FIPS

Financial Institutions Performance Survey

December 2016 Quarterly Results

Executive summary

New Zealand's economy has continued to grow, with GDP growth at 0.4% for the December quarter. This result comes as Moody's Investors Service forecasts New Zealand's economy "to be among the fastest growing 'Aaa' rated economies in coming years". While quarterly net profit after tax (NPAT) for the banking sector has increased by 10.73%, to $1.24 billion, repricing of loans to lower margin fixed rate loans is putting some downward pressure on net interest margins (NIMs) as seven out of nine survey participants saw reductions to NIMs.

Summary of banking sector performance

Our review of the banking sector's performance for the December quarter shows net profit after tax (NPAT) has increased by 10.73%, to $1.24 billion. This is much welcomed news for the banking sector, having bounced back from declining NPAT levels for the two consecutive quarters prior to the December quarter. While there was a modest increase in net interest income of $12.32 million (0.54%) during the quarter, the result was substantially driven by increases in non-interest income and a sharp decrease in the impaired asset expense. Non-interest income rose $68.74 million (10.96%), while impaired asset expense had an exceptional decrease of 70.28% ($106.32 million) to $44.95 million. Despite registering a slight increase of $208k or 0.02%, operating expense levels for the quarter remained largely consistent with the previous quarter.

Net profit after tax (NPAT) has increased by 10.73%, to $1.24 billion.

When looking at size, the banking sector ended the quarter with an additional $4.42 billion (0.94%) in total assets, off the back of $5.62 billion (1.48%) in loan book growth over the quarter.

Total provisioning levels are up 0.95% from the previous quarter, however, this is largely in-line with loan book growth of 1.48%. While past due assets have risen by 9.96% to $553.33 million, other evidence such as the total provisions to gross loans and advances ratio remaining unchanged at 0.54%, indicates that the asset quality of the sector's loan book is still strong. While impaired asset expense was significantly lower than the previous quarter, with a 70.28% decrease, this was largely skewed by Westpac recognising impairment recoveries of $37 million after having reported $61 million in impaired asset expense for the previous quarter.

The banking sector ended the quarter with an additional $4.42 billion (0.94%) in total assets.

In spite of a larger loan book, interest income for the quarter was down 1.05% (or $53.62 million). However, a $65.94 million (2.34%) reduction in funding costs meant that net interest income was still able to continue its upward trajectory by $12.32 million (0.54%), after a minor setback in the September quarter that saw net interest income decline by 1.65%.

Survey participants had to endure another round of contractions to net interest margins (NIMs) this quarter.

Overall, seven of the nine participants saw reductions that ranged from 2 basis points (bps) to 7 bps, with some attributing the following performance to lower mortgage rates. Lower mortgage rates were not only the result of increasing competition between the banks for new loans, but were also driven down by borrowers who looked to reprice their loans more frequently to lower margin fixed rate loans. During the December quarter, interest income relative to average interest earning assets decreased from 4.77% to 4.62%, as the growth in interest earning assets outpaced the growth to interest income.

ROA and ROE levels have recovered by 9 bps to 1.04% and 126 bps to 14.62%, respectively. While the banking sector might have regained most of the ground it had lost during the June and September quarters of 2016, there is still much work to be done before ROA and ROE returns to levels as high as 1.27% and 17.14%, as it once did during the September 2014 quarter.

Economic environment

Since the release of our annual publication in February, the New Zealand economy has continued to grow, albeit at a slower pace, with GDP growth of 0.4% for the quarter ended December 2016, which is lower than the previous quarter's growth of 1.1%[1]. In Westpac's weekly commentary (dated 27 March 2017), economists have forecasted GDP growth for 2017 to be fairly consistent with last year at 3.2% (Actual GDP Growth for 2016: 3.1%)[2].

In-line with forecasts from bank economists, credit rating agency, Moody's Investors Service, announced that the New Zealand sovereign debt rating would be held at 'Aaa' with a stable outlook[3]. In comparison, both Standard & Poor's (S&P) and Fitch have New Zealand's sovereign debt rating at 'AA' with a stable outlook[4]. Across the board, all three global credit rating agencies have in recent months cited New Zealand's resilient economy (to both internal and external market shocks) as a key reason for their rating, with Moody's forecasting New Zealand's economy "to be among the fastest growing 'Aaa' rated economies in coming years"[5].

Moody's Investors Service, announced that the New Zealand sovereign debt rating would be held at 'Aaa' with a stable outlook.

On another note, Moody's has described the Reserve Bank of New Zealand (RBNZ) as a central bank that is "proactive and credible, with a strong track record with monetary and financial stability", while also giving recognition to financial institutions here in New Zealand for "an equally strong record of managing shocks through effective fiscal policies"[6].

In its most recent official cash rate (OCR) announcement in late-March, the RBNZ kept the OCR unchanged at 1.75%[7]. This move, or the lack thereof, was expected by most industry experts in the financial sector after the release of the RBNZ's Monetary Policy Statement in February, which also included an official forecast of the OCR holding at 1.75% till the end of 2019[8].

Furthermore, earlier that month, RBNZ Governor, Graeme Wheeler, indicated that the RBNZ views the risks of increasing or decreasing the OCR as being equally weighted, with a fair chance of the OCR either moving up or down as the global outlook remained largely uncertain, but with domestic output growth expected to rise if migration and commodity prices continue to trend upwards[9].

Meanwhile in the United States, within three months of the last interest rate rise, the U.S. Federal Reserve (Fed) has again increased interest rates by 0.25%, bringing its targeted 'Fed Funds Rate' to a range of 0.75% to 1.00%[10]. The Fed has announced that the global market could expect two more interest rate hikes in the upcoming year as the U.S. economy gets closer to achieving the Fed's objective of a 2% inflation rate and with unemployment rates holding steady at 4.7%[11]. This comes at a time when New Zealand's financial institutions are finding themselves having to rely more on higher costing wholesale funds to manage their funding gap position, as the task of attracting local deposits becomes increasingly challenging, in the face of competition with not only other banks, but with the local non-banking sector as well.

In terms of the dairy sector, within Rabobanks' monthly Agribusiness update for March 2017, economists at Rabobank see current dairy prices as being largely sustainable and that any further upside potential to dairy prices would be constrained by the demand for dairy products in certain key markets[12]. Since our last update on the Global Dairy Trade (GDT) price index's performance, two of the four auctions held during that period (8 February

2017 to 4 April 2017) reported weaker than expected results. Despite a minor rebound of 3.35% from the last two auctions, the GDT price index is down by more than 6.36% between the period of mid-February 2017 and early April 2017[13]. Over that same period, the NZD/USD exchange rate also dropped by 4.49%[14], providing some level of relief to New Zealand dairy farmers who are paid in NZD.

Despite the recent performance, Fonterra has continued to maintain its forecasted farmgate milk price at $6.00/kgMS, but revised its total forecasted payout range downwards by 5 cents, to the range of $6.45/kgMS and $6.55/kgMS[15]. Having just lifted its forecast in February after successive periods of positive GDT price index gains, economists with the big four banks have adjusted their forecasted 2016/2017 milk payout downwards to the range of $5.90/kgMS to $6.15/kgMS[16], to better reflect the latest performance of the GDT price index.

The housing market appears to have reached its peak and the early indicators are that it is now starting to slow down with a noticeable decrease in sales volume. According to a representative from one of Auckland's leading real estate companies, lower buyer activity in the housing market has meant that its monthly house sales volumes for the month of February was the lowest in six years, with inventory levels reaching a five year high[17]. Real Estate Institute of New Zealand (REINZ) data also shows that the median national house sales price has decreased from $520k to $495k (-4.76%) between November 2016 and February 2017[18].

Similarly, the median Auckland house sales price has declined from $868k to $800k (-7.83%) between October 2016 and February 2017[19].

While the housing market has started to move towards a more favourable and desirable trend for the RBNZ, RBNZ Governor, Graeme Wheeler, was cautious to comment on whether he thought the current cooling in the market would 'stick' if demand-supply imbalances are not resolved[20].

Shortly after, REINZ reported an unexpected recovery to median house sales prices, both nationally and in Auckland. Median house sales prices for the whole of New Zealand and Auckland have rebounded by as much as 10.30% and 11.25%, to reach new record highs of $546k[21] and $890k[22], respectively.

Regulation

The RBNZ has continued to work closely with the Banking sector on the 'Dashboard' approach to quarterly disclosures for locally incorporated banks. Based on the initial policy consultation, which ended on 15 December 2016, RBNZ Deputy Governor, Grant Spencer, highlighted some of the banking sector's concerns in regard to the functioning of the 'Dashboard' approach, particularly around the timing and control over the release of financial information, comparability of presented data, and the incorporation of short-term liquidity measures[23].

Though the 'Dashboard' approach is RBNZ's preferred outcome, the summary of submissions report, outlining the responses received during its consultation period, showed that the issues raised above were enough to cause a majority of the banks to lean towards a preference for the alternative option to the 'Dashboard' approach[24]. The alternative option would seek to reduce the amount of information disclosed in off-quarter disclosure statements, thereby reducing costs and driving the focus of the content to information that would be most useful to key stakeholders.

The RBNZ expects to publish their final policy decision sometime around mid-2017, with a possible phased approach to its implementation in the months thereafter.

Since our last publication, the RBNZ has also called for submissions to answer some key questions on its 'housing, household debt and policy', and for a better understanding of the intricate workings of the housing and household debt sector. The consultation period comes to a close on 1 August 2017, with a conference to follow that will be held on 11-12 December 2017. A list of the key questions has been included in their press release[25]. The RBNZ has also released its Exposure Draft on the final Outsourcing Policy for consultation and outlined the context and scope for the upcoming capital review, with an Issues Paper due for release and consultation by the end of April 2017.

On another note, in connection with the Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Act that was passed in 2013, the 2016 Anti-Money Laundering and Countering Financing of Terrorism (Prescribed Transactions Reporting) Regulations was recently passed into legislation in November 2016[26]. Under the new regulation, banks would be required to disclose any and all prescribed transactions to the Financial Intelligence Unit (a branch of the New Zealand Police) from 1 November 2017 onwards, till its revocation on 31 October 2022[27]. Building on section 48A of the AML/CFT Act, the following piece of legislation sets out to define disclosable prescribed transaction as wire transfers of more than $1,000 and domestic cash transactions exceeding $10,000. It also includes a listing of all details that the banks are obligated to collect on transactors of prescribed transactions.

Recent comments from Karen Scott-Howman, Chief Executive of the Bankers' Association, has showed that while the banks do recognise the need for them to play a pro-active role in dealing with the issues of anti-money laundering and terrorism financing, some are also concerned about the significant increase in costs that it will bring and the possible need to transfer some of these costs onto its customers by the way of increased fees[28].

What else is happening?

1 March 2017: With the increased focus of Fintech applications being explored within the financial sector, TSB Bank announced the launch of its new lending application system. The new system was the product of a key partnership with Cloudcase, CoreLogic, Decision Intellect, and TSWG. In a statement to the media, TSB Bank Chief Transformation Officer, Shaun Tubb, claims that with the new lending platform in place, the time required to complete a simple loan contract would be substantially reduced from an hour or two, to just under 40 minutes.

15 March 2017: Most recently in March, Kiwibank disclosed in a statement to the media that a retrospective review of its bond issuances has led the RBNZ to come to the view that over $250 million of debt issuances currently held within its books may not meet the definition of capital[29]. The affected bonds includes $100 million of unsecured subordinated capital notes issued in 2014 and $150 million of perpetual capital notes issued in 2015[30]. This assessment was based on requirements set out in the RBNZ's capital adequacy rulebook, over which the RBNZ plans to carry out a review of the capital requirements framework laid out. Following this announcement, Kiwibank has decided not to move forward with the A$175 million bond issuance that was initially planned to be settled on 15 March 2017[31] with shareholders NZ Post, New Zealand Superannuation Fund and ACC providing additional capital to ensure the maintenance of Kiwibank's capital ratios.

20 March 2017: Following suit with ANZ, Kiwibank becomes the second bank that was named in the class action lawsuit lead by 'The Fair Play on Fees', to agree to an undisclosed out of court settlement[32]. Similar to arrangements made with ANZ last October, Kiwibank will not have to admit any liability concerning accusations of what The Fair Play on Fees alleges as excessive charging of fees, and with that all charges filed against it will be withdrawn.

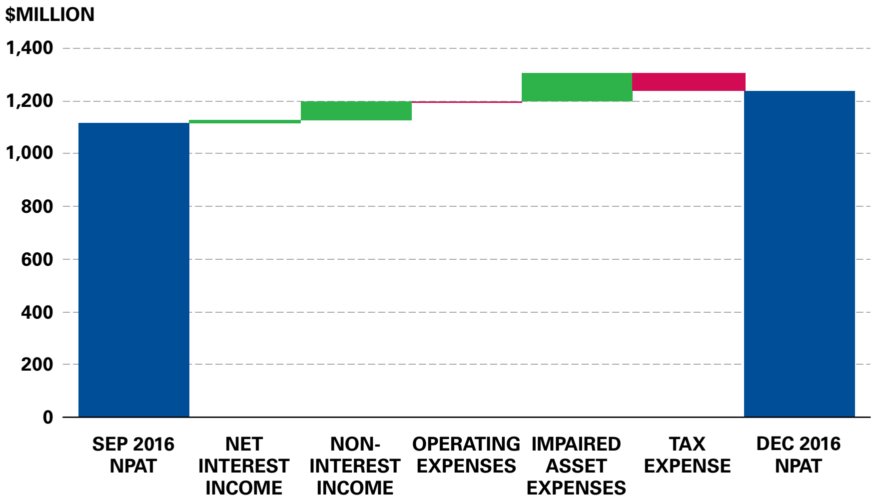
24 March 2017: ANZ introduces the 'Tap & PIN' functionality for its ATM systems. By merely tapping either their debit card or mobile phone (via ANZ go Money Wallet)[33], ANZ customers will be able to initiate their transactions seamlessly with greater ease and security. According to Paula Milne, ANZ's Head of Financial Crime Department, the use of contactless technology provides an extra layer of security that helps prevent its customers from falling victims to card skimming devices[34].

31 March 2017: Australian Regulatory Body, APRA, advises all deposit taking institutions in Australia to restrict the amount of interest only loans to no more than 30% of new residential mortgages[35]. As it stands, the subsidiaries of the big four Australian banks account for over 80.84% of all new lending in New Zealand. Currently, 33.32% of all new residential mortgages in New Zealand are made on interest only terms[36].

Quarterly analysis

After two consecutive quarters of negative net profit after tax (NPAT) growth, a 10.96% rebound in non-interest income and improvements to impaired asset expense of $106.32 million (70.28%), gave NPAT a $119.87 million (10.73%) lift for the December quarter.

1 **MOVEMENT IN NET PROFIT AFTER TAX**



Net profit after tax (NPAT)

For the December quarter, six of the nine survey participants reported an increase to NPAT levels. ANZ and Westpac led the increase for the banking sector, as they collectively made up $115.00 million of the total $119.87 million increase in NPAT for all nine survey participants. Performing equally as impressive were Kiwibank and The Co-operative Bank, with a 25.00% ($7 million) and 21.30% ($587k) increase to NPAT, respectively.

BNZ had the largest reduction in NPAT for the December quarter, which was attributed to a reduction in net interest income of $3 million, a $12 million increase in operating expenses and a $6 million increase in impaired asset expense. Although BNZ did see a 5.47% ($7 million) increase in non-interest income, this was not sufficient to offset the increase to impaired asset expense and operating expense. Based on a press release by its Australian Parent, the substantial increase in operating expense was attributable to the salary increases which took effect on 1 October, and higher redundancy costs from restructuring efforts that took place late last year[37].

At the other end, Westpac stood out with a $61 million increase in NPAT for the December quarter. The key aspect of its performance for this quarter was the 160.66% ($98 million) decrease in impaired asset expense from the previous quarter, which resulted in a $37 million impairment recovery charge to its bottom line.

When analysing ANZ's increase in NPAT of $54 million, non-interest income continued to be the single most dominant factor to ANZ's performance. After having seen its quarterly non-interest income level decline from $302 million to $152 million in the previous two quarters, it regained some of its position with a $40 million increase from $152 million to $192 million. In a statement to the press, David Hisco, CEO of ANZ New Zealand, credited the rebound in non-interest income to higher global markets trading income and valuation gains on derivatives[38]. Furthermore, a higher net interest margin (NIM) provided an additional $11 million to ANZ's net interest income, as the decline in interest expense outpaced the decline in interest income.

TABLE 1: Movement in interest margin	31 Dec 16 quarter ended (%)	Movement quring the quarter (bps)	Movement for the 6 months (bps)	Movement for the 12 months (bps)
ANZ Banking Group	2.18%	1	-6	-4
Bank of New Zealand	2.07%	-5	-8	-14
Commonwealth Bank of Australia	1.97%	-7	-25	-15
Heartland Bank[39]	4.44%	-2	-9	-74
Kiwibank Limited	1.92%	-4	-10	-15
Southland Building Society	2.60%	-3	3	-3
The Co-operative Bank	2.39%	-7	-12	-32
TSB Bank Limited	2.18%	6	16	10
Westpac Banking Corporation	2.03%	-5	-9	-14
Average	**2.10%**	**-3**	**-10**	**-11**

In reviewing the performance of the banking sector as a whole, a summary of its financial performance for the December quarter is as follows:

- Net interest income grew by a further 0.54% or $12.32 million, to $2.29 billion. This was in-spite of a 3 bps contraction to NIMs and a result of a $53.62 million decrease in interest income.
- Non-interest income rebounded with an increase of 10.96% ($68.74 million) to $695.83 million, reversing the $51.70 million reduction seen during the September quarter.
- Operating expense remained largely consistent, albeit a slight rise of 0.02% or $0.21 million, to $1.22 billion.
- Impaired asset expense had a noticeable improvement, with a 70.28% or $106.32 million reduction, to $44.95 million.
- Lastly, tax expense for the quarter rose in line with higher NPAT levels as it climbed by 15.47% or $64.47 million, to $481.22 million.

Net interest margin (NIM)

Despite interest earning assets having increased by a further 3.11% ($13.38 billion) to $443.60 billion by the end of the December quarter, interest income for the quarter fell by $53.62 million (1.05%). Simultaneously, interest expense was down by 2.34% ($65.94 million) over the same period despite a 3.19% ($11.99 billion) increase in interest bearing liabilities.

This meant that while net interest income saw an increase of $12.32 million (0.54%) for the quarter with, the 3.11% growth in interest earning assets resulted in a 3 bps contraction to NIM for the banking sector. The sector ended the December quarter with NIM at 2.10%, and with all but ANZ and TSB Bank seeing a reduction in lending profitability. The seven remaining survey participants reported reductions of 2 bps to 7 bps towards NIM levels.

Although ANZ's NIM stayed relatively steady at 2.18%, a 1 bps increase from the previous quarter, ANZ was the single largest contributor to lower interest income and interest expense levels for the sector. ANZ alone accounted for $42 million (78.33%) and $53 million (80.37%) of the total decrease to interest income and interest expense, respectively. TSB Bank on the other hand, enjoyed a 6 bps improvement as its NIM reached 2.18%. NIM for the major banks ranged from 1.92% to 2.18%, while the smaller banks have been able to command a slight premium with NIMs at 2.18% to 2.60%, and with Heartland Bank continuing to be an outlier with a NIM of 4.44%.

3 SEE FIGURE 3 – PAGE 10

From the lending side of the equation, ANZ Chief Executive Officer, David Hisco, noted in a press release that a contraction to NIM was the result of a change in consumer behaviour while an increasing number of New Zealanders are opting for cheaper fixed rate home loans, in anticipation of a rise in interest rates as wholesale funding costs are set to increase[40]. This was also reiterated by Barbara Chapman, ASB Chief Executive Officer, who agreed that a lower NIM for CBA (i.e. a 7 bps reduction to 1.97%) was the result of higher funding costs associated with wholesale funding, along with customers breaking their fixed rate loans in favour of lower margin fixed rate loans that were initially offered earlier during the year[41].

With eight of the nine survey participants reporting lower interest income to average interest earning asset ratios, combined with a shift in consumer preference for longer fixed rate loans, the real challenge for the banking sector is its ability to otherwise reprice existing loans in light of higher funding costs to come. According to the latest RBNZ data, over 89.31% of loans are on terms of two years or less[42], and as such this means that sector margins will continue to come under pressure as the majority of its loans will be repriced over the next year or two.

TABLE 2: Movement in impaired asset expense/ Average gross loans	31 Dec 16 quarter ended (%)	Movement during the quarter (bps)	Movement for the 6 months (bps)	Movement for the 12 months (bps)
ANZ Banking Group	0.12%	-2	-6	3
Bank of New Zealand	0.11%	3	-4	-11
Commonwealth Bank of Australia	0.10%	-2	-21	-4
Heartland Bank[43]	0.36%	-13	-27	2
Kiwibank Limited	-0.05%	-5	-7	-12
Southland Building Society	0.40%	-4	19	7
The Co-operative Bank	0.10%	-6	2	2
TSB Bank Limited	0.13%	1	6	5
Westpac Banking Corporation	-0.19%	-51	-21	-18
Average	**0.05%**	**-11**	**-11**	**-6**

Lending

In-line with Executives' comments that were highlighted in our annual publication, there still appears to be a good level of lending to be done in the market as gross loans and advances continued to show growth of 1.48% during the December quarter. It is worth noting that this is the lowest quarterly growth observed in the banking sector since the September 2014 quarter, when lending growth was at 1.30%. All nine participants finished the quarter with bigger loan books, bringing their total loan book size to $385.33 billion.

TSB Bank and SBS Bank saw the greatest percentage growth to their loan book, with increases of 6.70% ($280.58 million) and 6.06% ($186.29 million), respectively.

Despite their relative size (composing only 2.01% of total gross loans and advances for the sector), their combined increase of $466.88 million accounted for over 8.31% of the total increase (i.e. $5.62 billion) to gross loans and advances. An in-depth look into their financial statements reveals that TSB Bank's growth can be attributed to a significant increase of $250.09 million (7.36%) in residential mortgages, while SBS Bank's growth stemmed from higher residential and consumer lending which grew by $163.63 million (6.90%) and $26.73 million (8.65%), respectively.

4 SEE FIGURE 4 – PAGE 10

TABLE 3: Analysis of gross loans	Quarterly analysis			Annual analysis		
	31 Dec 16 quarter ended $Million	30 Sep 16 quarter ended $Million	% Increase	31 Dec 16 quarter ended $Million	31 Dec 15 quarter ended $Million	% Increase
ANZ Banking Group	122,305	121,101	0.99%	122,305	116,573	4.92%
Bank of New Zealand	76,248	74,693	2.08%	76,248	70,039	8.87%
Commonwealth Bank of Australia	79,601	78,362	1.58%	79,601	72,644	9.58%
Heartland Bank[44]	3,362	3,266	2.93%	3,362	2,951	13.92%
Kiwibank Limited	17,477	17,036	2.59%	17,477	16,402	6.55%
Southland Building Society	3,260	3,074	6.06%	3,260	2,813	15.91%
The Co-operative Bank	2,046	1,973	3.69%	2,046	1,757	16.45%
TSB Bank Limited	4,467	4,186	6.70%	4,467	3,745	19.29%
Westpac Banking Corporation	76,560	76,017	0.71%	76,560	70,959	7.89%
Total	**385,326**	**379,709**	**1.48%**	**385,326**	**357,883**	**7.67%**

The five major banks continue to drive lending growth in the sector, albeit at a slower rate. As a group, the major banks accounted for 88.69% of $5.62 billion in total lending growth. However, their increase (measured as a percentage) ranged from 0.71% to 2.59%. Of the major banks, Kiwibank and BNZ achieved the greatest percentage growth of 2.59% ($441 million) and 2.08% ($1.56 billion), respectively. Kiwibank's strong growth was attributable to increases across all sectors of lending (i.e. corporate, other retail and residential); however, residential lending accounted for $400 million of the total increase during the quarter. Meanwhile, BNZ's growth was equally attributable to increases to both housing loans ($793 million) and other term lending ($897 million).

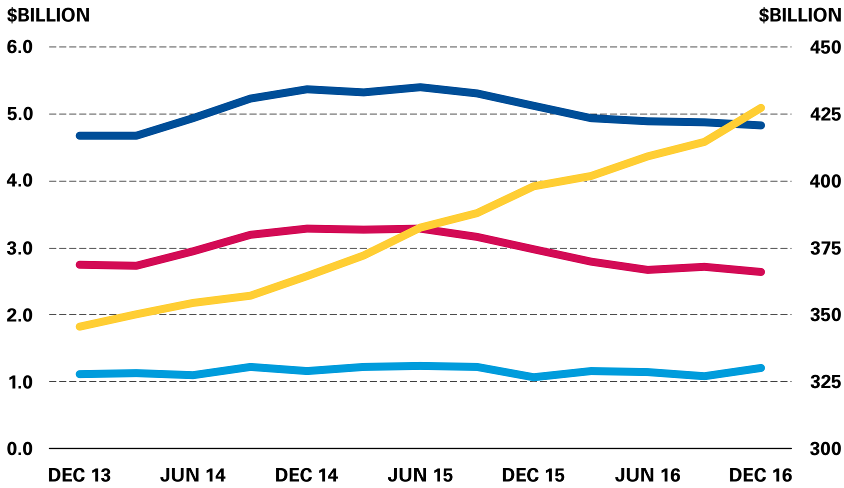
Over the December quarter, ANZ's market share (as a percentage of total gross loans) continued to slip by another 15 bps to 31.74%. In the meantime, BNZ, CBA and Kiwibank have all seen increases to their market share of 12 bps (to 19.79%), 2 bps (to 20.66%) and 5 bps (to 4.54%), respectively.

When looking at RBNZ data, it was interesting to note that the proportion of new residential mortgage lending to investors has been steadily declining since June 2016, decreasing from a high of 37.69%, to 26.24% as of February 2017[45]. This trend aligns with the timeline of when additional lending restrictions imposed by the bigger banks went into effect (i.e. 60% loan-to-value ratio (LVR) to investors and the restriction of foreign income in the debt servicing calculation).

As New Zealand's housing stock recently surpassed the $1 trillion valuation mark in the 3rd quarter of last year[46], residential lending will remain a key driver to loan book growth for the foreseeable future. A recent study by BNZ Futures Research reports that despite 62% of its participants believing that house prices are overvalued, many expect house prices to increase a further 21% in the upcoming year[47].

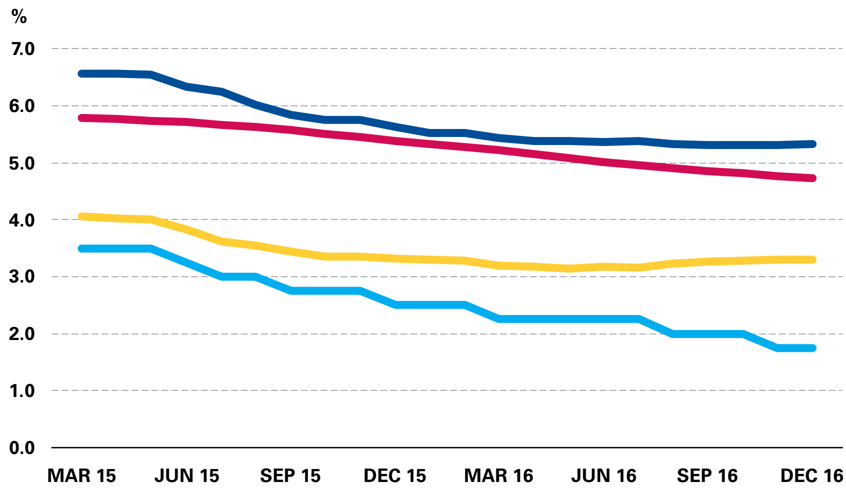
2 MAJOR BANKS: INTEREST EARNING ASSETS COMPARED TO INTEREST INCOME AND EXPENSE

- INTEREST INCOME (LHS)
- INTEREST EXPENSE (LHS)
- NET PROFIT (LHS)
- INTEREST EARNING ASSETS (RHS)



3 SIX MONTH TERM DEPOSIT VS. FIXED AND FLOATING MORTGAGE RATES

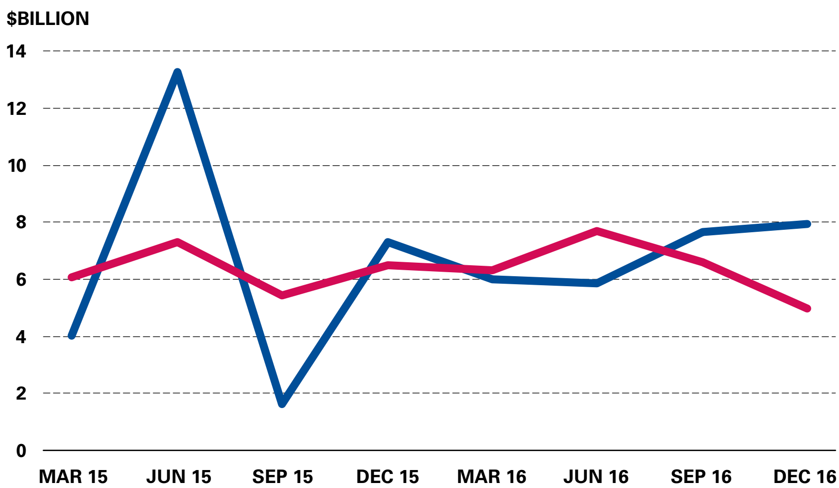
- EFFECTIVE FLOATING MORTGAGE RATE
- EFFECTIVE FIXED MORTGAGE RATE
- OCR
- SIX-MONTH TERM DEPOSIT RATE



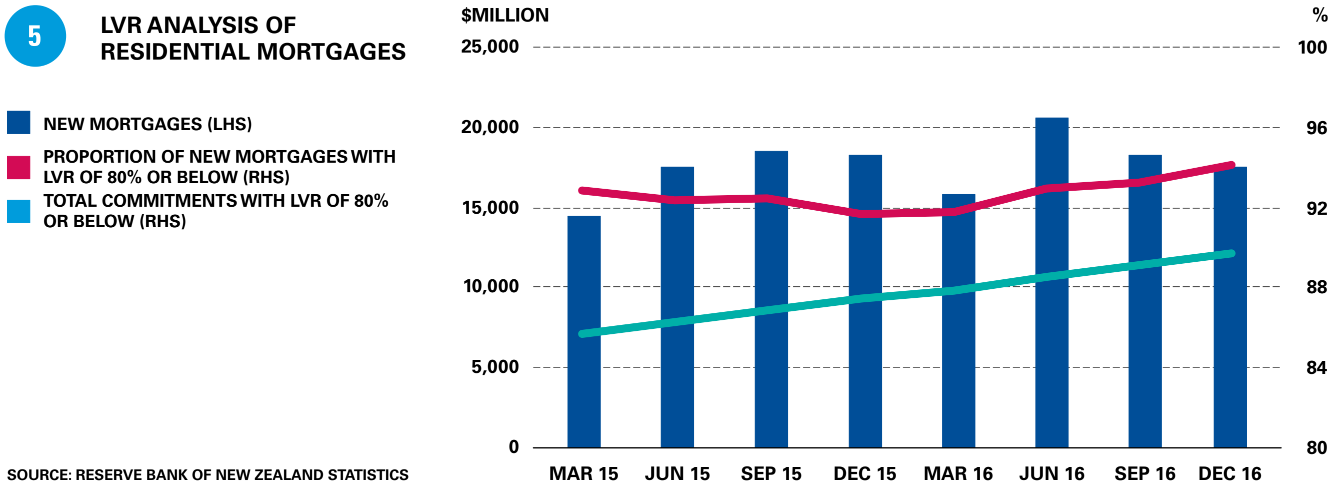
SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS (B3)

4 MAJOR BANKS: BORROWING GROWTH VS. LENDING GROWTH

- GROWTH IN BORROWING
- GROWTH IN LENDING

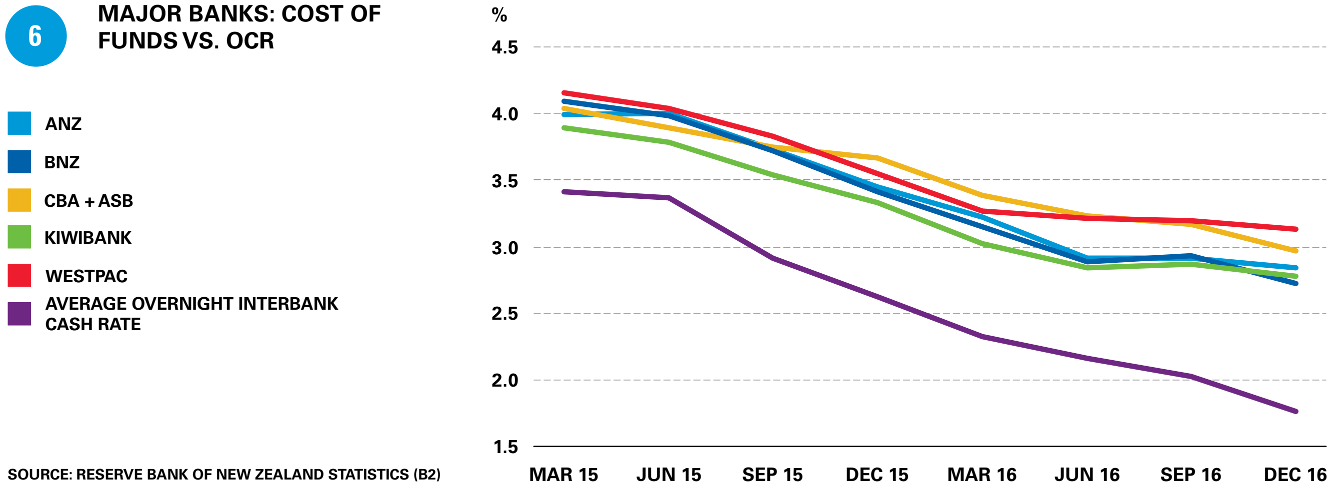


5 LVR ANALYSIS OF RESIDENTIAL MORTGAGES



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

6 MAJOR BANKS: COST OF FUNDS VS. OCR



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS (B2)

7 MAJOR BANKS: GROSS IMPAIRED VS. IMPAIRED ASSET EXPENSE

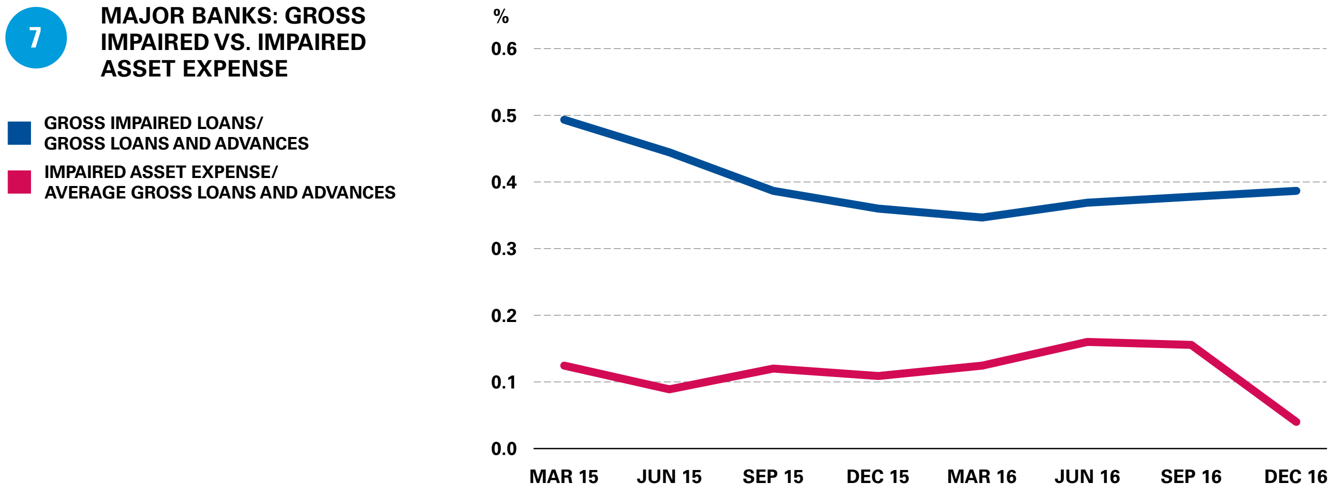


TABLE 4: Movement in over 80% LVR lending (On and off balance sheet)

	Quarterly analysis				Six month analysis			
Quarterly analysis	**31 Dec 16 $Million**	**30 Sep 16 $Million**	**Movement during the quarter $Million**	**% Change**	**31 Dec 16 $Million**	**30 Jun 16 $Million**	**Movement during the 6 month period $Million**	**% Change**
ANZ Banking Group	6,329	7,077	-748	-10.57%	6,329	7,829	-1,500	-19.16%
Bank of New Zealand	3,155	3,264	109	-3.34%	3,155	3,289	-134	-4.07%
Commonwealth Bank of Australia	6,937	7,136	199	-2.79%	6,937	7,323	-386	-5.27%
Heartland Bank[48]	33	26	-7	28.17%	33	21	12	55.52%
Kiwibank Limited	1,463	1,563	100	-6.40%	1,463	1,592	-129	-8.10%
Southland Building Society	314	293	-21	7.05%	314	314	-1	-0.23%
The Co-operative Bank	229	231	2	-0.93%	229	210	19	8.96%
TSB Bank Limited	389	392	2	-0.57%	389	392	-2	-0.59%
Westpac Banking Corporation	7,576	7,620	44	-0.58%	7,576	7,690	-114	-1.48%
Total	**26,425**	**27,601**	**1,176**	**-4.26%**	**26,425**	**28,660**	**-2,235**	**-7.80%**

Funding

For the December quarter, funding costs for the banking sector continued to show improvements that are in line with the overall trend for the past two years, despite uncertainty over global economic conditions that were driven by recent events in the past year. As a sector, the interest expense relative to average interest bearing liabilities ratio has contracted a further 14 bps for the quarter. Since the December 2014 quarter, funding costs has steadily fallen from 4.11% to a current low of 2.89%. During the December quarter, the OCR dropped a further 25 bps to 1.75%, the lowest since the RBNZ adopted it in 1999[49].

Across the board, all survey participants, with the exception of one, recognised lower funding costs ranging from 7 to 21 bps. The Co-operative Bank was the only participant to report higher funding costs, which saw its interest expense over average interest bearing liabilities ratio increase by 25 bps to 3.69%, the highest amongst all survey participants.

6 SEE FIGURE 6 – PAGE 11

ANZ and Westpac lead the way for lower funding costs this quarter, with both managing to secure a 21 bps (to 2.72%) and 20 bps (to 2.97%) reduction from the previous quarter, respectively.

Funding costs will continue to be at the forefront of each banks' business strategy, as this area of the business becomes an increasing challenge to effectively manage. Moreover, balancing lending and funding growth adds another layer of difficulty, given that current levels of domestic deposits (i.e. funding) are limited and the demand for loans from the housing sector does not show signs of dissipating. In a press release, ASB pointed out that the banking sector has had to rely more on offshore funding in recent months, thereby driving up interest expense levels as offshore funding is typically associated with higher costs[50].

Asset quality

The banking sector reported a 70.28% ($106.32 million) reduction in impaired asset expense for the December 2016 quarter. Seven of the nine survey participants saw reductions, resulting in a total impaired asset expense of $44.95 million for the December quarter. Driving this notable movement was Westpac, who reported a 160.66% ($98 million) reduction. This meant that Westpac went from having the highest impaired expense level of $61 million in the previous quarter, to recognising over $37 million in impairment recoveries in the December quarter. If Westpac was excluded from the analysis, impaired asset expense would have only decreased by 5.50% ($8.32 million). BNZ and TSB Bank were the only two survey participants who reported increases to their impaired asset expenses for the quarter of $6 million and $153k, respectively.

7 SEE FIGURE 7 – PAGE 11

The current level of past due assets at the end of the December quarter has risen by $50.14 million (9.96%) to $553.33 million, entirely reversing last quarter's decrease of $48.64 million. Despite its recent performance, the level of past due assets for the banking sector still appears to be on a downward trajectory when considering its overall performance over the last five years, coming down from a high of $1.45 billion as at June 2010 and more recently from $725.95 million as at March 2015. Excluding SBS Bank, all remaining survey participants reported increases in past due assets for the quarter.

8 SEE FIGURE 8 – PAGE 15

Total provisions relative to gross loans and advances has remained stable on last quarter's figures, with no movement from 0.54%. While total provisions has increased by 0.95% ($19.58 million), this was in-line with a 1.48% increase to total gross loans and advances. Specific provisions has decreased by 2.43% ($10.28 million), which was primarily driven by a $42 million (66.67%) decrease from Westpac, while four other survey participants saw more limited decreases to specific provisioning levels, in the range of $16k to $2.00 million. On the other side of the spectrum, ANZ reported a $32 million (17.20%) increase in specific provisions relating to non-retail exposures and retail mortgages. Meanwhile, collective provisions rose by 1.84% ($29.85 million) as seven of the nine survey participants reported increases. Interestingly, Westpac had the largest increase of $33 million, followed by CBA at $7 million. In contrast, ANZ and Kiwibank were the only survey participants that were able to reduce their collective provisioning levels by $16 million and $2 million, respectively. At the overall level, Kiwibank was the only bank that reported a decrease to both specific and collective provisioning levels for the quarter. While ANZ has clearly stated that the increase to total provisions reflects the "normalisation of provision levels, and lower write backs and recoveries"[51], we expect this trend to continue amongst many of the survey participants.

9 SEE FIGURE 9 – PAGE 15

The increase in impaired asset expense and total provisions is reflective of an emphasis on increased financial uncertainty within the foreseeable future, particularly around the housing market, global interest rates and other global events.

Operating costs ratio

Operating expenditure continues to be a strong focus point for survey participants, as the banking sector improved its operating cost ratio (i.e. operating expense/operating income) with a 113 bps reduction to 40.93%. Looking closer, it was noted that four of the nine survey participants achieved lower operating cost ratios with decreases in the vicinity of 285 bps to 574 bps. While ANZ and The Co-operative Banks' success stemmed from reduced cost levels alongside operating income growth, Heartland Bank and Kiwibank's improved efficiency was primarily driven by higher operating income levels.

Operating expenses for the banking sector as a whole remained relatively flat at $1.22 billion, as the increase to operating expense for the quarter came in at only 0.02% or $208k. Nevertheless, seven survey participants reported increases to operating expenditure levels. While ANZ reported a $33 million reduction in operating expense, the four other major banks all saw increases in the range of $6 million to $12 million. ANZ noted their achievement towards "ongoing disciplined cost management efforts and productivity gains"[52].

On the other hand, BNZ attributed the $12 million (5.26%) rise in operating expenses to higher personnel costs relating to the timing of salary increases (which effectively occurred on 1 October), redundancy costs from the announcement of its restructure in October last year and higher project related costs[53].

Even though CBA was unable to reduce its operating expense ratio, which was up by $6 million (29 bps) from the previous quarter, ASB Chief Executive, Barbara Chapman, has noted that the focal point of its cost strategies will rely on continued efforts to "invest in building frontline capabilities, leverage on technology, improve productivity, and simplify the business"[54]. As the banking sector looks to transform itself into a more agile and relevant sector in today's environment, many are taking the right approach in ensuring that the main objective of any cost efficiency effort has the customer's best interest in mind.

ROE/ROA and capital adequacy

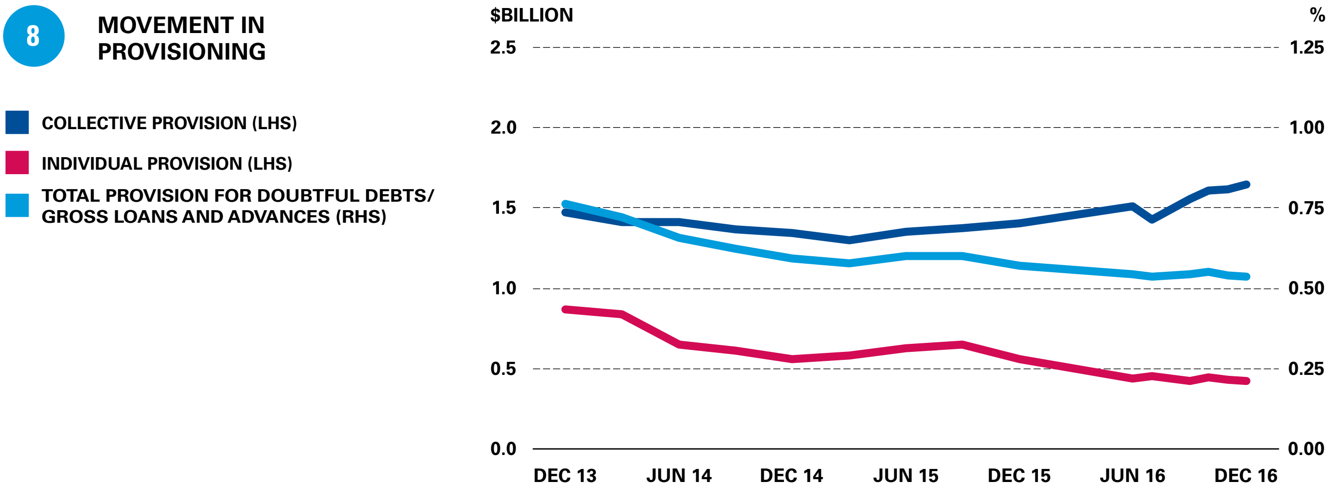
The banking sector's performance in this area for the December quarter is a turnaround to the downward trend on ROA and ROE levels. Collectively, ROA and ROE levels were up from the September quarter by 9 bps and 126 bps, respectively. This was the result of an upward movement in net interest income despite margins being squeezed, higher non-interest income due to more favourable market conditions for derivative instruments, and the stagnation of previously rising operating expenses.

10 **SEE FIGURE 10 – PAGE 15**

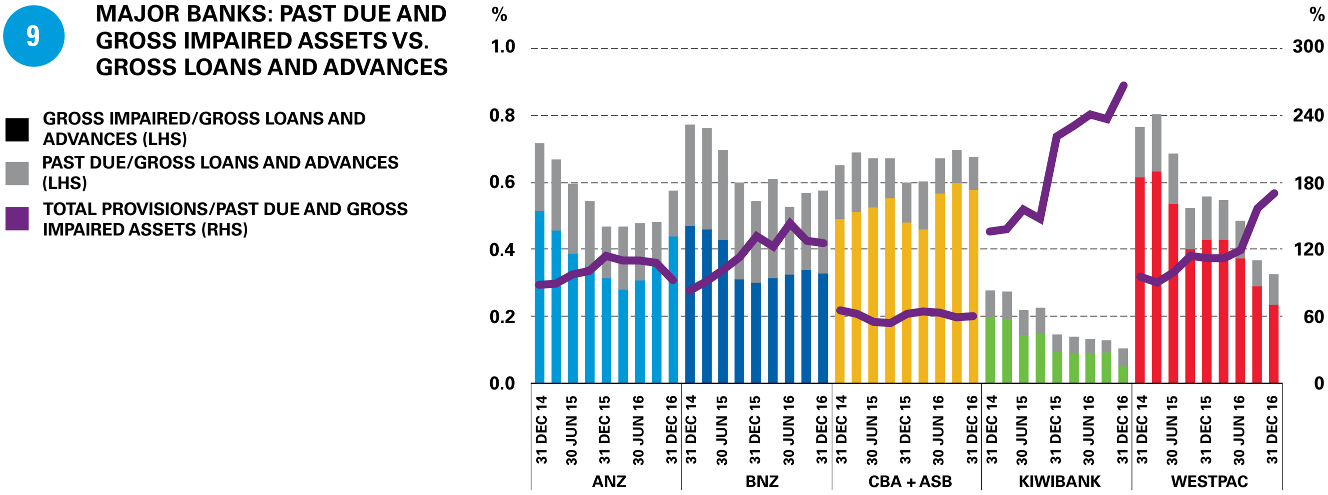
Of the six survey participants who reported higher ROEs, Westpac showed the largest increase, with an improvement of 287 bps (to 15.81%) from the previous quarter. This was off the back of a 27.23% ($61 million) increase in NPAT that was largely impacted by a one-off charge of $37 million in impairment recoveries, which was partially offset by a $25 million increase in tax expense. Similarly, ANZ and Kiwibank also showed significant improvements of 177 bps (to 14.19%) and 162 bps (to 11.44%), respectively. In both cases, this was the result of higher non-interest income levels that helped to lift up NPAT for the quarter by as much as 15.47% and 25.00%, respectively. Meanwhile, SBS Bank and TSB Bank posted a 184 bps and 45 bps decline to their ROE levels. SBS's performance was driven by an 11.98% fall in NPAT, as its equity position increased by more than 6.75%, the second highest increase amongst survey participants.

As for capital adequacy ratios, only two of the nine survey participants reported slightly weaker capital adequacy positions, with declines of 30 bps and 36 bps for ANZ and SBS Bank, respectively. BNZ, CBA and The Co-operative Bank were outliers with increases to capital ratios that ranged between 100 bps and 140 bps for the quarter. At 17.50% (a 140 bps increase from the previous quarter), The Co-operative Bank consolidated its position at the top by having the highest total adequacy ratio since January 2013, when banks were first made to comply with minimum RBNZ capital ratios[55].

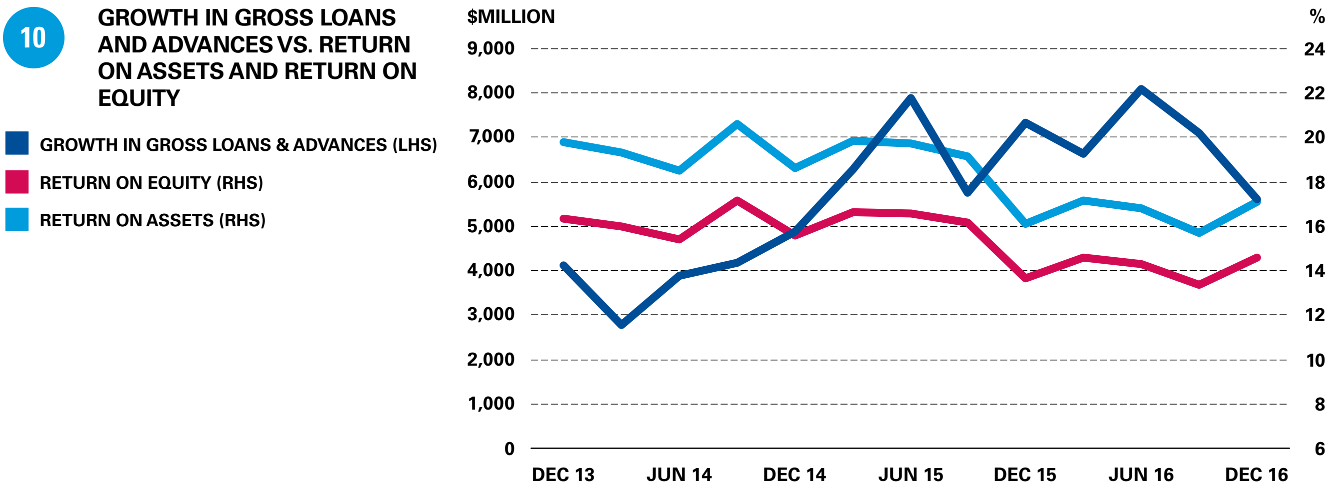
8 MOVEMENT IN PROVISIONING



9 MAJOR BANKS: PAST DUE AND GROSS IMPAIRED ASSETS VS. GROSS LOANS AND ADVANCES



10 GROWTH IN GROSS LOANS AND ADVANCES VS. RETURN ON ASSETS AND RETURN ON EQUITY

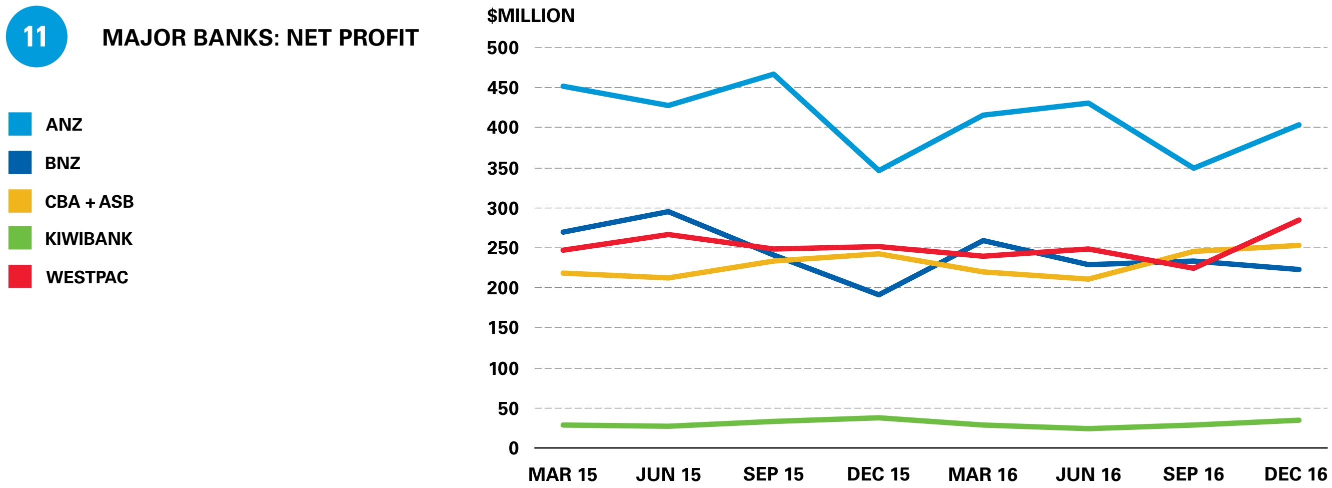


Major banks - Quarterly analysis

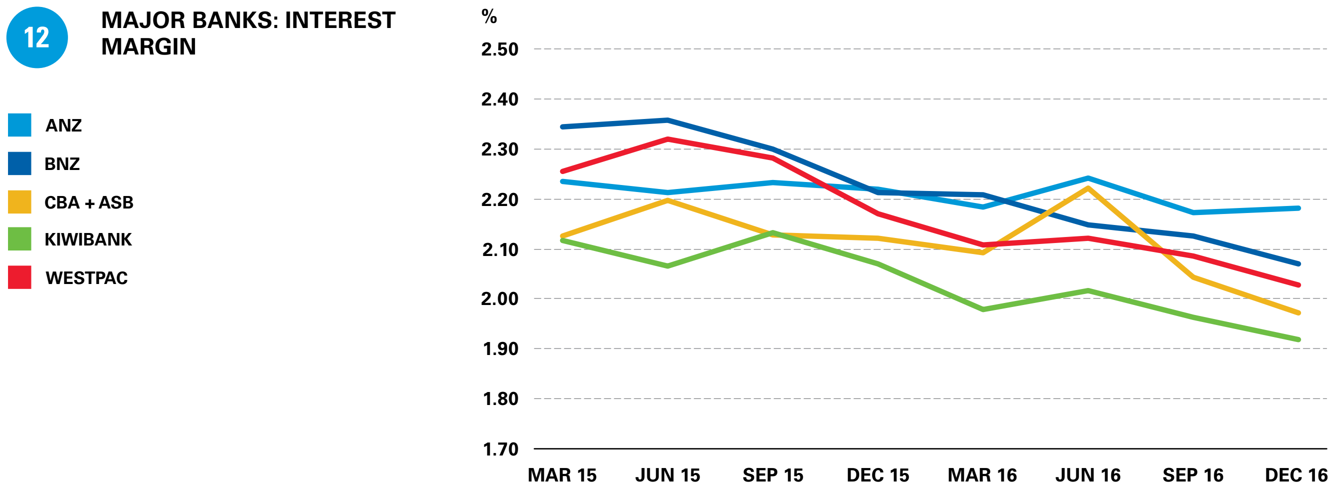
Entity	Size & strength measures							
	31 Mar 15	30 Jun 15	30 Sep 15	31 Dec 15	31 Mar 16	30 Jun 16	30 Sep 16	31 Dec 16
	Total assets[63] ($Million)							
ANZ[56, 62]	140,253	150,664	152,038	152,289	160,801	163,538	163,282	159,861
BNZ[57]	81,926	85,657	86,629	86,819	89,913	91,906	92,325	93,906
CBA + ASB[58, 62]	76,994	80,147	81,321	81,785	86,012	85,678	88,764	90,827
Heartland Bank[59]	2,623	2,772	2,825	3,290	3,334	3,489	3,595	3,755
Kiwibank	17,948	18,228	18,686	18,858	19,227	19,199	19,372	19,834
Southland Building Society	2,858	3,094	3,163	3,286	3,408	3,506	3,543	3,740
The Co-operative Bank Limited	1,795	1,838	1,896	1,971	2,029	2,109	2,179	2,257
TSB Bank Limited[60]	5,908	5,991	6,208	6,299	6,424	6,475	6,522	6,629
Westpac[62]	82,087	87,455	88,203	88,416	90,309	91,518	92,708	95,903
Total	**412,392**	**435,846**	**440,968**	**443,014**	**461,455**	**467,418**	**472,291**	**476,711**
	Increase in gross loans and advances (%)							
ANZ[56, 62]	1.75	3.60	0.86	1.51	1.47	1.94	0.43	0.99
BNZ[57]	1.57	1.01	1.72	2.35	2.24	1.80	2.46	2.08
CBA + ASB[58, 62]	2.75	2.04	2.29	2.53	1.87	2.38	3.43	1.58
Heartland Bank[59]	4.10	4.11	3.21	22.19	3.02	3.29	4.01	2.93
Kiwibank	2.04	1.50	2.24	2.51	0.53	1.55	1.74	2.59
Southland Building Society	2.50	11.34	2.71	2.04	2.67	3.19	3.15	6.06
The Co-operative Bank Limited	2.19	3.24	4.28	4.23	2.87	4.01	4.97	3.69
TSB Bank Limited[60]	1.73	5.27	3.39	4.57	2.80	3.26	5.32	6.70
Westpac[62]	1.51	1.57	1.99	1.38	2.22	2.88	1.86	0.71
Average	**1.90**	**2.34**	**1.67**	**2.09**	**1.85**	**2.22**	**1.91**	**1.48**
	Capital adequacy[61] (%)							
ANZ[56, 62]	12.60	12.50	13.30	13.30	13.70	14.40	14.30	14.00
BNZ[57]	12.90	12.59	12.67	13.26	12.58	12.48	12.04	13.09
CBA + ASB[58, 62]	12.10	12.70	13.30	14.10	13.70	14.30	12.70	13.70
Heartland Bank[59]	13.36	12.86	12.85	14.46	14.01	13.78	12.71	12.96
Kiwibank	12.40	13.40	12.80	12.80	12.90	12.90	12.80	13.40
Southland Building Society	15.61	14.59	14.21	14.27	13.76	13.50	13.63	13.27
The Co-operative Bank Limited	16.50	16.30	16.20	15.80	15.80	15.50	16.10	17.50
TSB Bank Limited[60]	13.85	13.71	15.77	14.86	14.52	14.62	14.59	14.65
Westpac[62]	12.10	12.40	13.30	13.90	14.00	14.00	13.10	13.40
	Net profit ($Million)							
ANZ[56, 62]	452	427	467	347	416	430	349	403
BNZ[57]	270	295	241	192	259	229	233	223
CBA + ASB[58, 62]	218	212	234	243	220	211	245	253
Heartland Bank[59]	11	10	10	15	14	15	14	15
Kiwibank	29	27	33	38	29	24	28	35
Southland Building Society	4	6	4	5	6	7	7	6
The Co-operative Bank Limited	2	2	3	3	2	2	3	3
TSB Bank Limited[60]	16	13	25	13	10	14	14	14
Westpac[62]	247	266	249	251	239	249	224	285
Total	**1,249**	**1,259**	**1,266**	**1,107**	**1,195**	**1,181**	**1,117**	**1,237**

Entity	Profitability measures							
	31 Mar 15	30 Jun 15	30 Sep 15	31 Dec 15	31 Mar 16	30 Jun 16	30 Sep 16	31 Dec 16
	Interest margin (%)							
ANZ[56, 62]	2.23	2.21	2.23	2.22	2.18	2.24	2.17	2.18
BNZ[57]	2.34	2.36	2.30	2.21	2.21	2.15	2.12	2.07
CBA + ASB[58, 62]	2.13	2.20	2.13	2.12	2.09	2.22	2.04	1.97
Heartland Bank[59]	4.91	4.83	4.81	5.18	4.58	4.53	4.46	4.44
Kiwibank	2.12	2.07	2.13	2.07	1.98	2.02	1.96	1.92
Southland Building Society	2.93	2.86	2.67	2.63	2.61	2.57	2.63	2.60
The Co-operative Bank Limited	2.80	2.81	2.77	2.71	2.61	2.51	2.46	2.39
TSB Bank Limited[60]	2.15	2.12	2.14	2.08	2.03	2.02	2.12	2.18
Westpac[62]	2.26	2.32	2.28	2.17	2.11	2.12	2.08	2.03
Average	**2.26**	**2.28**	**2.25**	**2.21**	**2.17**	**2.20**	**2.13**	**2.10**
	Non-interest income/Total tangible assets (%)							
ANZ[56, 62]	0.90	0.76	0.80	0.33	0.77	0.62	0.37	0.48
BNZ[57]	0.94	0.97	0.83	0.42	0.71	0.59	0.56	0.58
CBA + ASB[58, 62]	0.70	0.53	0.66	0.77	0.57	0.47	0.62	0.66
Heartland Bank[59]	0.41	0.36	0.39	0.89	0.45	0.45	0.26	0.49
Kiwibank	0.57	0.57	0.59	0.62	0.55	0.46	0.56	0.80
Southland Building Society	1.03	0.98	0.95	1.03	0.97	1.00	1.00	0.93
The Co-operative Bank Limited	0.24	1.00	0.99	1.02	0.64	0.94	0.98	0.97
TSB Bank Limited[60]	0.40	0.24	0.38	0.20	0.21	0.21	0.35	0.27
Westpac[62]	0.66	0.73	0.69	0.63	0.62	0.65	0.71	0.67
Average	**0.80**	**0.74**	**0.74**	**0.51**	**0.67**	**0.58**	**0.53**	**0.59**
	Impaired asset expense/Average gross loans and advances (%)							
ANZ[56, 62]	0.07	0.10	0.06	0.09	0.08	0.18	0.14	0.12
BNZ[57]	0.26	0.10	0.38	0.22	0.23	0.15	0.08	0.11
CBA + ASB[58, 62]	0.14	0.08	0.09	0.14	0.17	0.31	0.12	0.10
Heartland Bank[59]	0.44	0.74	0.56	0.34	0.41	0.63	0.49	0.36
Kiwibank	0.08	0.03	0.08	0.07	0.10	0.02	0.00	-0.05
Southland Building Society	0.79	0.31	0.62	0.33	0.67	0.21	0.44	0.40
The Co-operative Bank Limited	0.05	0.16	0.04	0.08	0.05	0.08	0.16	0.10
TSB Bank Limited[60]	0.04	0.07	-1.47	0.08	0.31	0.07	0.12	0.13
Westpac[62]	0.07	0.08	0.01	-0.01	0.06	0.02	0.32	-0.19
Average	**0.13**	**0.09**	**0.11**	**0.11**	**0.13**	**0.16**	**0.16**	**0.05**
	Operating expenses/Operating income (%)							
ANZ[56, 62]	36.61	38.03	36.34	43.30	42.41	36.61	43.98	38.24
BNZ[57]	32.91	34.47	35.81	42.26	34.94	39.69	40.28	42.11
CBA + ASB[58, 62]	37.60	41.19	37.73	36.76	37.98	37.66	36.03	36.32
Heartland Bank[59, 64]	47.14	48.45	49.94	49.59	43.96	42.55	46.95	43.43
Kiwibank	62.07	67.52	59.84	59.35	62.39	71.30	67.80	64.62
Southland Building Society	62.82	60.39	67.73	70.22	57.43	60.30	59.65	62.30
The Co-operative Bank Limited	78.63	80.40	77.65	73.38	81.41	80.27	75.07	72.22
TSB Bank Limited[60]	43.59	44.68	42.50	47.83	51.65	45.26	47.36	48.60
Westpac[62]	37.89	38.95	43.11	40.48	40.80	41.25	38.92	40.69
Average	**37.90**	**39.80**	**39.52**	**42.52**	**41.07**	**40.33**	**42.07**	**40.93**

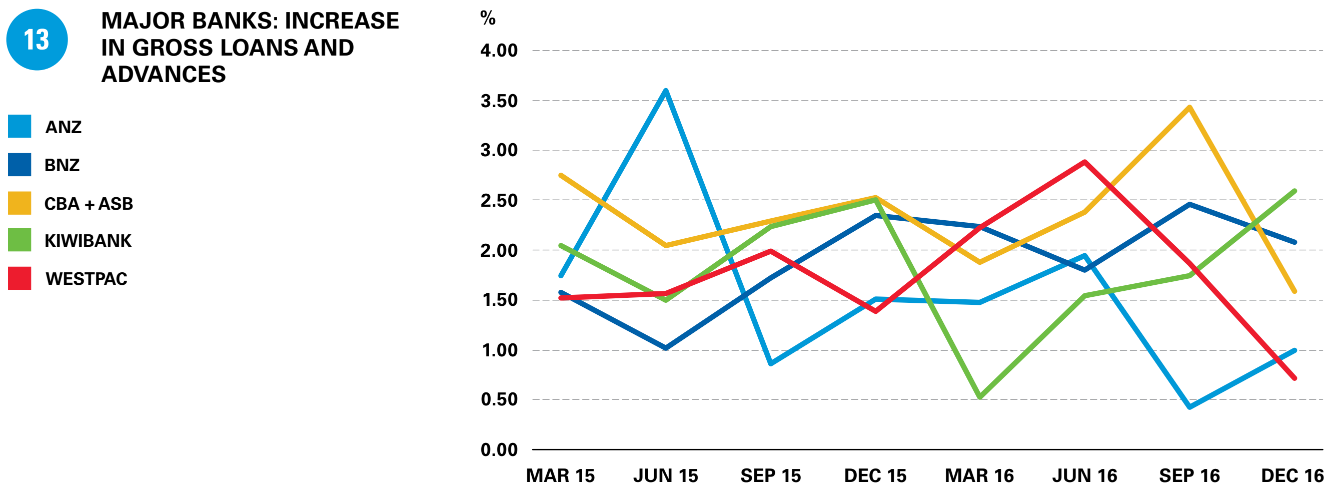
11 MAJOR BANKS: NET PROFIT



12 MAJOR BANKS: INTEREST MARGIN

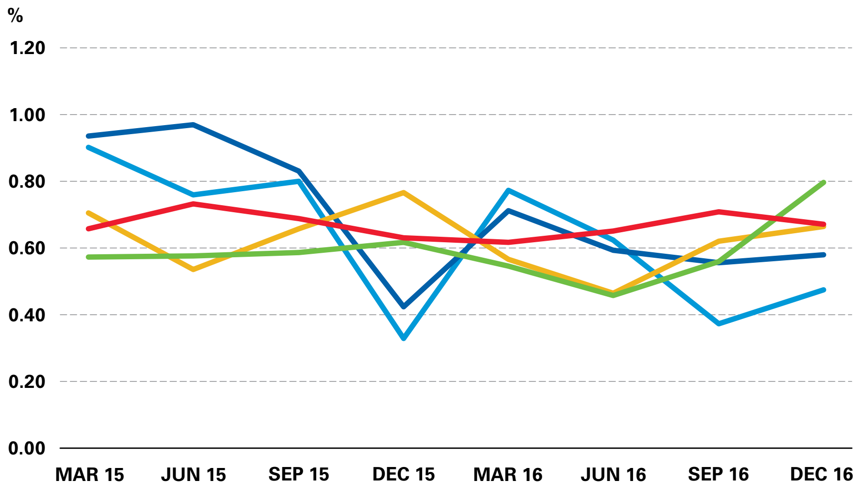


13 MAJOR BANKS: INCREASE IN GROSS LOANS AND ADVANCES



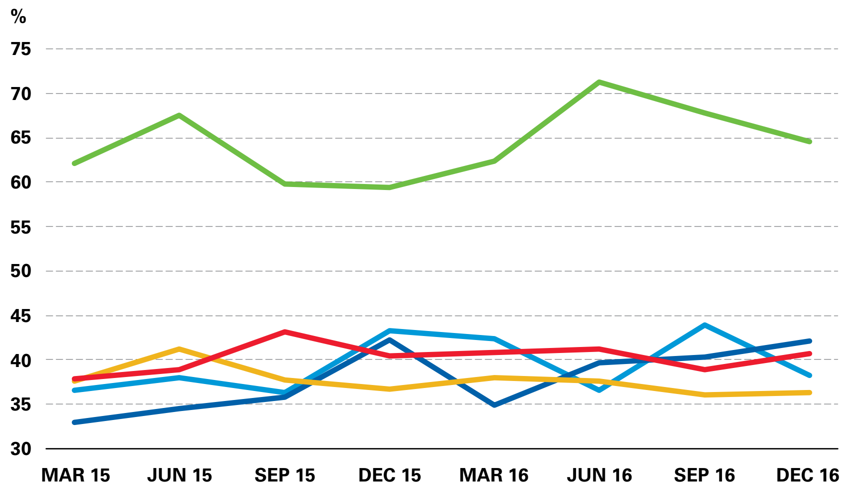
14 MAJOR BANKS: NON-INTEREST INCOME/ TOTAL ASSETS

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



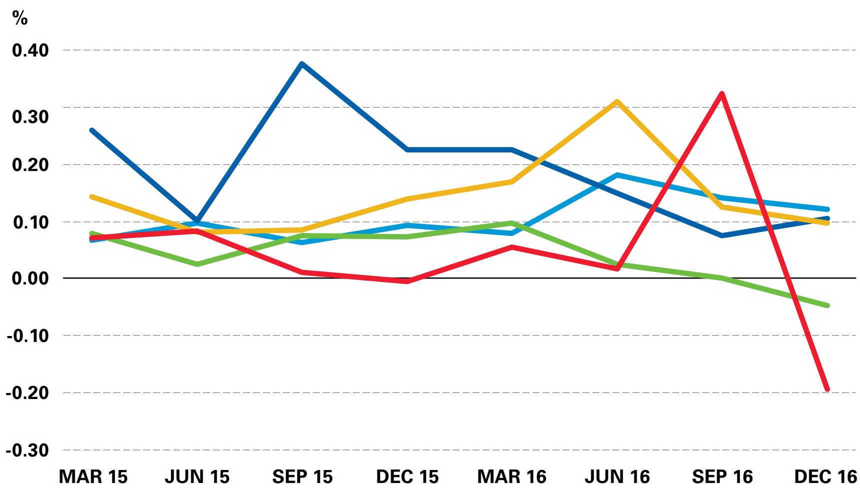
15 MAJOR BANKS: OPERATING EXPENSES/ OPERATING INCOME

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



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

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



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56. 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.
57. 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.
58. 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.
59. 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.
60. Most recently 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.
61. The capital adequacy ratio's reported are for the overseas banking group.
62. 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.
63. Total Assets = Total Assets - Intangible Assets.
64. Operating income for Heartland includes net interest income, net operating lease income, other income and fee income.

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