. Lenders mortgage insurance (LMI) is not prevalent in New Zealand as it is in Australia, although some banks have some level of LMI cover (20% or 100% cover) on their residential mortgages. Other banks offer a "low equity premium" product, whereby an additional interest rate levy is charged to the borrower for residential mortgages with LVRs above a certain level. While this may improve a bank's net interest margin, the levy does not provide the same protection as insurance cover.

FIGURE 6

New Zealand Major Banks - Residential Mortgages - Loan to Value Ratio



Source: Bank General Disclosure Statements, at June 2010

The risk to this high level of household indebtedness is rising unemployment, which could lead to higher delinquency rates and ultimately foreclosures if there are repayment difficulties.

Rising interest rates also place enormous pressure on borrowers, and are a particular shock when a lower fixed-rate mortgage is rolled into a much higher fixed-rate or variable-rate environment.

Earlier this year, the RBNZ began removing monetary policy stimulus, having raised official cash rates in June 2010. We believe this move will not significantly impact borrowers as the rise is from a very low base, with the end-rate to borrowers still below pre-crisis levels.

Rural Lending to Improve on Dairy Price Recovery, but Rural Property Market Remains Illiquid

New Zealand's geography means that the agriculture, forestry, and fishing industries (which typically comprises the rural sector) form a prominent lending category, comprising 15% of total loans and advances.

The once lucrative dairy industry, driven by strong overseas demand, has seen a significant correction in dairy prices after their dramatic rise from the end of 2006 to a peak in September 2007. After falling to the long-run average, the forecast for 2010-11 is now more optimistic. Fonterra (a New Zealand co-operative and the world's largest dairy exporter) had announced an opening forecast payout for the 2010/11 season of at NZ$6.90-7.10 (forecast milk solids price of NZ$6.60 per kg and forecast distributable profit of 30-50 cents per share).

The price reflects strong growth in demand from China, the rest of Asia, the Middle East and North Africa. This situation is coupled by the constrained state of global supply because of lower production in Europe, Australia, and the US.

These improved dairy payouts should aid dairy farms by providing higher levels of revenue, and which will assist in servicing loan repayments, while maintaining operating expenditures. That said, we remain somewhat cautious, as this sector is prone to cycles driven by overseas demand, prices, the exchange rate and climate. The market for rural properties also tends to be illiquid at times, exposing properties to fluctuating valuations.

Insurers and Banks Well Insulated from New Zealand Earthquake

The earthquake which hit the New Zealand city of Christchurch on Sep 4 2010 is likely to have negative implications for Australian-owned insurance companies operating in New Zealand, but is considered very limited. Similarly, the impact, if any, on the country's major four banks – which are the subsidiaries of the major Australian banks – will also be small.

As of September 7, the New Zealand government-sponsored Earthquake Commission (EQC) had estimated 100,000 potential claims costing as much as NZD2 billion in aggregate.

Recent economic commentary on this event points to an initial dip in forecast GDP, due to an interruption in business activity. However, GDP is then expected to rise due to increased investment and activity arising from rebuilding.

With the banks, their exposure to Christchurch is on average around 10% of their loan portfolios. In this respect, the immediate impact will be a rise in delinquency rates due to disruptions to business and as some individual borrowers face unemployment, or are forced to take unpaid leave. Many businesses and individuals with insurance policies will also have to wait for payouts. We may see an increase in loan restructurings by the banks. Impairment expenses relating to this event could be comfortably absorbed within current levels of provisioning.

Rating Universe

The outlook is stable for the C+ BFSRs of ANZ National Bank, ASB Bank, and BNZ. Meanwhile, the C+ BFSR of Westpac New Zealand has been placed on review for possible downgrade, reflecting the outlook for its asset quality, borrower concentration trends, and capital.

New Zealand banks' debt and deposit ratings of Aa2/Prime-1are driven by their C+ BFSR, as well as by the B BFSR ratings of their Australian parents. The Australian banks have strong strategic incentives to operate in New Zealand, given the trade and cultural links and relative geographic proximity.

At present, all four rated banks in New Zealand have a Aa2/Prime 1 foreign currency deposit ratings, and are unconstrained by the country ceiling, which is Aaa.

The stable outlook on the rated New Zealand banks' Aa2/Prime-1 debt and deposit ratings reflect the very high level of support from both their Australian parents, as well as their dominant positions in the New Zealand banking system. The ratings of their respective parents all carry negative outlooks, but under our Joint Default Approach, even if the Australian banks are downgraded one notch, the major

New Zealand banks would remain strong enough -- in combination with the potential for systemic support -- to maintain their current ratings.

Rating Actions

The following rating actions have taken place in the New Zealand banking sector since August 2009:

» On 24 August 2010, we downgraded ASB Bank Limited's BFSR to C+ from B-, reflecting the evolution of ASB Bank's risk profile over time, and is now more in line with its New Zealand bank peers, whose BFSRs are also C+

» On 24 August 2010, we placed Westpac New Zealand Limited's BSFR of C+ on review for possible downgrade. The review will focus on the outlook for the bank's asset quality, borrower concentration trends, and capital

» On 11 February 2010, we downgraded to A3 from A1 the non-cumulative hybrid Tier 1 securities ratings of ASB Capital Limited, BNZ Income Securities Limited, and BNZ Income Securities 2 Limited, three notches below its adjusted Baseline Credit Assessment (BCA) of Aa3

» On 11 February 2010, we downgraded to A1 from Aa3 the cumulative junior subordinated debt (Upper Tier 2) ratings of ANZ National Bank Limited and the cumulative junior subordinated debt (Upper Tier 2) ratings of the Medium Term Note (MTN) program of BNZ Int'l Funding Ltd, London Branch two notches below the issuer's bank debt ratings of Aa2, reflecting its lower status in liquidation, ranking senior to hybrid Tier 1 notes and common equity, and junior to Lower Tier II subordinated debt.

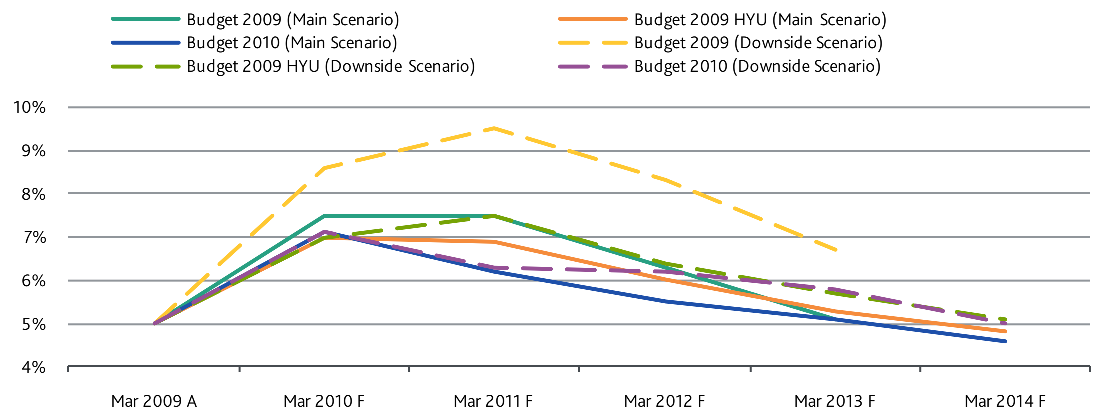
These last two rating actions were in line with our Revised Guidelines For Rating Bank Hybrids And Subordinated Debt, published in November 2009. The revised methodology largely removes our previous assumptions of systemic support, after considering the many cases during the recent global financial crisis where systemic support for these instruments was not forthcoming.

Operating Environment

New Zealand has shown a moderate level of economic volatility by global standards, reflecting the fact that it is a small, open economy that remains subject to commodity prices (especially agricultural products). This tends to have implications for bank asset quality and earnings, constraining the ratings of New Zealand banks relative to their Australian parents. The latter operate in a more diversified and stable economy.

FIGURE 7

New Zealand - Unemployment Budget Forecasts

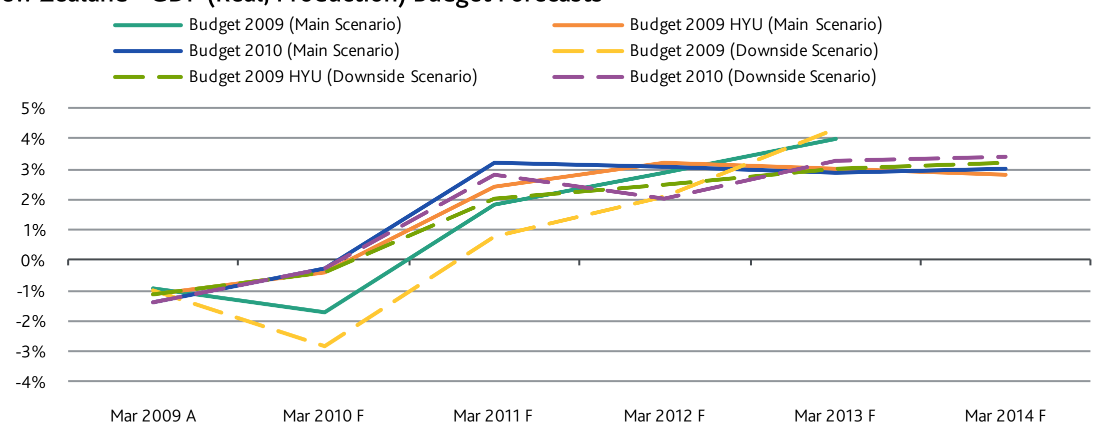


Source: New Zealand Treasury, March is Year-End for GDP

Unemployment in New Zealand unexpectedly rose to 6.8% in the June 2010 quarter, after falling to 6.0% in March 2010. However, the latest forecasts indicate lower unemployment rates across the forward estimates. Unemployment is now estimated to peak at 7.1% in March 2010, compared with the 7.5% forecast last year for March 2010 – March 2011, and the downside scenario has been scaled back dramatically.

FIGURE 8

New Zealand - GDP (Real, Production) Budget Forecasts



Source: New Zealand Treasury, March is Year-End for GDP

GDP is expected to recover faster than forecast last year. While GDP for the year to March 2010 was negative, it was a much smaller contraction of 0.3% when compared with the contraction of 1.7% forecast last year. GDP is also expected to grow faster in the near term, exceeding 3% for the 12 months ended in March 2011 and March 2012. Last year's forecast had estimated that growth of more than 3% would not take place until the 12-month period ending March 2013.

The downside scenario has brightened with the country now appearing to have avoided the deep recession previously forecast. Imports exceed exports in terms of their contribution to GDP because as a small economy, New Zealand must import much of its needs. The finance, insurance and business services continue to be the largest industry component to GDP, though many of these services are used locally. While agriculture is increasingly important, it only contributes around 5% of GDP.

The country has a strong legal system that allows creditors to pursue their claims efficiently.

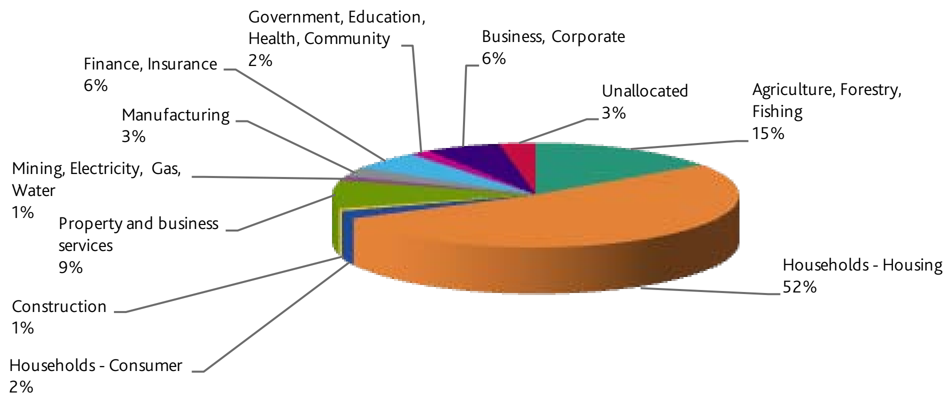
The following discussion follows the categories in our BFSR methodology, and addresses the intrinsic fundamentals of New Zealand banks.

Flat Loan Growth, Agribusiness Still A Significant Player

The popularity of housing investments in New Zealand means that housing remains the largest lending sector, at half of total NZD claims at registered banks. While lending was strong during the economic growth of the early 2000s, total loan growth stalled in 2009, and only minor growth is expected for 2010 as confidence returns.

FIGURE 9

New Zealand Banks - Loan Composition - at June 2010



Source: RBNZ Statistics

The loans composition among New Zealand banks, particularly the majors, is generally diverse across a number of industries, Construction, though a very small percentage of bank lending, has experienced a growth trajectory similar to housing and following the trend in the housing cycle. Agriculture remains an important lending component at the banks, despite the volatility in dairy prices.

The agriculture, fishing, and forestry sector reported the strongest growth of all industry sectors in 2009 at 8%. But, this was far below the double-digit growth of recent years as dairy farms halted expansion. Lending in the manufacturing sector declined 11%, owing to deleveraging among borrowers.

Borrower Concentration Levels To Remain High For Major Banks

The four major New Zealand banks continue to exhibit a number of significantly large borrower concentrations, measured as a percentage of pre-provisions pre-tax profit, or of Tier 1 Capital.

Given a small local bond market and a limited number of large financial providers, corporate entities often revert to the major banks for their funding needs. We do not see this trend changing in the near term.

Industry exposures are focused heavily on the sectors of agriculture, forestry and fishing, finance, investment and insurance. The rural industry sectors are susceptible to changes in weather and export prices. These are factors that can lead to changes in asset quality performance.

Risk Systems Integrated With Australian Parents

The four rated major New Zealand banks all have good risk systems through close ties with their Australian parents and, as such, employ appropriate risk management oversight. They also have generally conservative VaR trading limits.

Regulatory Environment

New Zealand's regulatory framework is at international standards, with the four major banks following the Advanced Approach under Basel II to calculate regulatory capital requirements, in line with their Australian parent banks (the remaining four locally incorporated banks in New Zealand report under the Standardized Approach).

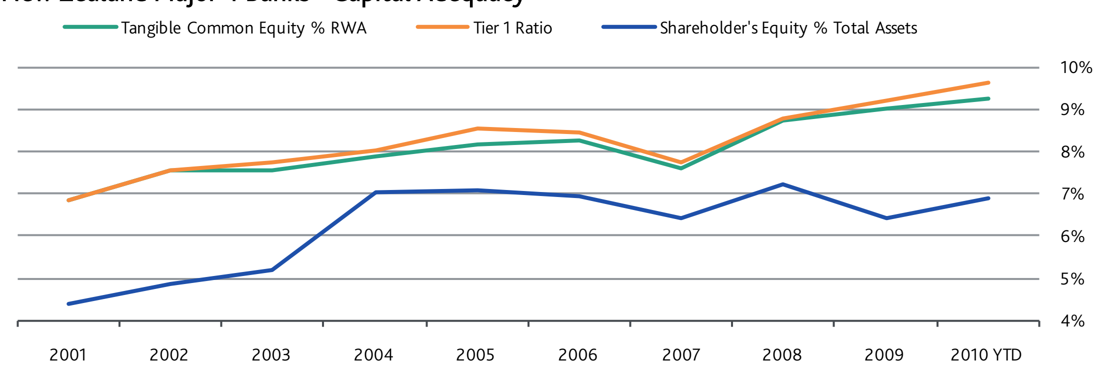
New Zealand banks also adopted the New Zealand equivalent to the International Financial Reporting Standards (NZ IFRS), which commenced in 2006. We view the New Zealand regulatory requirements, combined with the strong coordination with the Australian regulator, as a positive factor that underpins the ratings of the four major banks.

See section on "Deposit Rating Drivers".

Capital Adequacy

FIGURE 10

New Zealand Major 4 Banks - Capital Adequacy

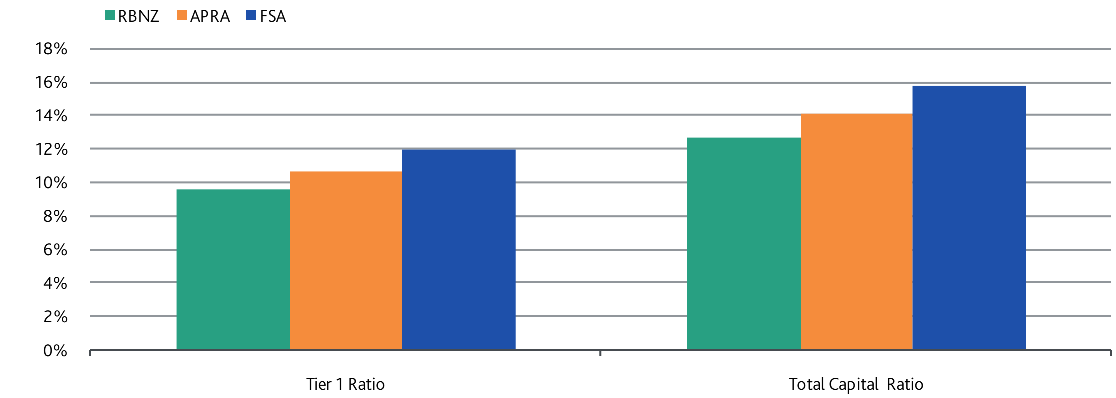


Source: Bank General Disclosure Statements, simple average of majors, WNZL from FY2007 onward

The four major banks have adopted the advanced approaches under Basel II for both credit risk (internal ratings-based approach) and operational risk (advanced measurement approach). These banks maintain a healthy level of core capital, with both their Tier 1 Ratios and tangible common equity (TCE), including equity credit from hybrid instruments, as a percentage of risk-weighted assets (RWA), averaging more than 9% at March 2010.

FIGURE 11

New Zealand Major 4 Banks - RBNZ APRA FSA Comparison



Source: Moody's estimate, at March 2010, weighted average of majors

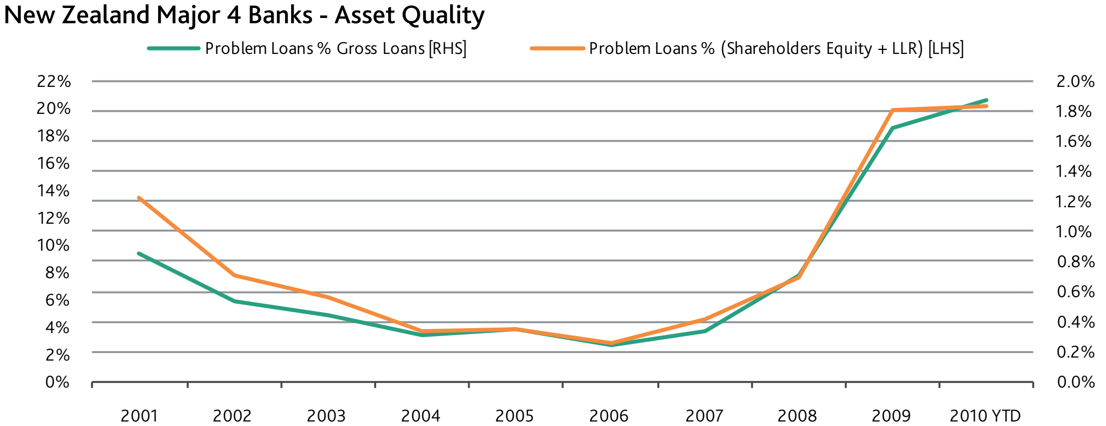
RBNZ has a more conservative regulatory capital calculation when compared with APRA in Australia and FSA in the UK because supervisory adjustment ensures more conservatism (a 15% scalar is applied to retail mortgages and there is a transitional requirement to maintain capital at a level no less than 90% of the previous Basel I capital requirement). In addition, RWAs include a scalar of 1.06.

Finally, banks must use RBNZ's prescribed risk estimates, such as a minimum probability of default (PD) of 1.25% on residential mortgages and downturn loss given defaults (LGDs) according to LVR. For rural loans, banks must use downturn LGDs, which are more conservative than their own estimates.

Asset Quality

FIGURE 12

New Zealand Major 4 Banks - Asset Quality



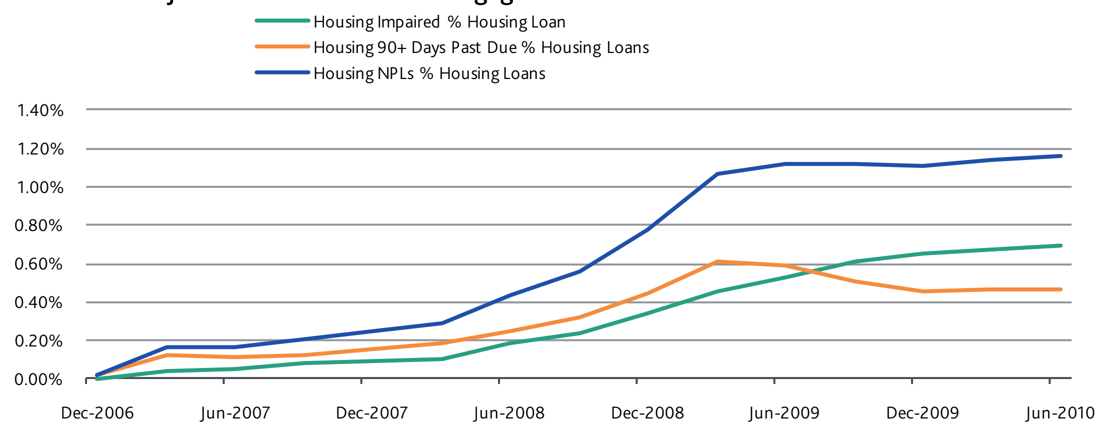
Source: Bank General Disclosure Statements, simple average of majors, WNZL from FY2007 onwards

All major New Zealand banks experienced an increase in non-performing loans (NPLs) since the crisis commenced in 2007. This was consistent with a weakening economic environment, which led to the long, but shallow, recession of 2008-early 2009, and rising unemployment rates.

It is worth noting that although asset impairment levels rose well above long-run averages, they were off a very low base, and when compared with banks globally, the four majors in New Zealand fared quite well.

FIGURE 13

New Zealand Major Banks - Residential Mortgages NPLS % Gross Loans



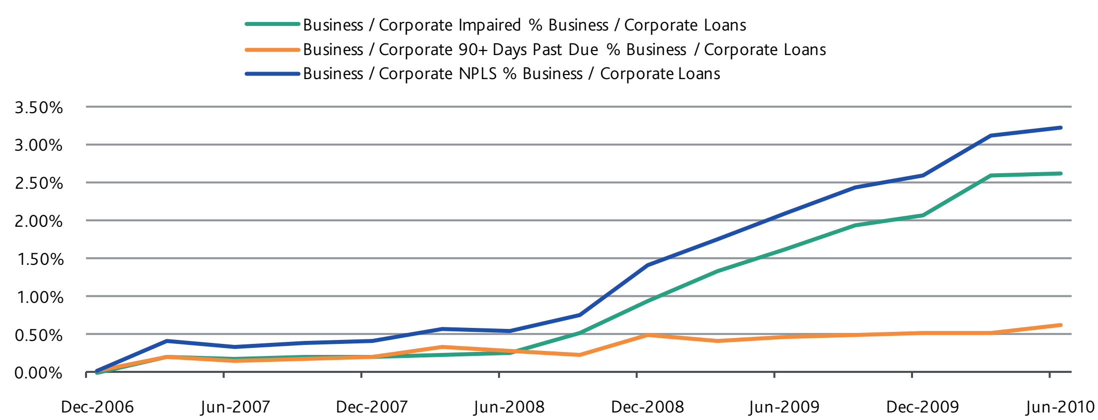
Source: Bank General Disclosure Statements

Residential mortgage portfolios are generally low risk, reflecting the buffer created by the loan-to-value profiles.

However, rising unemployment during 2008-09 resulted in a similar rise in delinquency rates and non-accrual loans. We should see an improvement in housing NPLs as unemployment rates fall and house prices recover.

FIGURE 14

New Zealand Major Banks - Business/Corporate NPLs % Gross Loans



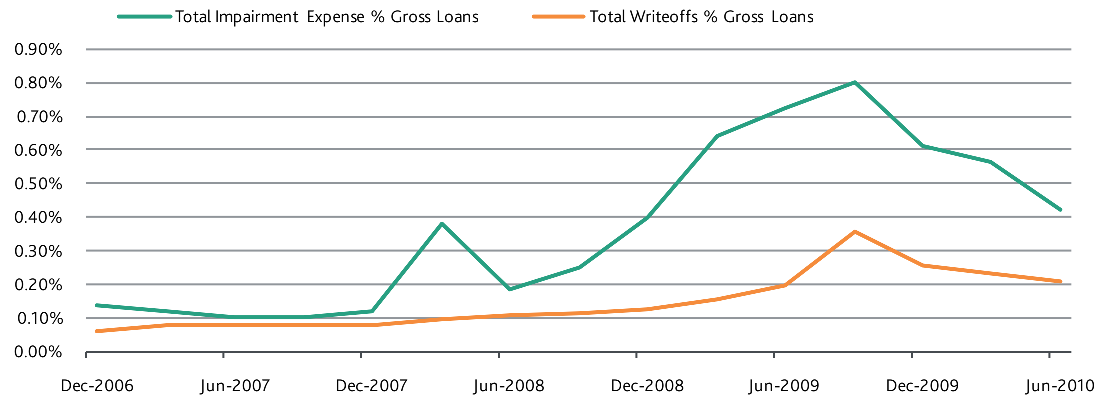
Source: Bank General Disclosure Statements

Banks' business/corporate loan portfolios have experienced a steeper rise in NPLs since the onset of the financial crisis. The long, but shallow, recession in New Zealand impacted particularly the rural, commercial property, and manufacturing industries.

The rise in NPLs has come from loan impairment, rather than delinquency rates, as banks applied a more conservative approach to identify and provision against specific exposures. We anticipate that impaired loans, particularly in the rural sector, will need some time to correct because of the cyclicality of the market. For instance, farm sales and settlement periods occur at certain times of the year. Commercial property is also a sector that may face extended delinquency periods, owing to the lumpiness of the exposures which attract limited purchasers.

FIGURE 15

New Zealand Major Banks - Impairment Expense vs. Write-offs as % Gross Loans



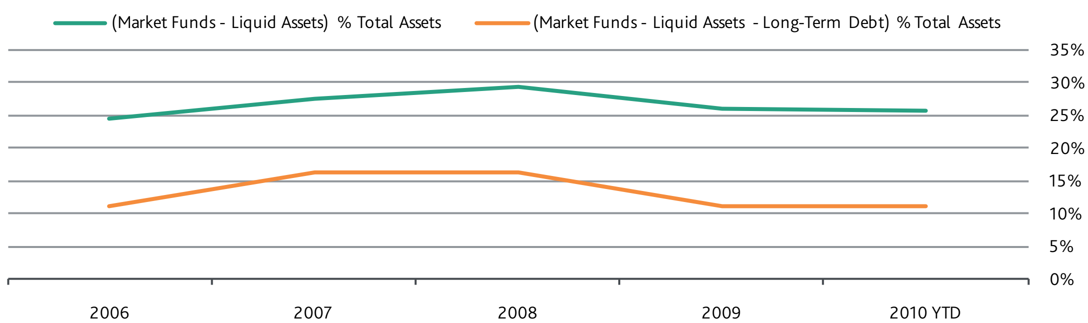
Source: Bank General Disclosure Statements, interim periods are annualized

While impairment expense rates -- measured as a percentage of gross loans -- have risen steeply since the end of 2008, actual write-off levels have been low. This reflects the major banks' conservatism when they identify impaired loans and increase provisioning accordingly to ensure the exposures are adequately collateralized to limit actual losses.

Liquidity

FIGURE 16

New Zealand Major 4 Banks - Market Funds Ratio



Source: Bank General Disclosure Statements, simple average of majors, WNZL from FY2007 onwards

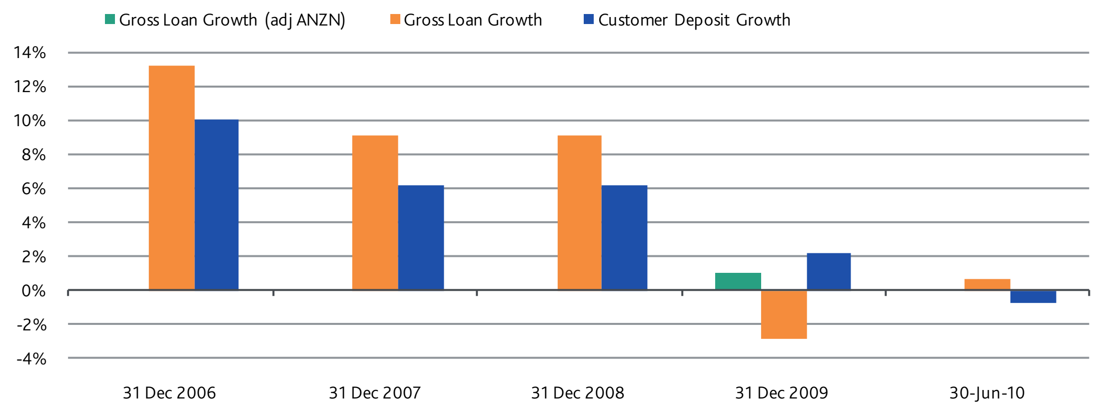
The New Zealand banks historically have a relatively moderate to high reliance on wholesale funding. As discussed earlier, around two-thirds of wholesale debt funding is sourced offshore, and while this is an important investor base for the major banks, it exposes them to disruptions in these markets.

During 2009, New Zealand's major banks made a conscious effort to lengthen the tenors of their wholesale funding portfolios. ANZ National, Bank of New Zealand, Westpac New Zealand, and Kiwibank utilized the wholesale funding guarantee facility from the New Zealand government, leading to a cumulative NZD11 billion in term issuance, with the majority of tenors in the two-to-five-year range.

The improvement to the market funds ratio, measured as wholesale funding (including certificates of deposit and related party funding) less liquid assets as a percentage of total assets, in fiscal year 2009 arose from a refocus by the banks to grow their customer deposit base and slow loan growth to the speed of customer deposit growth. This trend has continued into 2010.

FIGURE 17

New Zealand Major 4 Banks – Growth Rates



Source: Bank General Disclosure Statements, weighted average of major 4 banks. 2009: Major 4 banks loan growth 1.5% if mortgages not transferred from ANZ National to ANZ NZ Bch

Customer deposits fell 1% in the year-to-date to June 2010, compared with a rise of 1% in housing loans[3] , and a decline of 2% in business/corporate loans.

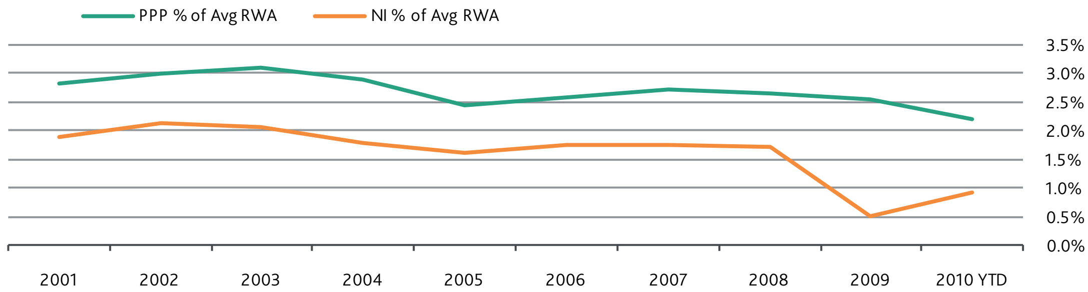
We do not expect a significant increase in customer deposit growth rates in New Zealand, as wealth is generally held through property ownership, rather than deposits.

[3] Balance at June 2010 is after the transfer of residential mortgages from ANZ National Bank to ANZ New Zealand branch to maintain a balance of NZD10 billion in the ANZ New Zealand branch

Profitability

FIGURE 18

New Zealand Major 4 Banks - Risk-Adjusted Profitability



Source: Bank General Disclosure Statements, simple average of majors, WNZL from FY2007 onwards

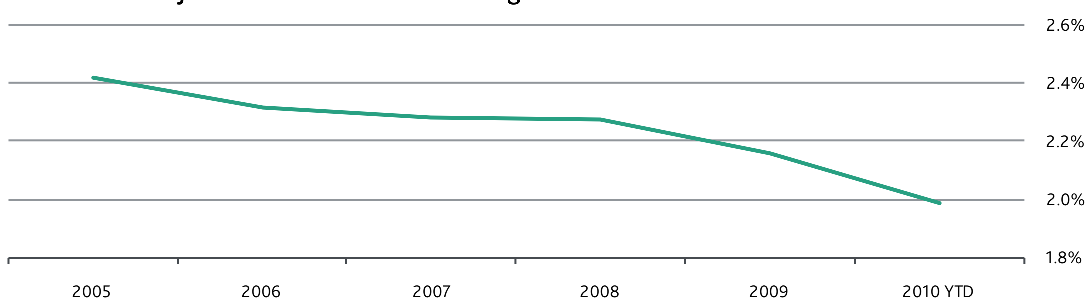
Risk-adjusted profitability -- measured as pre-provision pre-tax profit as a percentage of average risk weighted assets, or net income after tax as a percentage of average risk weighted assets -- has been challenged in recent years because of net interest margin contraction, fluctuating fee and commission income, rising provision expenses, and one-off expenses relating to New Zealand Inland Revenue Department's (NZIRD) tax rulings on certain structured finance transactions[4].

We expect risk adjusted profitability to remain under pressure because of the following reasons:

» Net interest margins face ongoing pressure from rising funding costs, more recently from strong competition for customer deposits, particularly from fast-growing banks, such as Kiwibank, but also from wholesale funding margins that remain higher than pre-crisis levels

FIGURE 19

New Zealand Major 4 Banks - Net Interest Margin



Source: Bank General Disclosure Statements, simple average of majors, WNZL from FY2007 onwards

» Banks have been successful in raising asset margins in their small-to-medium enterprise (SME) corporate/rural lending portfolios to appropriately reflect risk in order to combat the rise in funding costs. With a greater proportion of residential mortgages now on variable rates, banks are also able to incorporate a higher margin in this loan type of portfolio, which has traditionally carried lower margins from fixed-rate products

[4] In 2H2009 calendar year, the New Zealand Inland Revenue Department (NZIRD) determined that certain structured finance transactions constructed by New Zealand banks, often with offshore counterparties, were deemed to be taxable. All the banks involved have settled their respective cases with the NZIRD

» Unseasonably high fee and commission income in the latter half of 2008 and into 2009, as official interest rates fell, resulted in lower interest rates for variable-rate mortgages. This prompted borrowers to convert their existing fixed-rate loans into variable-rate mortgages to get the lower rates, by paying a one-off break-fee to the bank. However, we do not see this as sustainable with interest rates expected to rise

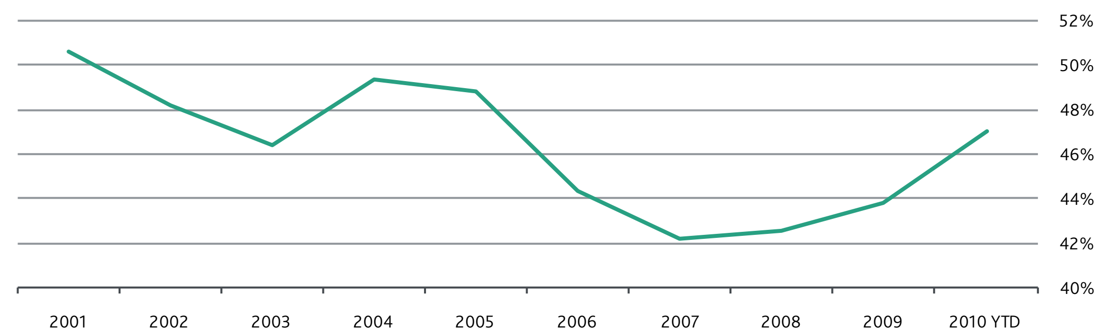
» Higher levels of impairment expenses, reflecting downward risk-grading of exposures and increasing loan impairment. These are expected to remain higher than the long-run average as current impaired loans make their way through the portfolio.

Of the majors, ANZ National Bank, ASB Bank, and Bank of New Zealand have been impacted by recent tax rulings by the NZIRD relating to certain structured finance transactions undertaken in the past decade (Westpac operated as a New Zealand branch operation only; hence its ruling was directed to Westpac New Zealand Branch). This has resulted in one-off tax expenses for these banks, which are reflected in the fiscal year 2009 reports of ANZ National Bank and Bank of New Zealand; and are, in the case of ASB Bank, is financed in fiscal 2010 and therefore reflected in that year's annual report.

Efficiency

FIGURE 20

New Zealand Major 4 Banks - Efficiency



Source: Bank General Disclosure Statements, simple average of majors, WNZL from FY2007 onwards

Driven by disciplined cost management practices and rising operating income, the four major banks enjoyed improved cost-to-income ratios going into the financial crisis. However, over the past couple of years, slower operating income growth, impacted by lower loan growth and interest margin pressures, has reversed this metric.

We expect the sector's cost-to-income ratios to trend back towards long-run averages in the high 40s-low 50s percent range as operating income remains under pressure and further improvements to cost efficiencies are exhausted.

Moody's Stress Test For Estimating New Zealand Bank Credit Losses

In 2008, Moody's began conducting a series of asset quality stress tests that measured likely losses under a number of scenarios relative to capital and stressed earnings.

To determine expected losses in these stress test scenarios, we first disaggregated a bank's loan portfolio into asset classes according to the type of risk. Finally, we constructed our analytical assumptions on the probabilities of default and loss-given default based on weakening economic assumptions, such as rising unemployment and falling house prices, as well as comparisons to the last actual 'worst' situation: the recession of the early 1990s.

Due to the increases in capital and strong performance of pre-provision earnings during the financial crisis (excluding the impact of the one-off NZIRD tax rulings on New Zealand structured finance transactions), New Zealand banks performed well under these scenarios. The 2010 assumptions for New Zealand are presented below for reference.

It is important to note that operating conditions have improved to such a degree that the actual losses which the banks will experience during the current credit cycle may not even reach our "base case" of last year.

New Zealand

SCENARIO ASSUMPTIONS: 2 YEAR LOSSES NET OF RECOVERIES	EXPECTED CASE	BASE CASE	STRESSED CASE
Personal/Consumer Lending	3.0%	5.5%	12.0%
Housing Lending	0.1%	0.4%	1.6%
Rural	1.0%	2.5%	4.5%
Commercial Property	0.5%	2.0%	4.5%
Commercial Property (Development)	2.0%	6.0%	15.0%
Business Secured by Residential Property	0.3%	1.5%	3.0%
Business – Other / Corporate / Other Lending	2.0%	5.0%	9.0%
Total	**0.7%**	**1.8%**	**3.9%**
ECONOMIC ASSUMPTIONS:	**EXPECTED CASE**	**BASE CASE**	**STRESSED CASE**
Unemployment	7.1%	7.5%	9.5%
GDP	3.0%	-1.5%	-3.0%
House Prices (Peak to Trough)	-9%	-15%	-30%

The results of our stress tests show that the banking sector's Tier 1 Ratio could decline by about 3 percentage points.

That said, capital ratio calculations under the RBNZ are more conservative when compared to calculations under APRA and the FSA (as discussed in an earlier section, Capital Adequacy).

Hence we do not have any immediate concerns with the current level of capital held by the banks for their assigned ratings.

Joint-Default Analysis and the Baseline Credit Assessment

The previous section discussed the key qualitative and quantitative drivers of Moody's bank financial strength ratings (BFSRs) in New Zealand. BFSRs – which are assigned on an alphabetical scale from A to E – are Moody's opinions on the intrinsic safety and soundness of a bank enterprise and, in effect, address the susceptibility of a particular institution to financial distress. They measure a bank's standalone default risk and do not consider any systemic or other external support that might be available to the bank. For more information, see "Bank Financial Strength Ratings: Global Methodology", February 2007.

By contrast, Moody's bank deposit ratings – which are assigned on Moody's traditional alphanumeric scale (Aaa, Aa1, Aa2, etc.) – additionally take into account any potential external support that might be forthcoming for a particular bank. These ratings are assigned under Moody's "Joint Default Analysis" methodology, which operates on the principle that the risk of default (and therefore, loss) for certain obligations depends upon the performance of both the primary obligor and another entity (or entities) that may provide support to the primary obligor. This methodology takes the bank's BFSR as the starting point and then, in a sequential process, assesses the capacity and willingness of each potential support provider to support the bank in order to arrive at the deposit ratings. For more information, see "Incorporation of Joint-Default Analysis into Moody's Bank Ratings: A Refined Methodology", March 2007.

As BFSRs are assigned on their own scale, Moody's has developed a mapping grid for translating BFSRs to a measurement on Moody's traditional scale – this is the Baseline Credit Assessment (see mapping grid in Appendix 3).

The following section discusses the external support considerations that drive the deposit ratings of banks in New Zealand in addition to the Baseline Credit Assessments derived from their BFSRs. It looks at both the support guideline for the country as a whole and an overview of Moody's external support assessments for individual institutions.

Deposit Rating Drivers

New Zealand is a "moderate support" country

The New Zealand regulator has a proactive approach to system management, favoring an open resolution approach to prevent problems arising at individual institutions, so as to safeguard financial system stability and depositor interests (and by extension, creditor interests).

There has been some instances of regulatory support for the New Zealand banking sector, and which occurred in the late-1980s/early-1990s. This included the case of the Bank of New Zealand, a government-owned bank that was partially floated in 1987 and again in 1989, and a bail-out in 1990. It was bought by National Australia Bank in 1992.

That said, there has been instances of bank failures, including DFC New Zealand Limited, a government-owned development bank which was privatized in 1988, and ultimately collapsed in 1989. There have also been a number of collapses in the finance company sector since 2006. This sector is now regulated by the RBNZ under the non-bank deposit-taking regime, which came into effect 1 March 2010.

The New Zealand authorities have also demonstrated a pronounced willingness to provide liquidity support -- directly from the central bank, or indirectly through supporting the liquidity of the country's major banks -- on numerous occasions in recent decades. During the current crisis, a raft of measures was taken, including broader eligibility for central bank repo funding and the government's guarantee scheme.

Local Currency Deposit Ratings

The global local currency (GLC) deposit ratings of Aa2 of the rated New Zealand banks are supported by the Baseline Credit Assessment of A2, as well the Aa3 Baseline Credit Assessment of their parents, CBA, ANZ, NAB, and Westpac respectively, and the Aaa local-currency deposit ceiling (LCDC) of New Zealand.

The banks receive a 3-notch uplift from their Baseline Credit Assessments, bringing their GLC deposit ratings to Aa2.

Moody's expects a very high level of support from the Australian parents of the rated New Zealand banks based on the following: (1) shared branding, (2) close operational integration between the rated New Zealand bank and the rest of the Australian parent's group, (3) the relatively low risk that the parent would dispose of the rated New Zealand bank. In addition, the unique situation of New Zealand, whose banking system is dominated by the four major Australian banks, and the close working relationship at both a regulatory and political level between Australia and New Zealand, also increase the likelihood that parental support would be forthcoming.

It is worth noting that in 2006, both the Australian Banking Act of 1959 and the Reserve Bank of New Zealand Act were amended to include clauses on Trans-Tasman cooperation. In the Australian Act, Section 8A requires of the Australian regulator that:

1. In performing and exercising its functions and powers, APRA must:

   "to the extent reasonably practicable, avoid any action that is likely to have a detrimental effect on financial system stability in New Zealand."

At the margin, we would interpret this as increasing the probability that the Australian regulator would permit its major banks to support their New Zealand subsidiaries, if required. Furthermore, and separate to the trans-Tasman provision of the Act, there is a track record of the Australian regulator allowing Australian financial institutions to support their foreign subsidiaries.

The New Zealand banking system is very concentrated, with the four largest banks accounting for over 90% of locally incorporated system loans and deposits. Given the significance of the major banks in the financial system, Moody's believes that in practice the range of policy options open to the authorities may be limited, and that there is quite a high probability for strong systemic support (in the event of a stress situation) for these banks.

Foreign Currency Deposit Ratings

The Foreign Currency Deposit ratings of the New Zealand banks are unconstrained because New Zealand has a country ceiling of Aaa.

Moody's Related Research

Bank Credit Analysis:

» ANZ National Bank Limited, December 2009 (121919)

» ASB Bank Limited, December 2009 (122186)

» Bank of New Zealand, December 2009 (121903)

» Westpac New Zealand Limited, December 2009 (121956)

Banking Statistical Supplement:

» New Zealand, June 2010 (117483)

Special Comments:

» Insurers and Banks Well Insulated from New Zealand Earthquake, September 2010 (127453)

» No Rating Impact on Asia- Pacific Banks from Proposed Treatment of Hybrid Securities, March 2010 (124045)

» The Removal Of Some Temporary Emergency Liquidity Facilities In New Zealand, November 2009 (120867)

» Moody's Comments on Impact of Government Guarantee on New Zealand Bank Ratings, December 2008 (113280)

Press Releases:

» Moody's sees more stability in Asia Pacific banking systems, 26 January 2010

» Moody's says New Zealand bank ratings remain resilient under stress, 23 October 2009

Rating Methodologies:

» Bank Financial Strength Ratings: Global Methodology, February 2007 (102151)

» Incorporation Of Joint-Default Analysis Into Moody's Bank Rating Methodology, March 2007 (102639)

» Moody's Approach to Estimating Bank Credit Losses and their Impact on Bank Financial Strength Ratings, March 2009 (117326)

» Proposed Changes to Moody's Hybrid Tool Kit, March 2010 (120730)

» Moody's Approach to Rating Financial Entities Specialised in Issuing Covered Bonds, August 2009 (SF175831)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Appendix

Appendix 1: Sovereign Credit Opinion

Credit Opinion: New Zealand

Global Credit Research - 28 May 2010

Ratings

CATEGORY	MOODY'S RATING
Outlook	Stable
Country Ceiling: Fgn Currency Debt	Aaa/P-1
Country Ceiling: Fgn Currency Bank Deposits	Aaa/P-1
New Zealand, Government of	
Outlook	Stable
Government Bonds	Aaa
Commercial Paper	P-1
Other Short Term -Dom Curr	P-1

Key Indicators

NEW ZEALAND	2005	2006	2007	2008	2009	2010F	2011F
Real GDP (% change) [1]	3.3	2.4	2.5	-1.0	0.8	3.2	4.2
Inflation (CPI, % change Dec/Dec)	3.2	2.6	3.2	3.4	2.0	2.0	2.8
Gen. Gov. Financial Balance/GDP	5.2	5.9	5.0	3.1	-1.2	-3.3	-3.9
Gen. Gov. Primary Balance/GDP	6.6	7.4	6.3	4.4	0.1	-2.1	-2.4
Gen. Gov. Debt/GDP	27.4	27.1	26.2	25.3	27.0	31.0	35.6
Gen. Gov. Debt/Gen. Gov. Revenue	62.0	58.7	57.9	57.3	65.6	77.4	89.4
Gen. Gov. Int. Pymt/Gen. Gov. Revenue	3.2	3.1	2.9	3.0	3.2	3.1	3.8
Current Account Balance/GDP (%)	-8.3	-8.5	-8.0	-8.7	-2.9	-2.7	-5.0

[1] Fiscal years ending March 31, e.g. 2005 refers to fiscal year 2005/06

Credit Strengths

New Zealand has the following credit strengths:

» Advanced economy with strong government finances and sound monetary policy.

» Low, although rising, government debt in comparison to other advanced economies.

» Political consensus that should sustain policies supportive of low government debt and a market-oriented economy.

» A strong banking system that is mainly foreign owned, lessening the government's contingent liability.

Credit Challenges

New Zealand faces the following credit challenges:

» A resource-based economy that, on balance, remains exposed to volatile export earnings.

» Among the largest net external liability positions of advanced economies.

Rating Rationale

New Zealand's Aaa ratings are based on the country's high economic strength, very high institutional and government financial strength, and very low susceptibility to event risk. New Zealand's flexible and market-oriented economic policies have supported economic performance that has become stronger and less subject to external shocks. Although per capita income is at the low end of the Aaa range, it is nonetheless high by global standards. The relatively small scale of the economy is also a factor considered in assessing economic strength. Institutional strength is very high, as measured by governance, rule of law, and transparency. In addition, Moody's believes that the government, of whichever party, will maintain a policy of low debt and fiscal soundness.

With a relatively low level of debt and assured access to liquidity, the government's financial strength is high. While the fiscal outlook is for a deterioration in the coming few years, the coalition government that came into office in late 2008, has indicated its intention to keep debt at a prudent level. General government debt is well under 30% of GDP and until now has been declining. However, the government now projects significant increases in debt ratios for the next several years, but Moody's believes the government's position will still be compatible with a Aaa rating.

The external liability position will remain high. However, there are several factors that make the large external liability position less risky than it might appear, including the high proportion of liabilities denominated in NZ dollars and of foreign currency liabilities that are hedged, and the related-party nature of much of bank liabilities. The composition of the external liability position supports an assessment of low susceptibility to event risk.

Rating Outlook

The stable outlook is anchored by the government's low debt and Moody's belief that New Zealand will continue with fiscal and monetary discipline and market-oriented policies.

What Could Change the Rating - Down

Inability to correct looming fiscal deficits and a resultant upward trend in government debt ratios could pose a threat over the long term.

Recent Developments

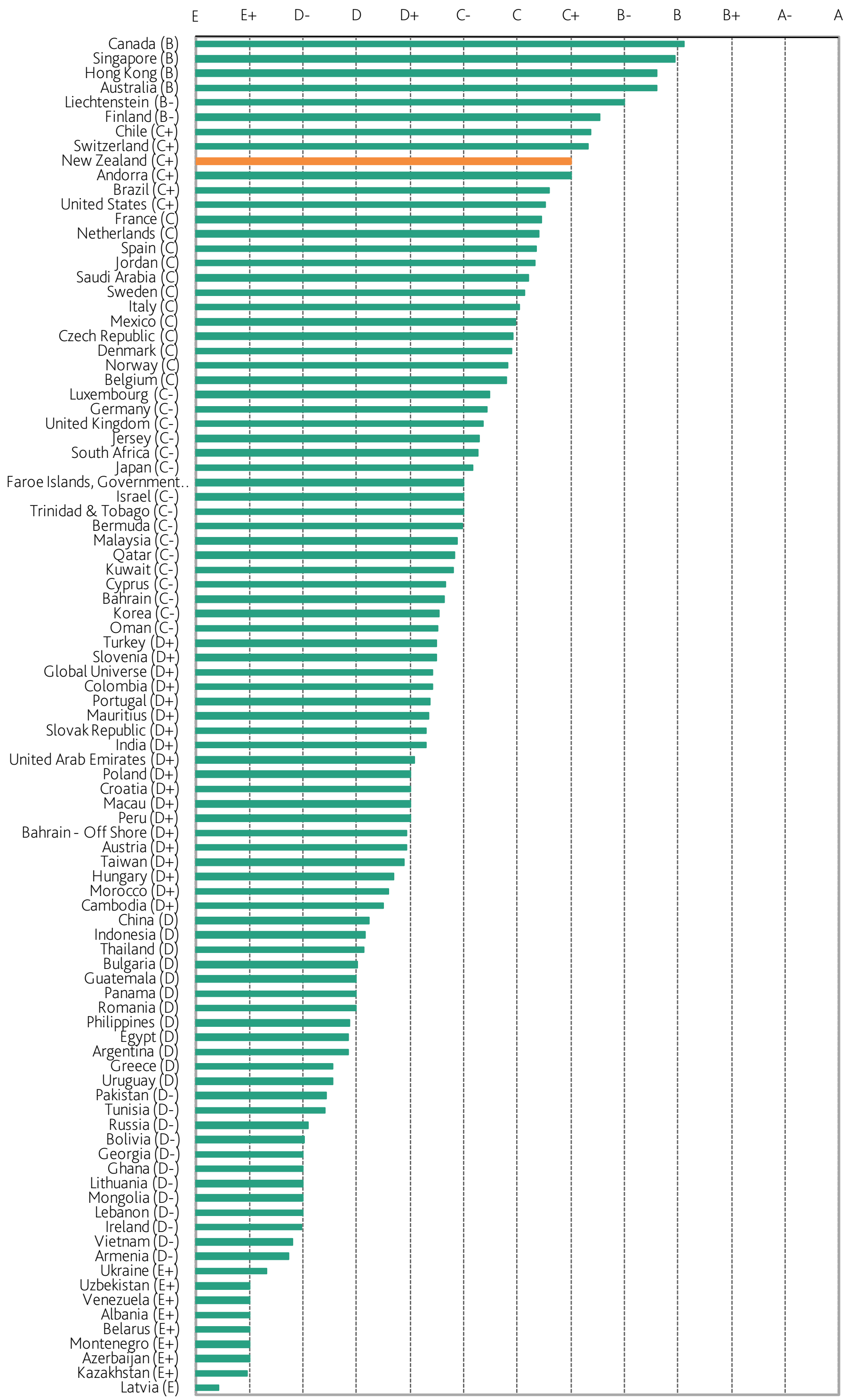
Projections in the recent budget show smaller deficits and an improvement in government debt ratios compared to figures released in December. The operating deficit, after peaking in the coming fiscal year at 3.5% of GDP, will be halved the following year and then return to surplus by 2015. As a result, gross (central) government debt will peak at 33% of GDP in 2015 before beginning to decline. Relative to the largest Aaa-rated sovereigns, this is a comfortable position. The budget included significant tax reform, raising the VAT and lowering both corporate and personal income taxes. These moves could help investment and saving, and they could therefore increase growth potential over the medium term.

Recent economic indicators show that the economy has recovered from--and was not so vulnerable to--the global financial crisis. Very high commodity prices for dairy and other products have considerably improved the terms of trade, which is a positive development for incomes and domestic demand. New Zealand's export growth has been supported by demand from China and India, in particular, even though exports to Europe have declined.

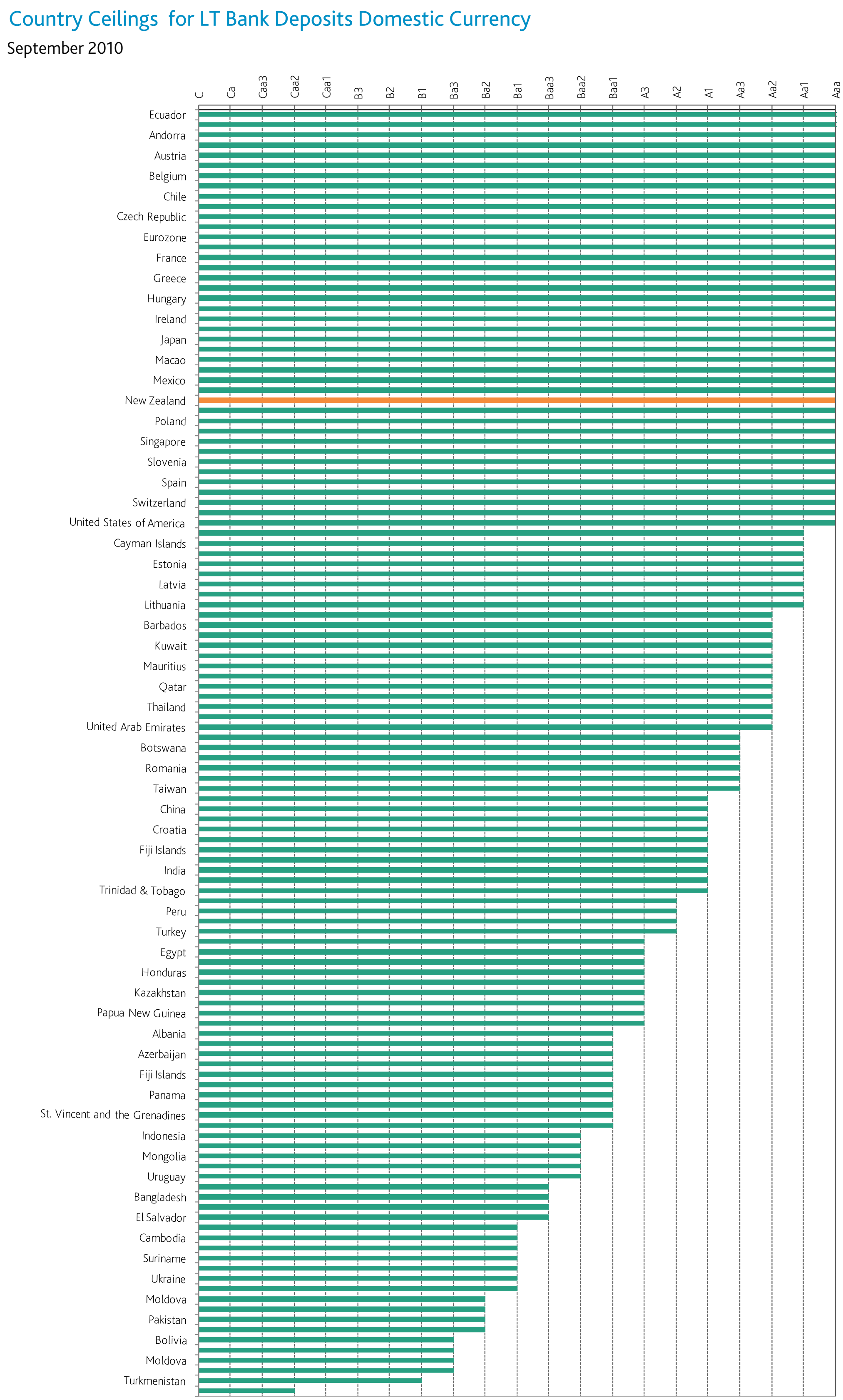
Appendix 2: Global Comparisons

Average* Bank Financial Strength Ratings by Country

September 2010

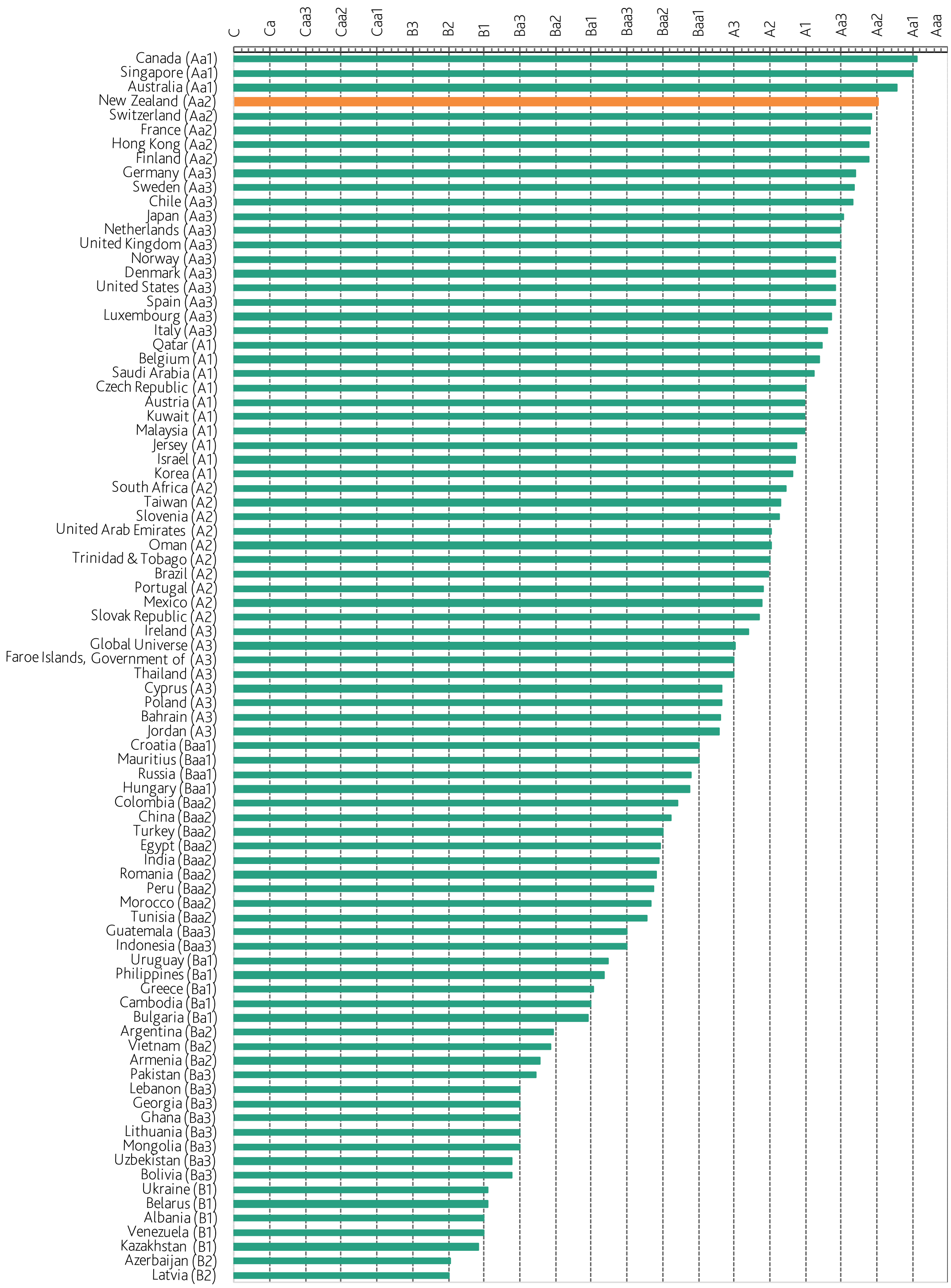


*Weighted by Assets


Country Ceilings for LT Bank Deposits Domestic Currency
September 2010
C
Ca
Caa3
Caa2
Caa1
B3
B2
B1
Ba3
Ba2
Ba1
Baa3
Baa2
Baa1
A3
A2
A1
Aa3
Aa2
Aa1
Aaa
Ecuador
Andorra
Austria
Belgium
Chile
Czech Republic
Eurozone
France
Greece
Hungary
Ireland
Japan
Macao
Mexico
New Zealand
Poland
Singapore
Slovenia
Spain
Switzerland
United States of America
Cayman Islands
Estonia
Latvia
Lithuania
Barbados
Kuwait
Mauritius
Qatar
Thailand
United Arab Emirates
Botswana
Romania
Taiwan
China
Croatia
Fiji Islands
India
Trinidad & Tobago
Peru
Turkey
Egypt
Honduras
Kazakhstan
Papua New Guinea
Albania
Azerbaijan
Fiji Islands
Panama
St. Vincent and the Grenadines
Indonesia
Mongolia
Uruguay
Bangladesh
El Salvador
Cambodia
Suriname
Ukraine
Moldova
Pakistan
Bolivia
Moldova
Turkmenistan

Average LT Bank Deposits by Country Domestic Currency

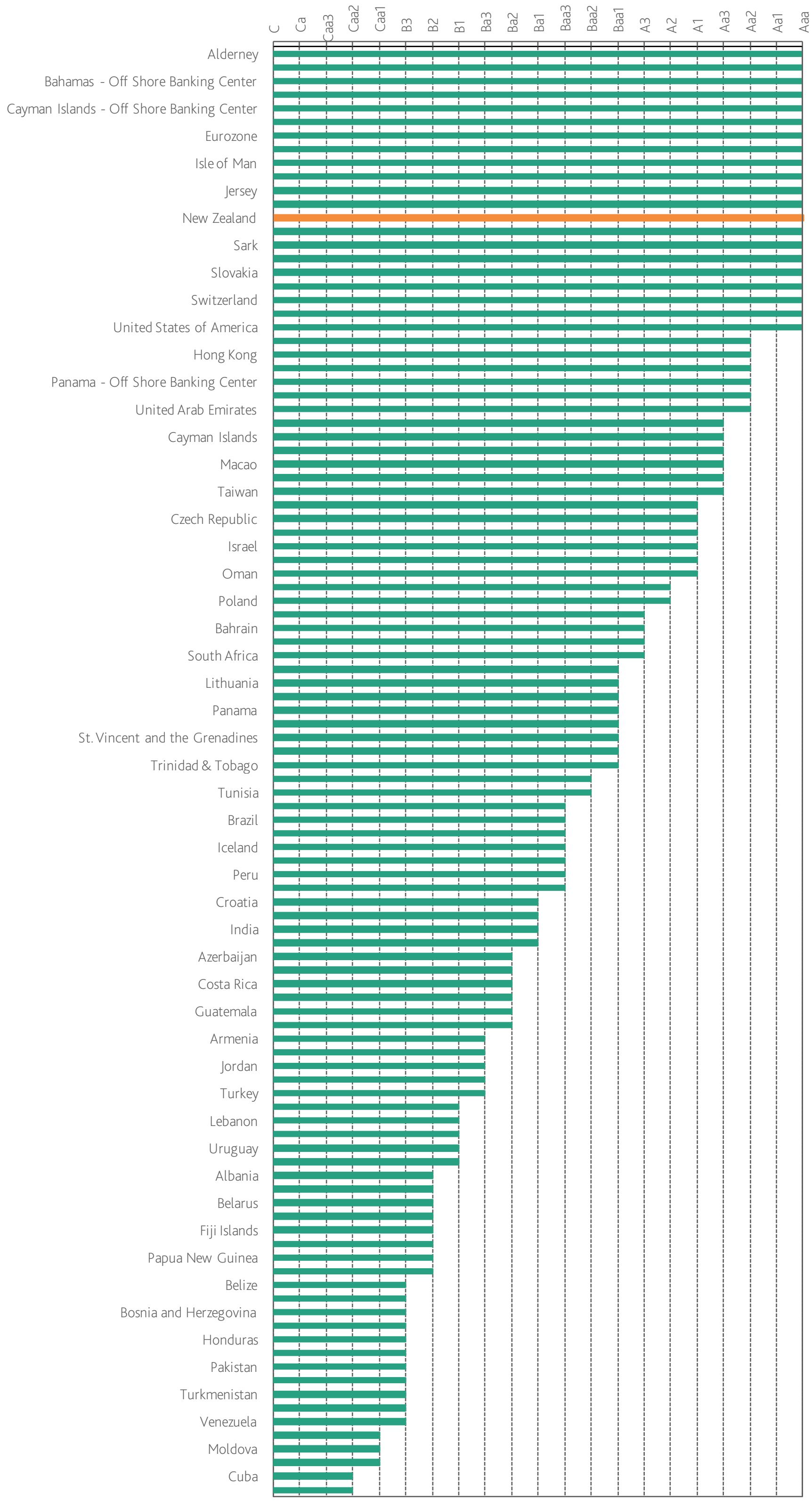
September 2010



*Weighted by Assets

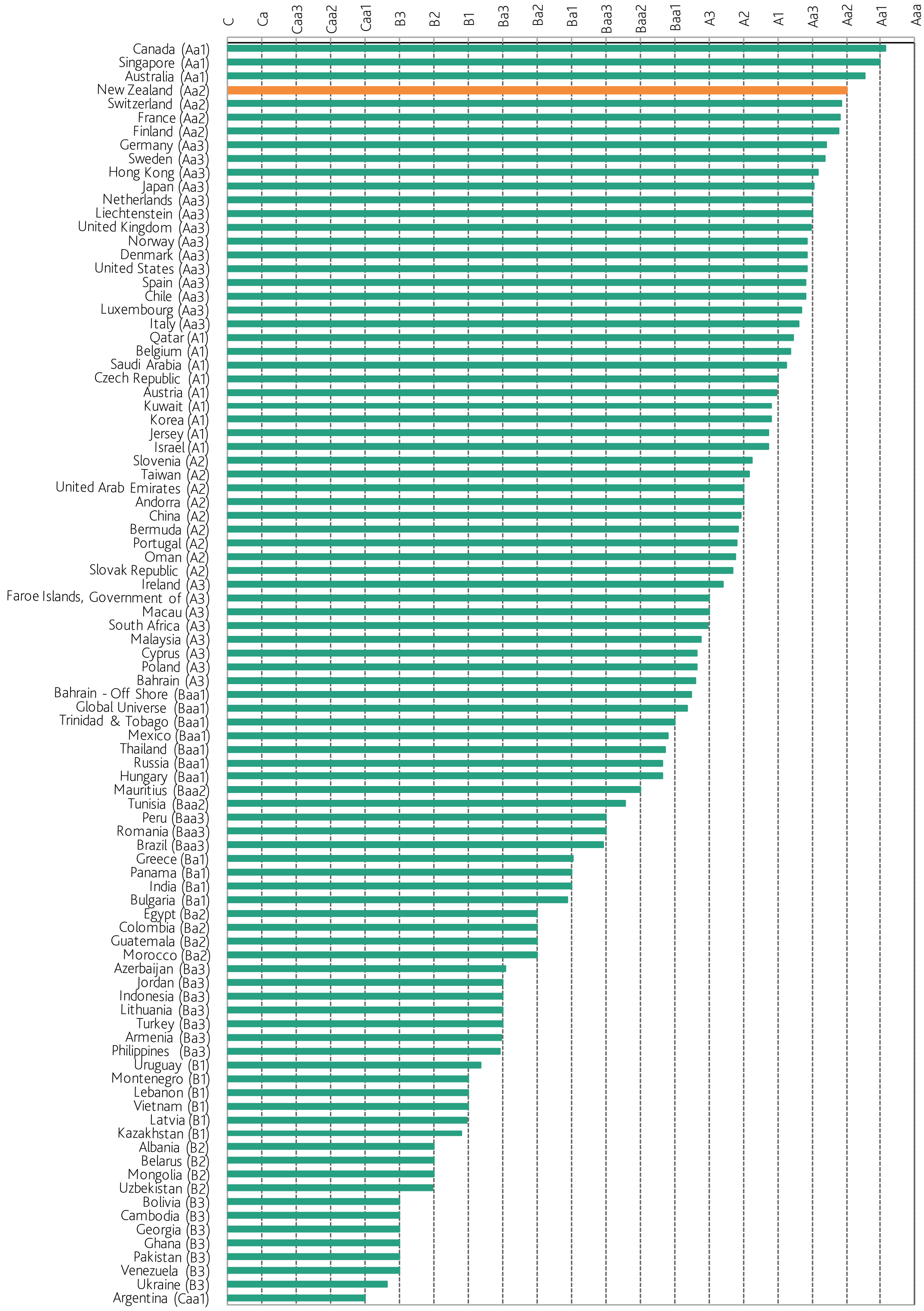
Country Ceilings for LT Bank Deposits Foreign Currency

September 2010



Average LT Bank Deposits by Country Foreign Currency

September 2010



*Weighted by Assets

Appendix 3: BFSR/BCA Mapping Table

Mapping the BFSR to the Baseline Credit Assessment (BCA)

BFSR	BASELINE CREDIT ASSESSMENT (BCA)
A	Aaa
A-	Aa1
B+	Aa2
B	Aa3
B-	A1
C+	A2
C	A3
C-	Baa1
C-	Baa2
D+	Baa3
D+	Ba1
D	Ba2
D-	Ba3
E+	B1
E+	B2
E+	B3
E	Caa1
E	Caa2
E	Caa3

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