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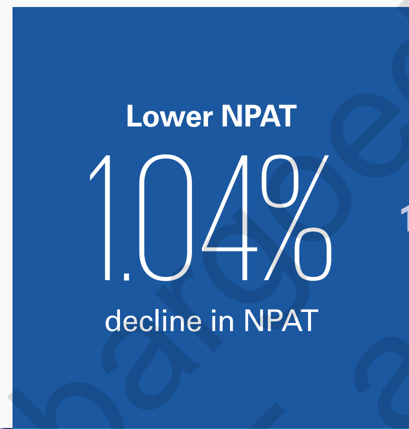
FIPS

Financial Institutions Performance Survey
June 2017 Quarterly Results



Lower NPAT

1.04%

decline in NPAT

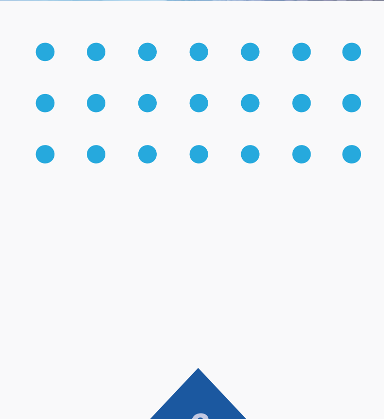
1

2

Better net interest margins

6 bps

growth in NIM



Slow lending growth

1.18%

increase in gross lending

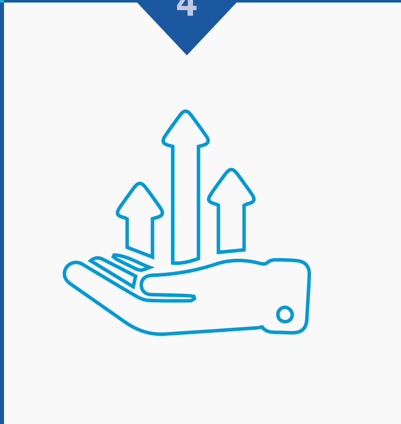
3

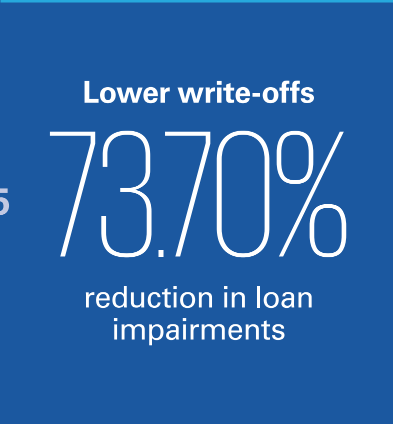
Higher costs

13.92%

rise in operating expenses

4





5

Lower write-offs

73.70%

reduction in loan impairments

6

Improved loan quality

6.80%

reduction in provisions

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Industry update

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Election result in the balance

As we draft this review of the June quarter, the major story in all the headlines is the delicately balanced electoral result. No party can form a majority alone and commentators across the spectrum are discussing potential coalition options and outcomes. It is too early to tell with 15% of the vote and special votes to be counted. The base numbers may still move ahead of any collation talks or deals being announced. To date, markets have remained relatively unaffected. 14-21 days may be needed to produce a clear picture.

Local economy

Cooling housing market?

After the housing market's "bull run" over the past few years, especially in the stretched Auckland region, potential buyers are looking forward and hoping that the cycle will slow or reverse. However, market data is mixed, and while it does show a definite slow down compared to previous years' growth, explicit major declines are not yet clearly discernible.

While there was not much movement in the national ex-Auckland median house price over the quarter, Auckland's median price dropped 4% in April, recovered by 1% in May, but fell by 2% in June, meaning that the median price was down four percent for the quarter ended June. Nevertheless, nationally median prices have increased from 2016 levels. Mean price information supports a less aggressive, but steady market view; mean prices were flat from quarter end to quarter end in Auckland, but increased 1.2% nationally. The housing price index painted a similar picture; nationally, the index was almost flat, diminishing at a marginal 0.3% in the quarter ended June 2017, but in Auckland it decreased by 1%.[1,2]

Mean prices were flat from quarter end to quarter end in Auckland, but increased 1.2% nationally.

A slower housing market was more clearly demonstrated by sharply lower sales volume figures (which are down 24.7% across the country compared to June 2016) and higher levels of inventory available in the market.[3]

Floating interest rates on new residential mortgages have been steadily increasing this quarter which may be contributing to softer demand and selling volumes. Over the year from June 2016, rates have increased by 17 basis points (bps) on average, but remained in the 5.59% to 5.61% range for a period of five months from August to December 2016, after spending two months at 5.67% in June and July 2016. New mortgages became much more costly in January and March when rates increased sharply by 10 bps and 7 bps, respectively.[4]

Demand-side constraints, such as the uptick in interest rates noted above, the RBNZ's LVR (Loan-to-Value Ratio) restrictions as well as Chinese exchange control regulations which are restricting the movement of funds offshore, have contributed to the cooling effect observed in the empirical data. However, fundamental factors bolstering the market are expected to persist over the short to medium term. For instance, New Zealand's relatively prosperous economy amongst the advanced economies continues to attract migrants and deters Kiwis from emigrating or encourages them to return, thereby supporting demand. Although supply is expected to increase to meet demand, as construction activity remains robust and as sales volumes remain low, it is still expected to lag; hence, current prices could still be supported going forward by the baseline supply shortage.[5,6,7,8]

Dairy sector: 2018 milksolids forecast price up; butter looking tastier

On 27 July, Fonterra announced an increased forecast Farmgate Milk Price for the 2018 season of $6.75 per kilogram of milksolids (kgMS). This increase represents a lift of $0.25 per kgMS from the opening forecast price released in late May 2017. In a press release, Fonterra's chairman reported that "we are seeing growing confidence on-farm across the country and, with global demand for dairy strengthening, the signs are for a good start to the season for our farmers and their rural communities although following a challenging period of very wet conditions for some of our farmers". Although the co-operative labelled the forecast price as 'prudent', economists dissented amongst themselves regarding price forecasts: Westpac reported in their August 2017 *Quarterly Economic Overview* report that it would maintain its forecast price at $6.50 per kgMS, while ASB reported that the updated price was in line with their long-term forecasts.[9,10,11]

Milkfat products made the news in the quarter.

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Milkfat products made the news in the quarter. Butter prices rose by a massive 12% in the month of May based on GlobalDairy Trade auction prices, with the following month's price growth of 5.27% continuing this strong growth. Butter prices were supported by more positive sentiment coming out of Asia. In its Global Dairy Update for July 2017, Fonterra reported that shifting preferences towards butter were evident in higher Chinese imports and that "recently we've seen the demand, particularly out of China, exceed supply". The co-operative also reported that cream cheese is encountering a "steady surge in popularity". The dairy giant is responding to these trends by expanding its production capabilities in the following ways: a new butter line will be able to produce 650 million mini-dishes per year (representing a 160% increase on previous capabilities) and new cream cheese lines will enable the co-operative to increase production by 3,500 tonnes a year. Technology at the new cream cheese plant will enable Fonterra to change the firmness and consistency of the product and thus respond more deftly when consumer preferences shift.[12, 13, 14]

Fonterra announced that it will be starting a trial of new weather technology which would provide more detailed forecasts, seasonal insights and real-time information to farmers. The co-operative is working with Metservice and Bloomsky (a smart camera based hyperlocal weather station solution) to provide this information to users of the Agrigate platform. The plan is to install 70 weather stations across the country.[15]

Other agricultural sectors: Meat up but wool down

This quarter, Silver Fern Farms announced that it would close its Ashburton sheep meat plant. Beef and Lamb New Zealand figures show that farmers are switching from sheep toward dairy or beef farming. Although lamb, venison and beef prices were buoyant, new import tariffs in Japan on beef will impact upside potential for that commodity.[16]

Figures show that farmers are switching from sheep towards dairy or beef farming

New Zealand finished its worst wool season since the global financial crisis due to Chinese preference moving to fine wool. On the volume demand side, out of 420,378 bales put up for auction, only 311,698 were sold in the season ended 30 June. Prices also came under extreme pressure; ASB reported that the NZD wool price index dropped from 121.9 at the end of July 2016 to 74.5 at the end of June 2017. Stockpiles will most likely result in continued pressure on prices going forward.[17, 18]

Some of the long-term effects of the Kaikoura earthquake and aftershocks, which occurred in late 2016, were highlighted this quarter in the agricultural sector. A Radio New Zealand report in June revealed that quake-damaged fisheries may take up to a decade to recover from the damage. Viticulture production capability in the Marlborough region was also affected by the Kaikoura event, where over 60 million litres (or 20%) of tank capacity were damaged or destroyed.[19, 20]

Macroeconomic indicators: Low inflation, share price growth and NZD strength

The CPI was flat from the first quarter through to the second quarter ended 30 June, but was down 0.1 percent after seasonal adjustment. Food prices rose 0.7 percent, influenced by rising prices for vegetables (up 19 percent). Housing and household utilities prices rose 0.8 percent, influenced by purchase of new housing (up 1.8 percent). Transport prices fell 1.3 percent, with cheaper domestic airfares (down 15 percent).[21]

The S&P/NZX 50 index was up from 3376.38 at the end of March to 3563.25 at the end of June, moving by 5.53% over the period.[22]

The NZD strengthened against the greenback, the GBP and the Aussie dollar, reflecting improved terms of trade in the quarter as well as positive sentiment and comparably good returns in local markets, USD weakness amidst political concerns, and continued Brexit uncertainties.[23, 24]

Global and regional economy

Despite continued political controversies featuring both the US and North Korea, empirical economic and financial data over the quarter under review was encouraging. There were also other global uncertainties around inflation, central banks' monetary policy decisions, better corporate and market performance, steady GDP growth and the Brexit path forward. Future monetary policy tightening decisions overseas might result in an increase in funding costs which may put pressure on banks' margins.[25, 26]

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The US: Positive data, but QT on the horizon

In the US, real GDP expanded by 3% during the second quarter, up from 1.2% reported in the previous quarter. The components which contributed to this uptick were personal consumption (which added 2.28% to GDP) and domestic private investment and net exports, offset by slower government spending and investment.[27]

Corporate profits were also healthy, despite expansionary fiscal policy changes which are no longer looking likely to be implemented, with profits after tax, after inventory valuation and capital consumption adjustments, increasing at a rate of 8.6% compared to the corresponding 2016 quarter. Companies' stock prices were also favourably up over the period – the S&P 500 index was up by 2.57% in the quarter and the Dow Jones Industrial Average index increased by 3.32% over the same period.[28, 29]

In regard to monetary policy, after an unprecedented period of quantitative easing following the global financial crisis, the US Federal Reserve (Fed) announced that once interest rate normalisation is well under way it will gradually start winding down its balance sheet . The journey towards more normal interest rate levels continued this quarter when the Fed announced a 0.25% hike in the Fed Funds rate in mid-June, even though annual inflation numbers were not particularly concerning at 2.2% in April, 1.9% in May and 1.6% in June.[30, 31, 32, 33]

The programme to trim the balance sheet will involve only reinvesting maturing proceeds from treasury and agency security holdings which are in excess of USD 6 billion per month for treasuries and USD 4 billion per month for agency securities, as opposed to current practice where all proceeds on these maturing securities are reinvested. The dollar-value caps would gradually increase over a 12-month period to steady cap levels and, once reserves reach a "normalised" level, the quantitative tightening (QT) programme would cease. Nevertheless, Chairwoman Yellen emphasised that a cautious approach would be followed, stating "the Committee would be prepared to resume reinvestments if a material deterioration in the economic outlook were to warrant a sizable reduction in the federal funds rate."[34]

The region has already begun to feel the effects of a protectionist policy from a Trump-led US, as evidenced by the US electing to discontinue its participation in the Trans-Pacific Partnership agreement. However, other participants such as New Zealand and Japan have agreed to consider continuing the trade deal without the US, even though the volume of trade going forward would only be a quarter of what it would have been with American involvement. Those in favour of continuing the agreement note that key future focus areas would be protectionism concerns and maintaining open markets. The recent election campaigns have highlighted how different parties could continue or terminate New Zealand's ongoing support of the Trans-Pacific Partnership, making this issue very much a 'live' issue.[35]

Europe, including the UK: Modestly improving

European economic growth is continuing, albeit at a much slower pace than across the Atlantic. GDP in Europe rose by 0.6% in the quarter. This was double the growth rate in the UK alone, with the smaller economies of the Czech Republic, Sweden and Romania all growing at a rate of 1.6% or more. These smaller economies outpaced their larger Continental peers (Germany, France and Italy) who grew at 0.6%, 0.5% and 0.4% respectively in this quarter.[36]

Annual inflation in the Euro area was in the 1.3% to 1.9% range over the June quarter, while the CPI in the UK was considerably above the Continent and the US and within a narrow range between 2.6% and 2.9%.[37]

Despite rising prices in the UK, and in contrast to the Fed's decision to raise rates and announce a structured approach to reducing the size of its balance sheet, the Bank of England kept rates constant at 0.25% during the quarter and the Committee "voted unanimously to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves".[38]

Across the Channel, the threat of tightening monetary policy was dispelled by the European Central Bank (ECB) at its meeting on 20 July 2017, where the ECB Governing Council decided to keep interest rates unchanged. Issue 5/2017 of the ECB's Economic Bulletin states: "Looking ahead, the Governing Council confirmed that a very substantial degree of monetary accommodation is needed for euro area inflation pressures to gradually build up and support headline inflation developments in the medium term."[39]

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Eurozone equities advanced in the second quarter with the MSCI EMU index returning 1.8% on the back of lower political risk, GDP growth and improved corporate earnings.[40]

Australia and Asia: Steady growth

Data from the Australian Bureau of Statistics (ABS) shows the Australian economy grew by 0.8 percent during the June quarter. Chief Economist for the ABS, Bruce Hockman stated the following: "Recent swings in coal and iron ore prices have had significant effects on the Australian economy in terms of export revenues and real incomes, though export volumes continued to grow in the June quarter. Dwelling construction remains at elevated levels, although new residential building approvals are on the decline." Australian information shows improvements in business confidence and employment levels.[41]

Stronger Chinese macroeconomic indicators and more interest in riskier emerging markets resulted in Chinese equities gaining strength over the quarter. The Chinese yuan also finished the period 1.6% higher against the greenback.[42]

Technology

Global CIO survey released; innovation in focus

The results of a Harvey Nash/KPMG-sponsored survey of Chief Information Officers (CIOs), the largest IT leadership survey in the world, were published this quarter.[43]

The survey revealed that 44% of banking sector respondents expected their IT budgets to grow in the coming 12 months, demonstrating that technology continues to be a focus area. Key IT-related business issues flagged by the global banking sector CIOs were as follows: delivering stable and consistent IT performance, saving costs and increasing operational efficiencies, and developing innovative new products and services.

Interestingly, the banking sector respondents placed more emphasis on innovation than their non-banking peers. This emphasis clearly highlights the continued importance of Fintech and digital labour in disrupting the banking sector's landscape in the future. However, it is of some interest to note that, only 16% of CIOs viewed the current IT organisation in their banks as 'very effective' at fostering innovation, a perception which points to banks possibly tapping into external sources of ideas, such as universities, or holding more innovation contests to remedy this trend.

Predictably, for a highly regulated banking sector, adhering to legal and regulatory compliance requirements was seen as a challenge by 45% of respondents, but being able to easily implement new technologies was seen as an equally important challenge.

Accounting standards: IFRS 9 looming large

With the exception of BNZ, banks are in various stages of assessing the impact of NZ IFRS 9 *Financial Instruments* with the implementation date (being financial years beginning 1 January 2018) of the standard fast approaching.

Banks are in various stages of assessing the impact of NZ IFRS 9.

The most significant complexities arise from the implementation of the new financial instruments standard's forward-looking requirements around impairment which require a high level of management judgement. Banks will likely look to credit rating agencies, credit spreads, and economists' predictions around the future, as well as internal data collected from its systems (which, arguably, would need to increase in scope, depth and agility), to form the basis of their judgements. Banks will also need to define key terms such as 'significant increase in credit risk' and 'default', which will drive the level of expected credit losses. The new requirements, predictably, will require extensive new disclosures in order to explain the rationale supporting management's critical judgments.

An updated hedging model is also available within the new standard – this option purports to align more closely with the risk management practicalities than the previous model did and offers some benefits to banks. However, banks expect more of a favourable impact from the macro hedging project which is yet to be finalised by the International Accounting Standards Board. Until then, banks have an option to continue applying hedge accounting under NZ IAS 39 *Financial Instruments: Recognition and Measurement* and would need to assess whether or not to adopt NZ IFRS 9 for hedge accounting.

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The hedge effectiveness test will also evolve to a more principles-based approach; the '80-125%' test is replaced by a test that focuses on the economic relationship between the hedged item and the hedging instrument (rather than merely statistical correlation), which clearly is more aligned with banks' risk management practices. Unlike NZ IAS 39, NZ IFRS 9 requires only an ongoing prospective assessment which can be qualitative.

Although the classification and measurement aspects of NZ IFRS 9 are not expected to have a significant impact on most banks, the existing financial asset classifications under NZ IAS 39 would need to be revisited using the new principles under NZ IFRS 9.

Regulation

Changing OTC derivatives margin requirements

The RBNZ and the Ministry for Business, Innovation and Employment (MBIE) issued a paper entitled *A New Zealand Response to Foreign Margin Requirements* in July and invited submissions from interested parties on the contents.[44]

This paper discusses the margin framework for non-centrally cleared derivatives published by the Basel Committee on Banking Supervision in 2013 after the G20 agreement to reform over-the-counter (OTC) derivative markets. The framework is currently being implemented by subscribing national regulators and the RBNZ/MBIE paper discusses the potential effects on Kiwi banks. The Basel framework obliges parties to exchange initial and variation margin and, notably, set out requirements regarding the availability of posted margin in the event that a counterparty defaults.

While the RBNZ "does not intend to impose derivative margin requirements on its regulated entities at this stage", New Zealand banks that trade OTC derivatives with foreign counterparties, or are foreign-owned, will be affected by the cross-border implementation. However, some complications arise from local insolvency-related statutes and may impede local banks' compliance with the new regulations. Local law provides for a moratorium on the exercise of creditor rights when entities are under statutory management or voluntary administration; thus collateral, may not be promptly available should the bank default. Furthermore, the availability of margin on default would be further impeded by preferred creditor claims on funds.

When an entity is under voluntary or compulsory administration, these complications around the accessibility of collateral may have wide-ranging potential consequences. Such consequences may include the following: reduced access to key foreign counterparties, products and markets; a reduction in the competitiveness of the Kiwi sector within the global market; counterparty and country concentration risks; higher funding costs (which may be passed on to customers); and impact upon foreign funding programmes.

This consultation from the RBNZ and MBIE is welcomed by market participants. Changes in this area will require participants to put into place new legal documentation, internal policies and new processes to effect any future changes.

What constitutes 'Capital'?

Earlier this year the RBNZ issued its Issues Paper in relation to the review of the capital adequacy framework. The Issues Paper sought views on the topics that the RBNZ planned to consider as part of the review. This paper was followed up by *Capital Review Paper 2: What should qualify as bank capital? Issues and Options* (Paper 2) in July 2017. Paper 2 looks at the nature of financial instruments that are suitable for regulatory capital purposes.[45]

We see Paper 2 primarily focusing on two of the capital framework principles laid out by the RBNZ in its initial Issues Paper: capital must readily absorb losses before losses are imposed on creditors and depositors; the capital framework should be practical to administer; minimise unnecessary complexity and compliance costs; and take into consideration relationships with foreign-owned banks' home country regulators. The paper focuses heavily on the role and eligibility of Additional Tier 1 (AT1) capital and looks to overseas experience for how these financial instruments operate in practice, given it is an untested market to date.

The RBNZ raises a number of concerns with the current regime in Paper 2. We have provided a quick summary of some of the pertinent ones below as follows:

- The level of AT1 capital issuance: there has been large levels of issuance since 2013, particularly in intergroup issuances by the four major banks – has it been used as a substitute for ordinary shares (considered a higher quality of regulatory capital)?

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- Legal complications from conversion of AT1 instruments, in particular, where instruments are issued by New Zealand subsidiaries of Australian banks and conversion into parent bank shares is required: conversion is governed by Australian law, whilst other contractual terms are governed by New Zealand law, creating perceived additional complexity.
- The role of preference shares in AT1 capital: there is current uncertainty around the means to give legal effect to a write-off (as required by the capital adequacy framework) of preference shares and there is a perceived weakening of the capital qualities of preference shares compared to the pre-Basel III regime.
- What constitutes a banking group?: with changes to accounting standards and subsequent financial reporting groups, the RBNZ sees a need to review whether other entities outside the financial reporting group bring economic value to the bank or are controlled by the bank, i.e. special purpose vehicles (SPVs).
- Possible under-estimation of tax effects: the RBNZ is unclear whether the full circumstances of the arrangements and tax implications are captured in binding rulings to the Inland Revenue Department.
- Regulatory oversight of contingent debt: the RBNZ states that the regime implemented under Basel III for loss-absorbing capital instruments always provided discomfort, as evidenced by implementing the non-objection process; in addition, the perceived complexity of structures imposes a drag on RBNZ resources.
- 'Going concern' triggers: there are concerns that these triggers are accounting-based and backward looking; however, it is noted that market-based triggers are also problematic.

With such concerns, the RBNZ has taken the view that, broadly speaking, they see little value in 'going concern' triggers and conversion, which provide additional perceived complexity and are not all that different in effect to non-viability triggers (the prescribed trigger mechanism for Tier 2 subordinated capital).

The RBNZ has proposed a number of areas of reform to address some of these concerns, which are as follows:

- They want a clearer definition of preference shares in the regulations than exists currently and propose that only non-contingent and non-redeemable preference shares qualify for capital.
- They want to limit Tier 1 capital to common equity (e.g. ordinary share capital, retained earnings) and preference shares and limit Tier 2 capital to non-contingent debt (with only a write-off mechanism available). The latter removes the RBNZ's concerns around complexity upon conversion.
- The RBNZ will seek to amend the current accounting group definition for regulatory banking group purposes, so that if an SPV is included in the registered bank's corporate structure to raise capital on behalf of the bank, the SPV is included in the banking group.
- The policy intent that potential tax is accounted for should be put beyond doubt and the current tax ruling requirement needs to be clarified. Additionally, by removing the recognition of debt with conversion terms, there will likely be a simplification around the estimation of potential tax liabilities.

Some of the proposed areas of reform will frustrate New Zealand banks.

A lot more is to come on these proposed areas of reform and as with all regulatory change, the devil is in the details. Some of the proposed areas of reform will frustrate New Zealand banks – of particular note is the removal of eligible AT1 capital and the ineligibility of convertible Tier 2 capital. If these reforms were to proceed, there would likely be grandfathering afforded to banks on these instruments, but it may feel a bit like déja vu for the banks. It was only 2013 when the same mechanism came into effect for the phase-out of non-compliant Basel III instruments, which were deemed not to be sufficiently loss-absorbing under the new framework. For banks to potentially go through the same exercise only four to five years later will be concerning – a great deal of work and counsel is taken by banks for the issue of such instruments and, together with the higher funding cost for Basel III loss-absorbing instruments, it is a costly undertaking.

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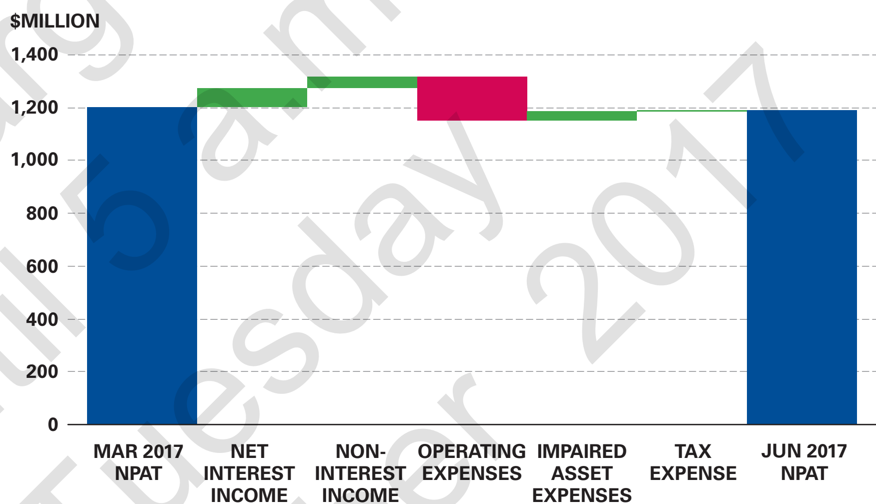
Quarterly analysis

Our review of the banking sector's performance for the June quarter shows net profit after tax (NPAT) remaining relatively stable with a slight dip of 1.04% to $1.19 billion, thus continuing the trend of small decreases from the previous quarter.

1 MOVEMENT IN NET PROFIT AFTER TAX



The major contributing factor to the observed decline in NPAT was an increase in operating expenses of $165.46 million (13.92%). This was offset by a $73.78 million (3.32%) increase in net interest income, a $42.75 million (6.27%) increase in non-interest income, and a significant decrease in impaired asset expense ($34.65 million or 73.70%) as a result of the banking sector's continued focus on sustainable and diversified lending.

The level of gross loans and advances was relatively stable at $394.53 billion; this amount represents an increase of 1.18% ($4.61 billion) on the previous quarter's level, very similar to the increase seen in the previous quarter of 1.19% which had been the lowest quarterly growth in the past three years. Better quality sector loan books are evident in the lower level of total provisioning (down by 6.80% from the previous quarter), while past due assets reduced from the last quarter by 4.92% ($31.14 million).

In line with the small growth in lending, interest income rose by 2.32% ($114.02 million) to $5.03 billion, almost completely reversing last quarter's reduction of 2.46% ($124.30 million). In contrast to the previous quarter, interest expense rose by 1.49% ($40.24 million), while interest-bearing liabilities remained relatively constant with a small 0.55% increase. As a result of these two movements, with the increase in the lending rate outpacing the increase in the cost of funding, net interest margin (NIM) has risen from 2.01% to 2.07%, with all survey participants, except The Co-operative Bank, showing increases in the range of 1 bps to 19 bps (see Table 1).

1 SEE TABLE 1 – PAGE 9

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TABLE 1: Movement in interest margin	30 Jun 17 quarter ended (%)	Movement during the quarter (bps)	Movement for the 6 months (bps)	Movement for the 12 months (bps)
ANZ Banking Group	2.14%	0	-4	-10
Bank of New Zealand	2.06%	8	-1	-9
Commonwealth Bank of Australia	1.92%	1	-5	-30
Heartland Bank	4.54%	19	10	1
Kiwibank	1.95%	13	3	-7
SBS Bank	2.43%	5	-17	-14
The Co-operative Bank	2.22%	-3	-17	-29
TSB Bank	1.82%	2	-36	-20
Westpac Banking Corporation	2.03%	17	0	-9
Average	**2.07%**	**6**	**-3**	**-13**

Net profit after tax (NPAT)

NPAT has remained relatively unchanged for the survey participants from the last quarter with a small contraction of 1.04% ($12.48 million) from $1.20 billion to $1.19 billion (see Figure 1). The movement was driven primarily by three participants (ANZ, CBA and Kiwibank) who collectively contributed $121 million worth of reductions.

1 SEE FIGURE 1 – PAGE 8

The major banks reported mixed results for the quarter with an aggregate reduction of $20 million. Of the major banks, BNZ and Westpac were the only banks to report increases in NPAT of $83 million (to $276 million) and $18 million (to $255 million), respectively.

BNZ's substantial increase completely reverses last quarter's reduction of $30 million. This significant increase is attributable to an increase in non-interest income of $93 million (113.41%) to $175 million, which was partially offset by an increase in operating expenses of $22 million (10.09%). Westpac's increase in NPAT was partly due to operating income growing faster than expenses. ANZ, CBA and Kiwibank saw NPAT reduce by $60 million (to $406 million), $7 million (to $248 million) and $54 million (to a $32 million loss), respectively, due to slowing income and increasing expenses. Kiwibank's notable reduction is due to increased expenses, mostly attributable to a $90 million impairment loss relating to the IT modernisation project known as CoreMod. The state-owned bank said in a press release that, due to rapidly changing technology and customers' preferences shifting towards digital banking experiences, a review of the CoreMod project is currently underway and that "while this review is being completed, a decision has been made to impair the value of the work in progress which currently sits on the balance sheet as an intangible asset."[46, 47]

For the non-major bank survey participants, NPAT improved on the back of a difficult first quarter. Notably, TSB Bank reported the greatest NPAT percentage increase of all survey participants of 122.66% to $10.72 million as a result of the 21.88% ($0.78 million) increase in non-interest income and a reduction in operating expenses for the quarter by 25.10% ($6.5 million). TSB was the only bank that managed to reduce its operating expenses this quarter; however, this reduction was off the back of a significant increase in the previous quarter, with the current quarter's expenses back closer to historic levels. The Co-operative Bank reported the second largest percentage increase in NPAT among the non-major banks of 36.02% ($0.72 million) to $2.70 million, with non-interest income rising by 70.65% to $5.72 million.

The overall movement in NPAT for survey participants over the quarter can be broken down into the following main drivers:

- Net interest income rose by 3.32%, or $73.78 million, to $2.30 billion.
- Non-interest income increased by 6.27%, or $42.75 million, to $724.86 million.
- Operating expenses increased by 13.92%, or $165.46 million; this growth more than offset the increases in both net and non-interest income for the quarter. Eight of the nine banks surveyed reported increases in operating expenses.

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- Loan book growth has remained relatively stable for the quarter with an increase of 1.18% (or $4.61 billion) to $394.53 billion.
- Impaired asset expense reduced by 73.70% or $34.65 million to $12.36 million this quarter.

Asset quality

The aggregate level of impaired asset expense reduced by 73.70% from $47.02 million last quarter to $12.36 million this quarter. The key contributors to this substantial movement were BNZ, Kiwibank, and Westpac; these banks reported reductions in impaired asset expense, with recoveries for the quarter of $1 million, $6 million and $13 million, respectively. SBS also reported a $0.16 million (5.73%) decrease in impaired asset expense (see Table 2). Press releases from two major banks noted improved credit quality in both the commercial and agriculture sectors over this quarter.[48]

2 SEE TABLE 2 – PAGE 10

As average gross loans have remained relatively stable compared to last quarter's loans, impaired asset expense relative to average gross loans and advances has reduced by 4 bps.

The level of past due assets declined from last quarter's level by $31.14 million (4.92%) to $601.67 million. BNZ saw the greatest reduction of $42 million (21%) to $158 million, a decrease which now puts BNZ in second place behind ANZ, which now has the highest level of past due assets of $199 million; this is in line with its loan book being the largest of all the banks.

TABLE 2: Movement in impaired asset expense/ Average gross loans	30 Jun 17 quarter ended (%)	Movement during the quarter (bps)	Movement for the 6 months (bps)	Movement for the 12 months (bps)
ANZ Banking Group	0.04%	3	-8	-14
Bank of New Zealand	-0.01%	-13	-12	-16
Commonwealth Bank of Australia	0.06%	1	-4	-25
Heartland Bank	0.47%	1	11	-16
Kiwibank	-0.13%	-18	-8	-15
SBS Bank	0.30%	-3	-10	9
The Co-operative Bank	0.11%	0	1	3
TSB Bank	0.08%	2	-5	1
Westpac Banking Corporation	-0.07%	-8	12	-9
Average	**0.01%**	**-4**	**-4**	**-15**

ANZ's past due assets also grew at the fastest rate of the major banks, showing an increase of $18 million (9.94%) from the last quarter. Notably, Kiwibank's past due assets have remained unchanged at $7 million from the last quarter. When looking at the ratio of past due assets to gross loans and advances, the picture is very much the same story with BNZ, Heartland Bank, and Westpac all reporting reductions. Heartland Bank disclosed the largest reduction in past due assets relative to gross loans and advances of 18 bps to 1.00%, while still having the greatest ratio of all survey participants. Their past due assets currently make up 1.00% of total lending, reflecting the different product make-up of their loan book compared to the other banks and the highest NIM earned during the period.

The ratio of total provisions to gross loans and advances has continued along a similar trend as the last quarter, with a further reduction of 4 bps to 0.48%. The level of total provisions has declined by 6.80% ($137.70 million), while gross loans and advances has remained relatively stable showing an increase of 1.18%. The decrease in total provisions for the last quarter was due to a reduction in both collective provisions of 7.21% ($116.71 million) and a specific provision of 5.17% ($21.00 million). The decline in collective provisions was primarily due to BNZ reporting a $119 million (25.59%) reduction in collective provisions (to $346 million). ANZ, CBA, Heartland and Kiwibank all also reported reductions in collective provisions. Overall, the proportion of collective provisions to gross loans and advances reduced by 3 bps to 0.38%.

Lending

Survey participants' loan books remained relatively stable for the

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TABLE 3: Analysis of gross loans	Quarterly analysis			Annual analysis		
	30 Jun 17 quarter ended $Million	31 Mar 17 quarter ended $Million	% Increase	30 Jun 17 quarter ended $Million	30 Jun 16 quarter ended $Million	% Increase
ANZ Banking Group	124,550	123,404	0.93%	124,550	120,588	3.29%
Bank of New Zealand	78,586	77,154	1.86%	78,586	72,898	7.80%
Commonwealth Bank of Australia	81,549	80,447	1.37%	81,549	75,765	7.63%
Heartland Bank	3,576	3,484	2.64%	3,576	3,140	13.87%
Kiwibank	17,855	17,870	-0.08%	17,855	16,744	6.64%
SBS Bank	3,545	3,427	3.45%	3,545	2,980	18.96%
The Co-operative Bank	2,176	2,108	3.25%	2,176	1,880	15.75%
TSB Bank	4,820	4,681	2.97%	4,820	3,975	21.26%
Westpac Banking Corporation	77,877	77,346	0.69%	77,877	74,626	4.36%
Total	**394,534**	**389,920**	**1.18%**	**394,534**	**372,596**	**5.89%**

quarter, showing a similar level of growth to the previous quarter of 1.18% ($4.61 billion). All survey participants (except Kiwibank) reported loan book growth, ranging from 0.69% (Westpac) to 3.45% (SBS). Based on RBNZ industry data for June 2017, residential-housing-based lending continues to dominate the lending space comprising over 56% of total loans.[49] This quarter's increase can mainly be attributed to growth in housing loans issued by registered banks, which increased by 1.48% for the quarter. The driving force behind this growth was very much similar to the previous quarter's growth, with owner-occupier housing loans growing by 1.66% compared to residential investment property loans' growth of 1.04%.

Similar to the last quarter, healthy growth was observed in business loans (up by 1.05%) through growth in commercial property loans. First home buyer, investor and business-purpose new mortgage lending trended downwards following an increase last quarter.

Sustainable lending continues to remain a key focus area for the major banks and, as a result, lending growth has slowed down over recent quarters with the four largest banks reporting growth between 0.69% and 1.86%. As highlighted in CBA's press release, CBA is "remaining focused on delivering sustainable, diversified balance sheet growth across key customer portfolios."[50]

As in the last quarter, non-major banks (Heartland Bank, SBS, The Co-operative Bank and TSB) grew their loan books at a quicker rate than the major banks. SBS once again led the charge with the greatest percentage increase of 3.45% through strong growth in its residential and consumer lending books, while The Co-operative Bank reported the second highest growth of 3.25%, similarly attributable to growth in residential mortgages and agricultural lending, followed by TSB and Heartland with percentage increases of 2.97% and 2.64%, respectively. Heartland noted in its NZX press release that it has seen strong loan book growth across all segments and expects to continue to see this growth going forward.[51] Kiwibank was the only survey participant to report a decrease in gross loans and advances for the most recent quarter of $15 million (0.08%). ANZ is still the clear leader in the market, making up around 31.57% of the total gross loans and advances, even though its market share declined by 8 bps this quarter. BNZ saw the greatest increase in market share of 13 bps to 19.92% of the market.

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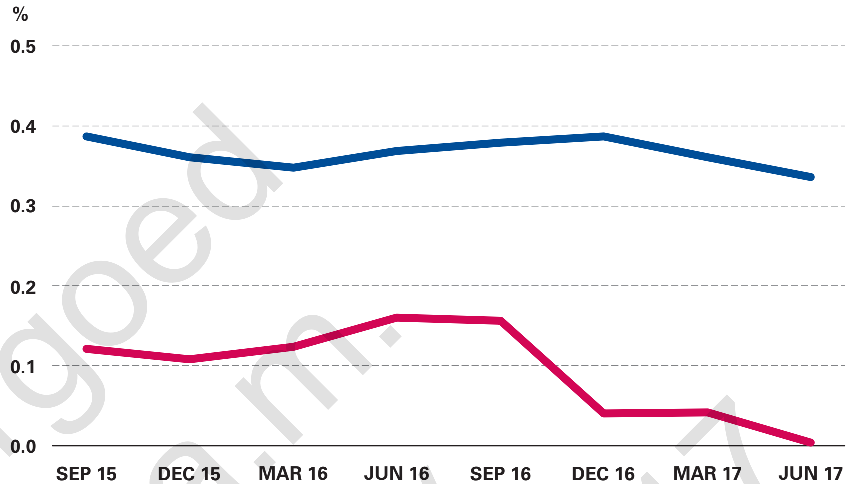
2 MAJOR BANKS: GROSS IMPAIRED VS. IMPAIRED ASSET EXPENSE

GROSS IMPAIRED LOANS/ GROSS LOANS AND ADVANCES

IMPAIRED ASSET EXPENSE/ AVERAGE GROSS LOANS AND ADVANCES

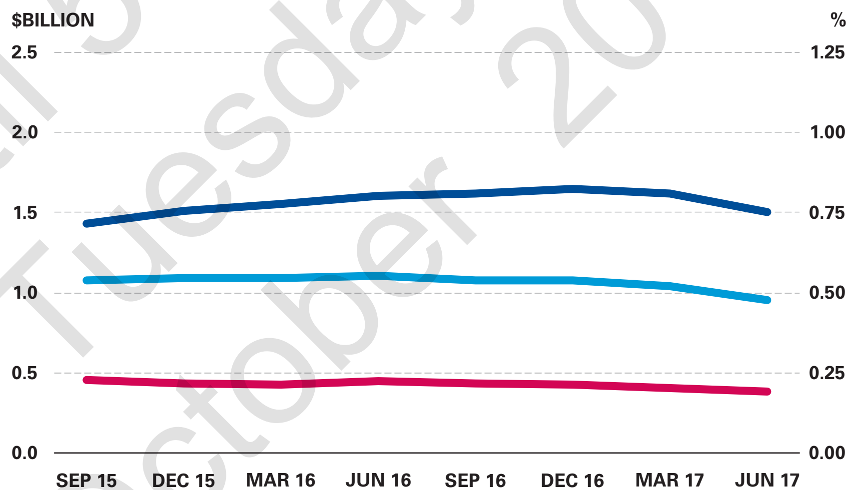


3 MOVEMENT IN PROVISIONING

COLLECTIVE PROVISION (LHS)

INDIVIDUAL PROVISION (LHS)

TOTAL PROVISION FOR DOUBTFUL DEBTS/ GROSS LOANS AND ADVANCES (RHS)



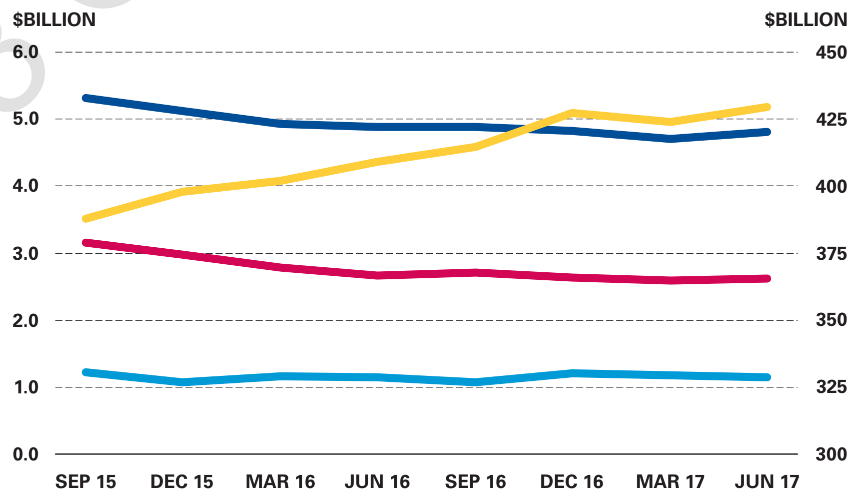
4 MAJOR BANKS: INTEREST EARNING ASSETS COMPARED TO INTEREST INCOME AND EXPENSE

INTEREST INCOME (LHS)

INTEREST EXPENSE (LHS)

NET PROFIT (LHS)

INTEREST EARNING ASSETS (RHS)



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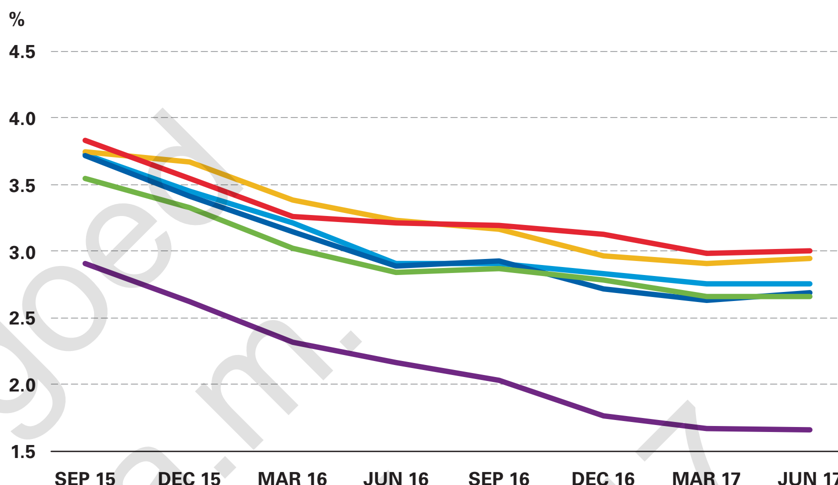
5 MAJOR BANKS: COST OF FUNDS VS. OCR

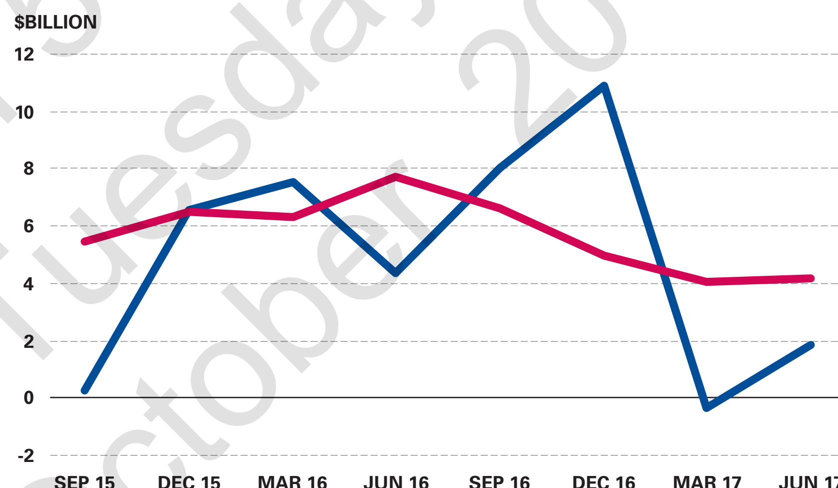
- ANZ
- BNZ
- CBA + ASB
- KIWIBANK
- WESTPAC
- AVERAGE OVERNIGHT INTERBANK CASH RATE



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS (B2)

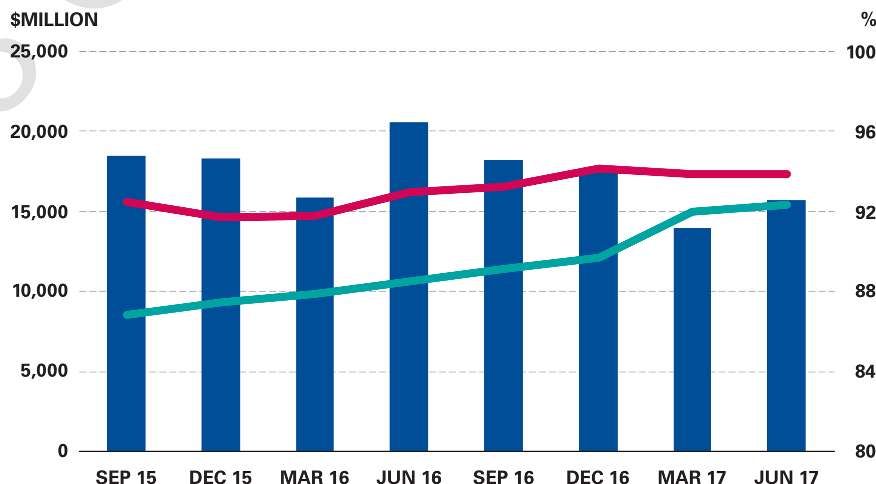
6 MAJOR BANKS: BORROWING GROWTH VS. LENDING GROWTH

- GROWTH IN BORROWING
- GROWTH IN LENDING



7 LVR ANALYSIS OF RESIDENTIAL MORTGAGES

- NEW MORTGAGES (LHS)
- PROPORTION OF NEW MORTGAGES WITH LVR OF 80% OR BELOW (RHS)
- TOTAL COMMITMENTS WITH LVR OF 80% OR BELOW (RHS)



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

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TABLE 4: Movement in over 80% LVR lending (On and off balance sheet)								
	Quarterly analysis				Six month analysis			
Quarterly analysis	30 Jun 17 $Million	31 Mar 17 $Million	Movement during the quarter $Million	% Change	30 Jun 17 $Million	31 Dec 16 $Million	Movement during the 6 month period $Million	% Change
ANZ Banking Group	5,120	5,765	-645	-11.19%	5,120	6,329	-1,209	-19.10%
Bank of New Zealand	2,948	3,011	-63	-2.09%	2,948	3,155	-207	-6.56%
Commonwealth Bank of Australia	4,844	5,074	-230	-4.53%	4,844	6,937	-2,093	-30.17%
Heartland Bank	21	36	-15	-41.34%	21	33	-12	-35.10%
Kiwibank	1,848	1,378	470	34.11%	1,848	1,463	385	26.32%
SBS Bank	345	326	19	5.79%	345	314	31	9.89%
The Co-operative Bank	225	228	-4	-1.61%	225	229	-4	-1.83%
TSB Bank	388	388	0	-0.07%	388	389	-2	-0.46%
Westpac Banking Corporation	4,586	4,675	-89	-1.90%	4,586	7,576	-2,990	-39.47%
Total	**20,324**	**20,881**	**-557**	**-2.67%**	**20,324**	**26,425**	**-6,101**	**-23.09%**

Operating expenses

Eight of the nine survey participants reported increases in operating expenses, thereby undoing last quarter's $34.12 million reduction as operating expenses rose by $165.46 million to $1.35 billion for the quarter. Notably, Kiwibank reported a $97 million increase in operating expenses for the quarter due to an additional $90 million of impairment relating to computer software work in progress, as previously mentioned above (allocated to operating expenses to allow for comparability). Even excluding this, the survey participants still saw an increase in operating expenses of $75.46 million during the quarter.

The operating cost ratio (i.e. operating expense/operating income) has also increased for the quarter (by 390 bps to 44.82%), with five of the nine survey participants reporting increases. Kiwibank saw a notable increase of 65.12 bps to 138.17% as a result of the $90 million impact previously mentioned. TSB Bank was the outlier this quarter, reporting the largest reduction in the operating cost ratio (22.37 bps) as it managed to reduce operating expenses by 25.10% ($6.5 million) and increase operating income by 5.37% ($1.80 million); however, the operating cost ratio of 55.00% is still above that seen in the December 2016 quarter, with the reduction more reflecting a return to normal after the significant increase in operating expenses in the previous quarter.

BNZ reported the second largest reduction in their operating ratio of 427 bps, followed by The Co-operative Bank of 238 bps and SBS of 158 bps. These three banks' operating income figures increased at a proportionally higher rate than their operating expenses.

With the exception of BNZ, the big four Australian-owned banks all reported increases in their operating expense ratios as operating expenses grew proportionally greater than operating income. ANZ's ratio increased by 361 bps to 39.28% as operating income reduced by 6.42% ($65 million) while operating expenses rose by 3.05% ($11 million). CBA's and Westpac's increases of 177 bps (to 38.02%) and 155 bps (to 43.81%), respectively, are attributable to sluggish operating income growth and increases in operating expenses.

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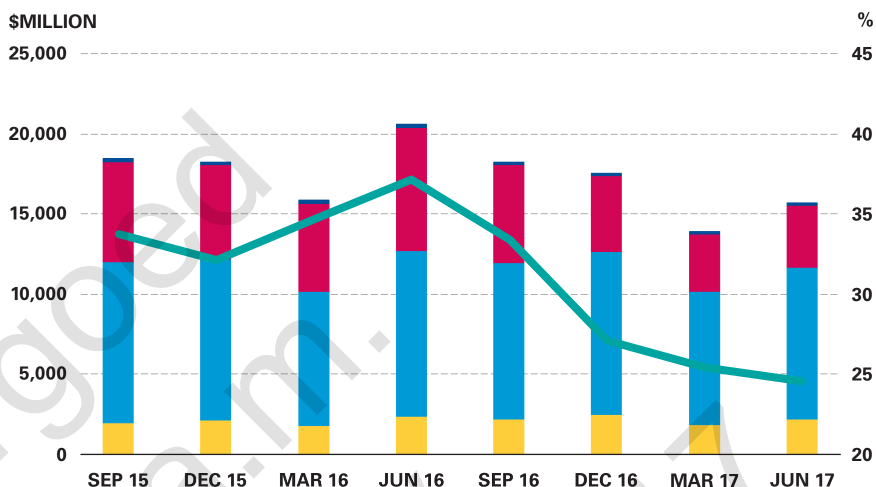
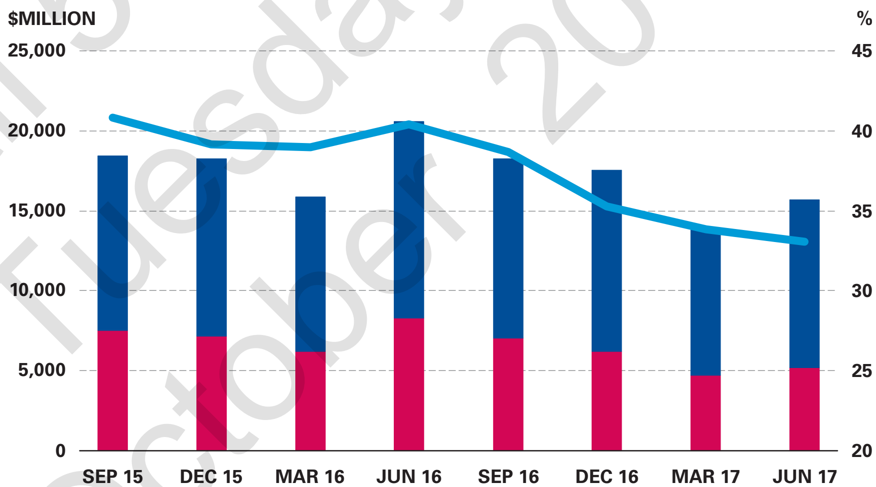
8 NEW MORTGAGE LENDING BY BORROWER TYPE



- BUSINESS PURPOSES
- INVESTOR
- OTHER OWNER OCCUPIER
- FIRST HOME BUYER
- INVESTOR LENDING (%)

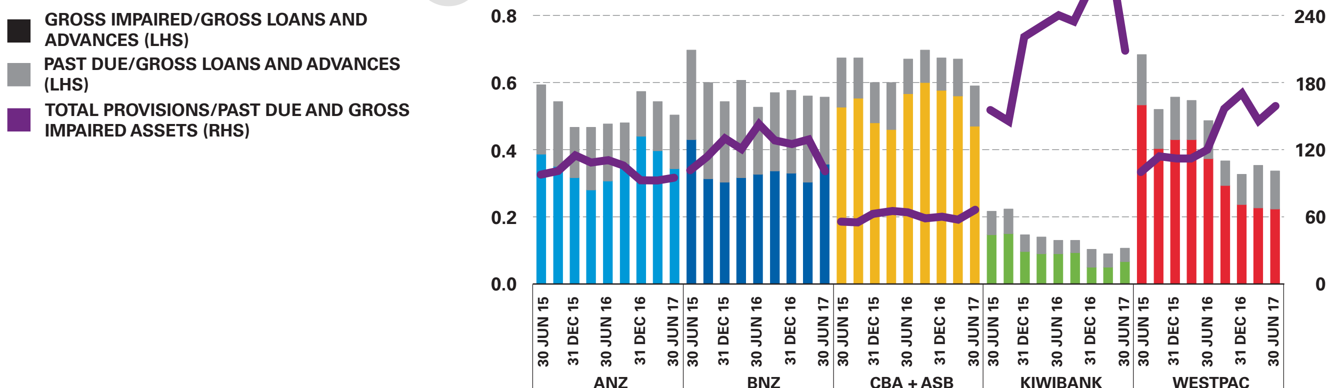
SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

9 NEW MORTGAGE LENDING BY PAYMENT TYPE



- PRINCIPAL AND INTEREST
- INTEREST ONLY (INCLUDING REVOLVING CREDIT)
- PROPORTION OF NEW LENDING INTEREST ONLY – INVESTOR

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS



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Although banks' press releases for this quarter continued to highlight the importance of ongoing disciplined cost management, on the face of it, it seems that this has proved to be difficult to implement.

Net interest margin

With the exception of The Co-operative Bank, all participants surveyed reported increases in NIM for the quarter, resulting in a total increase of 6 bps to 2.07%, almost completely undoing last quarter's decline. As mentioned in ANZ's and CBA's press releases, NIMs for the banking sector have stabilised, but still remain under some pressure due to increased funding costs and shifting customer preference towards fixed-rate home loans.

On the income side, it was observed that interest income over average interest-earning assets for the quarter increased, as interest income rose by 2.32% ($114.02 million), while interest-earning assets remained relatively stable. The major banks drove the increase in net interest income. Notably, BNZ and Westpac saw increases of $20 million and $30 million, respectively, and made up 67.77% of the total increase for the quarter. These two banks' interest expense lines remained relatively unchanged compared to those of the other banks.

The non-major banks reported the greatest percentage increases in interest income for the quarter, with increases varying between 4.98% and 6.15%. These increases were offset by interest expense increasing at a higher rate compared to the major banks, most likely due to the major banks being able to source cheaper funding. As a result, the cost of funding put a damper on the minor banks' strong growth in interest income for the quarter. One outlier is Heartland Bank; this bank continues to have the strongest NIM at 4.54% as interest income grew at an impressive rate while interest expense remained relatively constant. Heartland's strong position is likely attributable to the niche markets which the bank operates in, particularly in the areas of reverse mortgages, asset financing and working capital loans.

With respect to funding costs, all banks' ratios of interest expense to average liabilities increased during this quarter.

Funding

Funding costs have seen a small reversal on the trend seen in the past two years, with an increase of interest expense relative to average interest-bearing liabilities of 4 bps to 2.82%. Even though the RBNZ's Official Cash Rate still remains at the lowest level since inception in 1999, the increase in banks' funding costs was driven by an increase in interest expense of $40.24 million (1.49%) to $2.74 billion for the quarter rather than an increase in borrowings, given that interest-bearing liabilities have remained relatively stable with an increase of $2.13 billion (0.55%) to $388.94 billion.

All survey participants saw an increase in funding costs in the quarter, ranging from 1 bps to 16 bps.

Of the five major banks, BNZ and Kiwibank reported the lowest movement of 1 bps each, to 2.67% and 2.76% respectively. As a result of ANZ's 6 bps increase in funding costs to 2.69%, BNZ now has the lowest funding costs for all survey participants, with ANZ claiming second place. One notable exception of all survey participants was Westpac who reported a $2 million (0.36%) decrease in interest expense. However, with the drop in the average interest-bearing liabilities for the quarter, Westpac still saw a 4 bps increase in funding costs.

We have noted some key events which occurred during the quarter (such as changes in the US Federal Reserve Rate and downgrades in Moody's long-term credit ratings for all of the big four Australian-owned banks operating within New Zealand); these changes have likely contributed to higher funding costs.[52] In the previous quarter it was noted that funding costs were possibly at the low point in the economic cycle and it is expected that funding costs will continue on their upward trajectory in the near future.

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2017 - a year that changed the game for AML/CFT in New Zealand

Embargoed until 5 a.m. Tuesday 3 October 2017

Gareth Pindred
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KPMG

Gareth is a Director in KPMG's Auckland practice, specialising in anti-money laundering compliance, assisting clients to meet their obligations without burying their businesses. Gareth brings a wealth of experience from the UK and with New Zealand reporting entities, having assisted many with advice remediation efforts and AML/ CFT audits. His experience helps clients identify and target vulnerabilities in their business, while adopting a 'regulatory risk' lens to his work.

The Anti-money Laundering and Counter Financing of Terrorism (AML/CFT) rules have applied to New Zealand financial institutions for over four years. However, this year brings substantive change to the regulatory environment to help prevent and detect money laundering and terrorist financing (ML/TF).

This is timely. Terrorist events have increased 300% globally in the past five years and more rapidly in the western world. Globally, regulators continue an aggressive regulatory and enforcement posture, resulting in substantial cost and reputational damage to non-compliant firms – there are few things that draw the public's ire more than allegations that an institution's failures have enabled corruption, money laundering or terrorism financing.

There are few things that draw the public's ire more than allegations that an institution's failures have enabled corruption, money laundering or terrorism financing.

In this article, we signal key changes to New Zealand's regulatory environment and highlight some trends and lessons learnt from global enforcement action.

New Zealand's AML/CFT regulations were implemented in July 2013, principally capturing financial institutions and casinos. At its heart is the requirement for captured entities (reporting entities) to perform a ML/TF risk assessment and, based on this, implement a 'risk-based' programme of control activities to help detect and prevent its business from being used for ML/TF. Key programme aspects are client due diligence (identify and verify their customer and beneficial owners) and proactively monitoring those relationships and their transactions. One of the quite unique requirements to the AML regime compared with other compliance obligations, is the express requirement to proactively monitor compliance including a biannual audit requirement.

The driver of New Zealand's regime is our membership of the inter-governmental body, the Financial Action Task Force (FATF), which sets out standards and monitors country's compliance with its recommendations. New Zealand received a relatively damming review in 2009 which has been the catalyst for the extensive reform with agencies conscious of the follow up review scheduled in 2020 to assess our design and operational effectiveness.

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Changing landscape

While New Zealand's financial institutions have become attune to the obligations, one of the obvious gaps was the exclusion of 'gatekeeper' professions or in FATF language designated non-financial professions and businesses (DNFPB). This included lawyers, accountants, real estate agents professions that were excluded from the 2013 reform. The 2016 'Panama Papers' scandal reinvigorated the debate around the industry risk associated with 'shell company' formation. In the wake of growing public discontent over Panama Paper disclosures, the 'Shewin inquiry' recommended, and the government endorsed, expediting the 'Phase 2' reforms which received royal assent on 10 August this year. These reforms have extended capture to these gatekeeper professions as well as high value dealers (e.g. gems, precious metals, car dealers transacting in cash) as well as the New Zealand Racing Board. Implementation is staged to start in July 2018 for lawyers and end in August 2019.

The Phase 2 reforms have also brought significant 'tinkering' to existing obligations, including broadening what is reportable to the New Zealand Police including 'activity' as opposed to just 'transaction or proposed transaction'. It also makes a number of regulatory changes that will better enable captured entities to rely on each other providing opportunities to drive programme efficiencies.

The reforms also signal new and expanded powers for agencies to share information, including a mechanism for captured entities to share information proactively between themselves and with law enforcement agencies where appropriate and justified. Information sharing signals the growing partnership between law enforcement and the private sector through a legislated framework that provides reporting entities protection in making disclosures.

Not to be surpassed by Phase 2 reform, Prescribed Transaction Reporting (PTR) kicks in on 1 November this year and captures reporting entities that deal in cash or send or receive cross-border payments for their customers. PTR principally (but not exclusively) applies to banks and remitters requiring them to proactively report to the Police Financial Intelligence Unit large cash transactions (greater than $10,000) and payments that are cross border (greater than $1,000).

If harnessed correctly, the 2017 reforms should significantly enhance New Zealand law enforcement's ability to identify and disrupt criminal offending. Not only are gaps in New Zealand's capture of 'gatekeeper' professions closing, but enhanced information sharing together with a wealth of data or 'intelligence' available through reporting cash and cross border transactions should greatly assist law enforcement's detective capability. The real value in PTRs is the ability to take a macro view across reporting entities identifying suspicious trends not visible to a single reporting entity. Together with enhanced information sharing, the framework should enable law enforcement to 'join the dots' in financial investigations.

If harnessed correctly, the 2017 reform should significantly enhance New Zealand law enforcement's ability to identify and disrupt criminal offending.

Financial institutions already invest heavily in AML/CFT compliance and are at the front end for monitoring and reporting suspicious activity. These reforms reinforce the important role they play understanding the nexus between criminal offending and the use of the financial system to disperse or distance funds that originate from it.

Trends and lessons learnt

Given the level of regulatory change, what are some of the key trends we are seeing from a review of global change or enforcement action? Where should reporting entities be applying particular focus?

Senior management oversight and ownership

Globally as a result of significant or repetitive failures, countries are implementing requirements to reinforce Directors' accountability for inadequate oversight and disclosure of AML/CFT compliance. In the United States one of their regulators FinCEN released guidelines to strengthen compliance culture in financial institutions, these included:

1. Leadership must actively support and understand compliance efforts.
2. Efforts to manage and mitigate AML/CFT deficiencies and risk must not be compromised by revenue interests.

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3. Relevant information from departments must be shared with compliance staff to further AML/CFT efforts.
4. The institution must devote adequate resources to its compliance function.
5. The compliance programme must be effective – suggesting independent and competent party to test the programme.
6. Leadership and staff must understand the purpose of its AML/CFT efforts and how suspicious transaction reporting is used.

In the State of New York, Boards of Directors or senior officers of regulated institutions have had to make annual certifications to the regulator that they have taken all necessary steps to comply with transaction monitoring and filtering programme requirements. This stems from systemic failures and although on its face may seem limited to New York, numerous foreign banks are captured because they operate in New York State.

In the UK the Senior Managers' Regime is in operation and is designed to improve individual accountability within the banking sector. In relations to financial crime (including AML) in June this year reporting entities have had to appoint a member of Senior Management (typically executive level) to be responsible for ensuring its compliance programme is designed and implemented effectively. Currently, the UK Ministry of Justice is completing public consultation for a new corporate criminal liability offence to cover failing to prevent economic crimes such as money laundering.

Locally, New Zealand's regime has a requirement to appoint a compliance officer and monitor compliance with its AML/CFT obligations. While our requirement for management accountability is not as express as the examples above, supervisor's through their inspections make clear that their expect senior management to oversee reporting entities AML/CFT compliance programme. This involves understanding the ML/TF risks and receiving meaningful information from proactive assurance activities by the business and control functions. Where things go wrong the supervisors expect 'timely and effective' action and have been stern in their response where they consider senior management have not shown energy to make required changes.

What is evident from a number of global enforcement actions is the need for senior management to balance the commercial drivers and regulatory risks. Several commentators dissecting various enforcement actions suggest cause of failure was the sidelining of compliance to pursue efficiency drive and short-term profitability pursuits.

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Risk assessment is more than a theoretical exercise

Recent regulatory action has highlighted the importance of the risk assessment process and that it is not a static 'point in time' exercise. Increasingly, overseas regulators to be more effective in adapting to evolving ML/TF risks, including experience from agency information requests, investigations, suspicious transaction reports and the changing external environment. The institution's procedures and controls need to quickly adapt to changes in its risks, for example, identifying gaps in its processes, adjusting its rules or methods to monitor transactions or consider exiting clients where it cannot adequately mitigate its risk.

New Zealand regulations require reporting entities to have adequate procedures and controls to prevent products (e.g. misuse of technology) and transactions (e.g. non-face-to-face) favouring anonymity to be used for ML/TF. Recent regulatory action in Australia has shown the need to assess and mitigate risk of new technology and consider the evolving threat as the use or external environment changes.

As New Zealand reporting entities develop their digital strategies, they need to be acutely aware of the associated 'anonymity' risk and factor that risk into the decision making process and design. Reporting entities need to demonstrate how compliance is 'at the table' in considering new products, channels or changes to its existing approach. This needs to be robust, more than a box tick, and can show how additional risk is identified and mitigated.

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Understanding and assurance over systemic risk

An AML/CFT Programme for larger institutions relies on systemising controls including through automating customer risk scoring, 'watchlist' screening and transaction monitoring.

Added to the list in November this year is the need to automate PTR requiring consolidation of customer and transactional data from underlying source systems and upload it to the Police Financial intelligence Unit. This has proven problematic and been subject to significant remediations overseas which operate under a similar but less onerous regime. Complete and accurate reporting for PTR is particularly critical, by its nature reporting externally and subject to validation and ongoing continual review by regulators.

In terms of enforcement action for systemic risk, regulators have focused on 'completeness', challenging reporting entities to demonstrate:

- All products/ services offered or in the pipeline have been risk assessed and our programme is adequate.
- Relevant customer or transactional data is supplied by source transaction processing systems.
- Transactions have been screened appropriately and rules operate as designed and intended.
- Reportable transactions are captured with complete and accurate data reported.

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Major banks - Quarterly analysis

Entity	Size & strength measures							
	30 Sep 15	31 Dec 15	31 Mar 16	30 Jun 16	30 Sep 16	31 Dec 16	31 Mar 17	30 Jun 17
	Total assets[60] ($Million)							
ANZ[53, 59]	152,038	152,289	160,801	163,538	163,282	159,861	157,717	160,788
BNZ[54]	86,629	86,819	89,913	91,906	92,325	93,906	93,775	95,063
CBA + ASB[55, 59]	81,321	81,785	86,012	85,678	88,764	90,827	91,625	92,375
Heartland Bank[56]	2,825	3,290	3,334	3,489	3,595	3,755	3,829	3,963
Kiwibank	18,686	18,858	19,227	19,199	19,372	19,834	20,247	20,519
SBS Bank	3,163	3,286	3,408	3,506	3,543	3,740	3,987	4,053
The Co-operative Bank	1,896	1,971	2,029	2,109	2,179	2,257	2,349	2,434
TSB Bank[57]	6,208	6,299	6,424	6,475	6,522	6,629	6,794	6,949
Westpac[59]	88,203	88,416	90,309	91,518	92,708	95,903	91,883	93,564
Total	**440,968**	**443,014**	**461,455**	**467,418**	**472,291**	**476,711**	**472,206**	**479,709**
	Increase in gross loans and advances (%)							
ANZ[53, 59]	0.86	1.51	1.47	1.94	0.43	0.99	0.90	0.93
BNZ[54]	1.72	2.35	2.24	1.80	2.46	2.08	1.19	1.86
CBA + ASB[55, 59]	2.29	2.53	1.87	2.38	3.43	1.58	1.06	1.37
Heartland Bank[56]	3.21	22.19	3.02	3.29	4.01	2.93	3.62	2.64
Kiwibank	2.24	2.51	0.53	1.55	1.74	2.59	2.25	-0.08
SBS Bank	2.71	2.04	2.67	3.19	3.15	6.06	5.10	3.45
The Co-operative Bank	4.28	4.23	2.87	4.01	4.97	3.69	3.00	3.25
TSB Bank[57]	3.39	4.57	2.80	3.26	5.32	6.70	4.79	2.97
Westpac[59]	1.99	1.38	2.22	2.88	1.86	0.71	1.03	0.69
Average	**1.67**	**2.09**	**1.85**	**2.22**	**1.91**	**1.48**	**1.19**	**1.18**
	Capital adequacy[58] (%)							
ANZ[53, 59]	13.30	13.30	13.70	14.40	14.30	14.00	14.50	14.20
BNZ[54]	12.67	13.26	12.58	12.48	12.04	13.09	13.29	12.79
CBA + ASB[55, 59]	13.30	14.10	13.70	14.30	12.70	13.70	13.80	14.20
Heartland Bank[56]	12.85	14.46	14.01	13.78	12.71	12.96	13.19	13.56
Kiwibank	12.80	12.80	12.90	12.90	12.80	13.40	13.50	13.40
SBS Bank	14.21	14.27	13.76	13.50	13.63	13.27	12.56	11.91
The Co-operative Bank	16.20	15.80	15.80	15.50	16.10	17.50	16.90	16.60
TSB Bank[57]	15.77	14.86	14.52	14.62	14.59	14.65	14.60	14.85
Westpac[59]	13.30	13.90	14.00	14.00	13.10	13.40	14.00	14.00
	Net profit ($Million)							
ANZ[53, 59]	467	347	416	430	349	403	466	406
BNZ[54]	241	192	259	229	233	223	193	276
CBA + ASB[55, 59]	234	243	220	211	245	253	255	248
Heartland Bank[56]	10	15	14	15	14	15	16	16
Kiwibank	33	38	29	24	28	35	22	(32)
SBS Bank	4	5	6	7	7	6	6	7
The Co-operative Bank	3	3	2	2	3	3	2	3
TSB Bank[57]	25	13	10	14	14	14	5	11
Westpac[59]	249	251	239	249	224	285	237	255
Total	**1,266**	**1,107**	**1,195**	**1,181**	**1,117**	**1,237**	**1,202**	**1,190**

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Entity	Profitability measures							
	30 Sep 15	31 Dec 15	31 Mar 16	30 Jun 16	30 Sep 16	31 Dec 16	31 Mar 17	30 Jun 17
	Interest margin (%)							
ANZ[53, 59]	2.23	2.22	2.18	2.24	2.17	2.18	2.14	2.14
BNZ[54]	2.30	2.21	2.21	2.15	2.12	2.07	1.98	2.06
CBA + ASB[55, 59]	2.13	2.12	2.09	2.22	2.04	1.97	1.91	1.92
Heartland Bank[56]	4.81	5.18	4.58	4.53	4.46	4.44	4.35	4.54
Kiwibank	2.13	2.07	1.98	2.02	1.96	1.92	1.82	1.95
SBS Bank	2.67	2.63	2.61	2.57	2.63	2.60	2.38	2.43
The Co-operative Bank	2.77	2.71	2.61	2.51	2.46	2.39	2.25	2.22
TSB Bank[57]	2.14	2.08	2.03	2.02	2.12	2.18	1.80	1.82
Westpac[59]	2.28	2.17	2.11	2.12	2.08	2.03	1.86	2.03
Average	**2.25**	**2.21**	**2.17**	**2.20**	**2.13**	**2.10**	**2.01**	**2.07**
	Non-interest income/Total tangible assets (%)							
ANZ[53, 59]	0.80	0.33	0.77	0.62	0.37	0.48	0.63	0.46
BNZ[54]	0.83	0.42	0.71	0.59	0.56	0.58	0.35	0.74
CBA + ASB[55, 59]	0.66	0.77	0.57	0.47	0.62	0.66	0.63	0.62
Heartland Bank[56]	0.39	0.89	0.45	0.45	0.26	0.49	0.37	0.31
Kiwibank	0.59	0.62	0.55	0.46	0.56	0.80	0.52	0.67
SBS Bank	0.95	1.03	0.97	1.00	1.00	0.93	0.79	0.77
The Co-operative Bank	0.99	1.02	0.64	0.94	0.98	0.97	0.58	0.96
TSB Bank[57]	0.38	0.20	0.21	0.21	0.35	0.27	0.21	0.25
Westpac[59]	0.69	0.63	0.62	0.65	0.71	0.67	0.69	0.73
Average	**0.74**	**0.51**	**0.67**	**0.58**	**0.53**	**0.59**	**0.58**	**0.61**
	Impaired asset expense/Average gross loans and advances (%)							
ANZ[53, 59]	0.06	0.09	0.08	0.18	0.14	0.12	0.01	0.04
BNZ[54]	0.38	0.22	0.23	0.15	0.08	0.11	0.12	-0.01
CBA + ASB[55, 59]	0.09	0.14	0.17	0.31	0.12	0.10	0.05	0.06
Heartland Bank[56]	0.56	0.34	0.41	0.63	0.49	0.36	0.46	0.47
Kiwibank	0.08	0.07	0.10	0.02	0.00	-0.05	0.05	-0.13
SBS Bank	0.62	0.33	0.67	0.21	0.44	0.40	0.33	0.30
The Co-operative Bank	0.04	0.08	0.05	0.08	0.16	0.10	0.11	0.11
TSB Bank[57]	-1.47	0.08	0.31	0.07	0.12	0.13	0.06	0.08
Westpac[59]	0.01	-0.01	0.06	0.02	0.32	-0.19	0.01	-0.07
Average	**0.11**	**0.11**	**0.13**	**0.16**	**0.16**	**0.05**	**0.05**	**0.01**
	Operating expenses/Operating income (%)							
ANZ[53, 59]	36.34	43.30	42.41	36.61	43.98	38.24	35.67	39.28
BNZ[54]	35.81	42.26	34.94	39.69	40.28	42.11	42.91	38.65
CBA + ASB[55, 59]	37.73	36.76	37.98	37.66	36.03	36.32	36.25	38.02
Heartland Bank[56, 61]	49.94	49.59	43.96	42.55	46.95	43.43	41.23	42.93
Kiwibank	59.84	59.35	62.39	71.30	67.80	64.62	73.04	138.17
SBS Bank	67.73	70.22	57.43	60.30	59.65	62.30	62.36	60.78
The Co-operative Bank	77.65	73.38	81.41	80.27	75.07	72.22	79.33	76.96
TSB Bank[57]	42.50	47.83	51.65	45.26	47.36	48.60	77.37	55.00
Westpac[59]	43.11	40.48	40.80	41.25	38.92	40.69	42.26	43.81
Average	**39.52**	**42.52**	**41.07**	**40.33**	**42.07**	**40.93**	**40.92**	**44.82**

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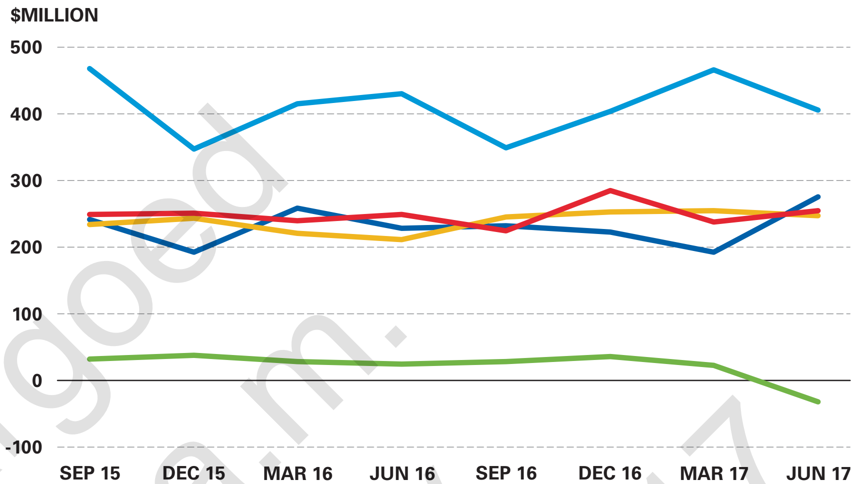
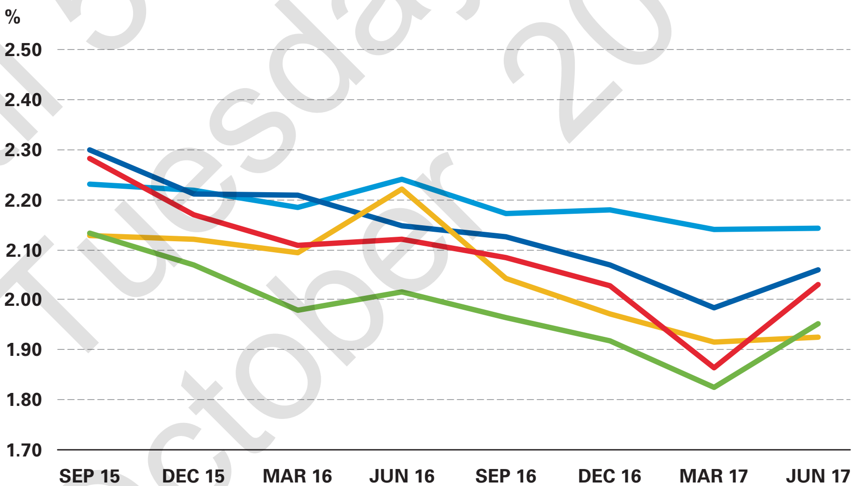
11 MAJOR BANKS: NET PROFIT

- ANZ
- BNZ
- CBA + ASB
- KIWIBANK
- WESTPAC



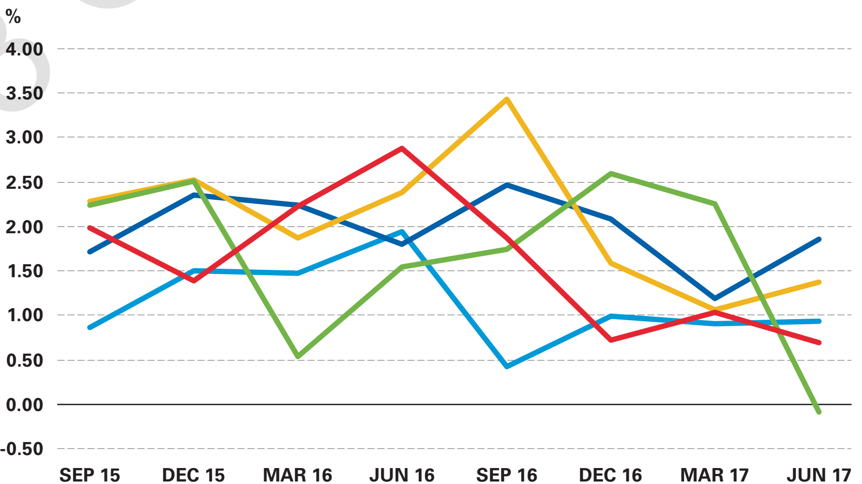
12 MAJOR BANKS: INTEREST MARGIN

- ANZ
- BNZ
- CBA + ASB
- KIWIBANK
- WESTPAC



13 MAJOR BANKS: INCREASE IN GROSS LOANS AND ADVANCES

- ANZ
- BNZ
- CBA + ASB
- KIWIBANK
- WESTPAC



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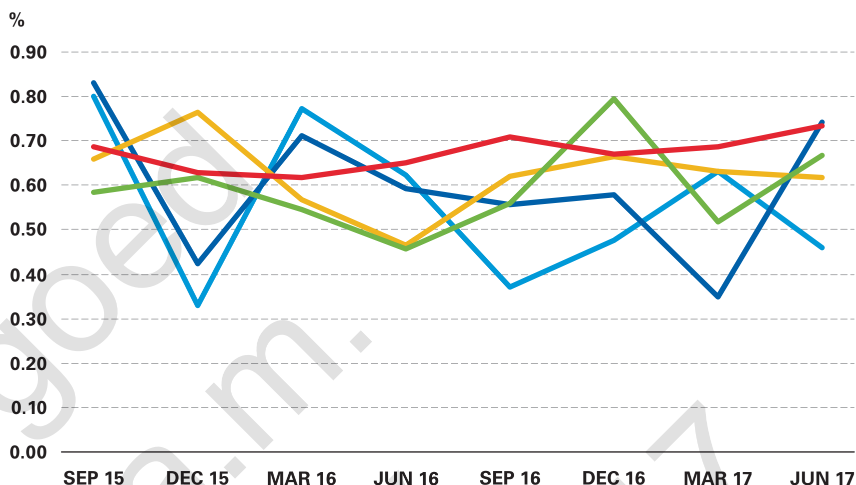
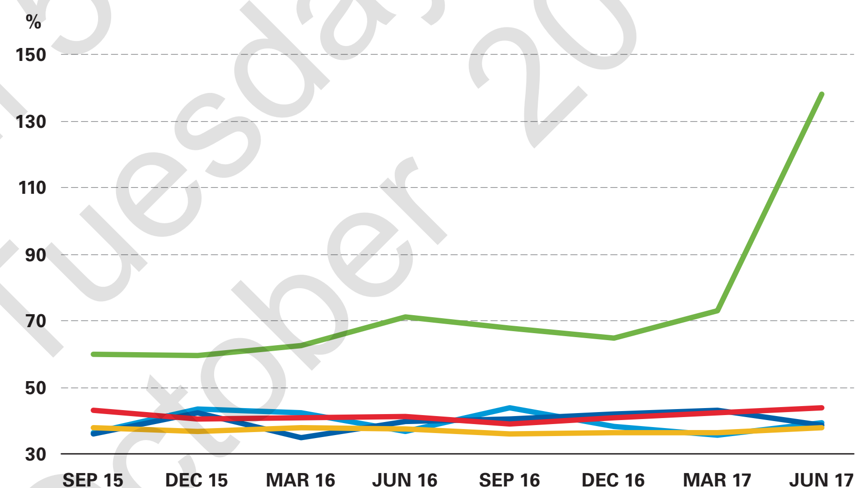
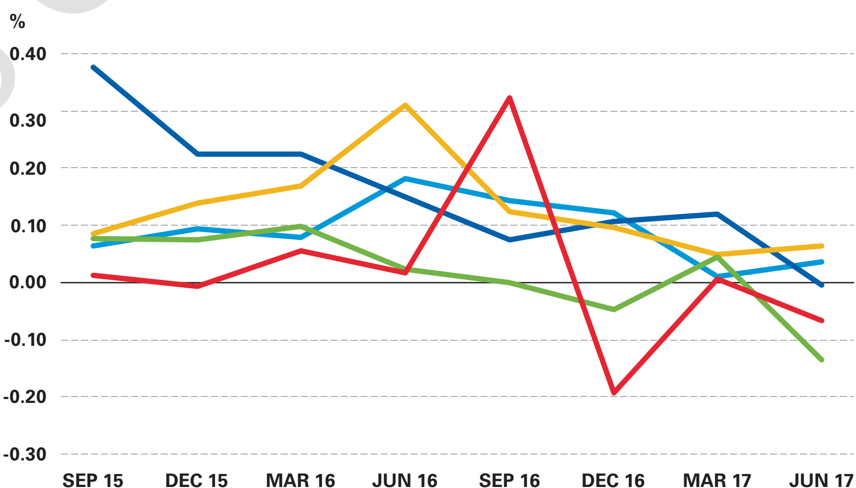
14 MAJOR BANKS: NON-INTEREST INCOME/ TOTAL ASSETS



15 MAJOR BANKS: OPERATING EXPENSES/ OPERATING INCOME



16 MAJOR BANKS: IMPAIRED ASSET EXPENSE/AVERAGE GROSS LOANS AND ADVANCES



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Endnotes

1. Median price, house price index, based on the April, May and June 2017 reports released by REINZ:
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52 http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11879485

53 A revision on the application of accounting policies for capitalisation of expenditure on internally generated software assets was made, effective 1 October 2015. This has affected comparatives for amortization of goodwill and other intangibles. Prior period comparatives (data and ratios) do not reflect this change and as such, ratios calculated in this survey may differ if restated 30 September 2015 figures and its prior period comparatives had been used for the purpose of analysis.

54 Effective from 30 September 2016 onwards, Bank of New Zealand changed its methodology for the calculation of interest earning assets (to exclude mortgage offset account). Prior period comparatives (data and ratios) do not reflect the change in methodology and as such, ratios calculated in this survey may differ if restated 30 June 2016 figures and its prior period comparatives had been used for the purpose of analysis.

55 As at 1 July 2015, interest from certain derivatives (transacted as economic hedges) are recorded as part of net interest earnings instead of other income. In addition, fixed rate prepayment cost recoveries have been reclassified from other income to interest income in order to align with industry practice, effective for the period ended 30 June 2016 onwards. Prior period comparatives (data and ratios) do not reflect the change in methodology and as such, ratios calculated in this survey may differ if restated 31 March 2016 figures and its prior period comparatives had been used for the purpose of analysis.

56 Heartland Bank Limited amalgamated with one of its wholly owned subsidiaries, effective from 31 December 2015. Prior period comparatives (data and ratios) do not reflect the amalgamation and as such, ratios calculated in this survey may differ if restated 30 September 2015 figures and its prior period comparatives had been used for the purpose of analysis.

57 On 1 April 2015, 'Investment in associates – held for sale' was transferred to a new group structure under TSB Community Trust. In addition to this, certain comparatives in relation to interest income, interest expense, other operating income and other operating expenses have been restated on numerous occasions in the last few periods. Prior period comparatives (data and ratios) do not reflect these changes and as such, ratios calculated in this survey may differ if restated 31 March 2015 figures and its prior period comparatives had been used for the purpose of analysis.

58 The capital adequacy ratios reported are for the overseas banking group.

59 The results for Australia and New Zealand Banking Group, Commonwealth Bank of Australia and Westpac Banking Corporation relate to the total New Zealand operations of these entities.

60 Total Assets = Total Assets - Intangible Assets.

61 Operating income for Heartland includes net interest income, net operating lease income, other income and fee income.

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