KPMG

FIPS

Financial Institutions Performance Survey

March 2018 Quarterly Results

Foreword

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John has been with KPMG's Financial Services audit team for over 30 years. He spent nineteen of these working as a partner with a wide range of financial services audit clients, specialising in banks and finance companies.

John has a wealth of experience in auditing and accounting for banking products and services including treasury, retail offerings, corporate loans, and loan provisioning. He is currently Head of KPMG's Banking and Finance team and editor of this publication. John is also Deputy Chairman of the New Zealand Auditing and Assurance Standards Board (NZAuASB), serves as a board member of the XRB (External Reporting Board), and is also a member of CA ANZ and the Institute of Directors.

In May 2018, following extensive consultation, the Reserve Bank of New Zealand (RBNZ) released the first publication of its much anticipated Bank Financial Strength Dashboard[1] (Dashboard).

As discussed in the article by Geoff Bascand, Deputy Governor and Head of Financial Stability at the RBNZ, in the *FIPS Review of 2017*[2], the Dashboard allows anyone to compare New Zealand registered banks on many different metrics with ease. The main subject areas of the dashboard are: bank credit ratings, capital adequacy, asset quality, profitability, balance sheet, liquidity, and credit concentrations.

The information to produce the Dashboard is submitted quarterly by all banks to the RBNZ. The release of this Dashboard coincided with the removal of banks needing to produce off-quarter disclosure statements, with only half-year and year-end disclosure statements being published from 31 March 2018 onwards.

While this information in the Dashboard is much more accessible and comparable, the actual information available is different from what was previously disclosed in the off-quarter disclosure statements. This has not only led to some new metrics and data being available, such as detailed credit exposure information by sector, but also led to certain metrics no longer being available, such as interest bearing liabilities and intangible assets.

In response to this change, we have also changed our quarterly FIPS publication. We have changed the types of metrics we disclosed (based on availability of data), we have placed less emphasis on quantitative analysis (given the Dashboard already allows for interactive comparison), and have tried to place more focus on sector themes, trends and macro-economic changes. As more quarters pass with the Dashboard reporting, and we build historic data sets for these new metrics, we will look to evolve our analysis to use more of this new information available.

Another significant change to our quarterly FIPS publication is that the information in the Dashboard is not required to be put through the normal governance processes that a disclosure statement was subject to (Board or Audit Committee sign-off).

We hope you enjoy the new look and feel of the publication, and we look forward to giving you more detailed information and analysis going forward.

Banking sector update

Conduct continues to be front and centre of mind

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Banking Commission) continues to dominate the headlines in Australia, with three rounds of public hearings already having taken place, and the fourth ongoing during the time of publication[3]. With New Zealand's biggest banks being subsidiaries of big Australia banks, the next question in New Zealand was: "if it is happening there, is it happening here?" The New Zealand banks distanced themselves from their parents, with ANZ CEO, David Hisco, even saying to the RBNZ "to come and have a look" inside their bank to see they didn't have the same problems[4]. The regulators didn't take long to respond, with the RBNZ and Financial Markets Authority (FMA) jointly issuing letters to the CEO's of New Zealand's registered banks on 3 May 2018 asking the banks to explain:

- what the banks had done to identify and address conduct risk;
- plans and actions taken in response to Royal Banking Commission issues and themes; and
- any other work planned or underway to identify and address conduct and culture risk, including where they are remediating issues where their conduct has resulted in detrimental outcomes for customers[5].

Responses were due 18 May 2018, with further actions by the FMA and RBNZ to be taken after considering the banks' responses. On 30 May 2018, the RBNZ noted that from their monitoring work to date, they had "not seen evidence of the widespread, systemic issues to warrant a commission of inquiry in New Zealand"'; however, recognising that the work they had commenced may test this view.

They also discussed their initial observations on the banks' responses to their letter, noting variability in both detail and content of the responses, and also variance in the banks' maturity in respect of conduct risk[6].

The RBNZ and FMA issued a press release on 22 June 2018, noting that they were working through the submissions, and were now working on beginning to notify banks on when and why they will be visited, where this will primarily be to assess validity of their written responses[7]. It is still early days in this process, and it is yet to be seen what will come out from these reviews.

See KPMG's Conduct Article

Banking and finance industry to feel impact of new government

Hon. Kris Faafoi has hit the ground running in his role as Commerce and Consumer Affairs Minister since the new government was formed, already getting involved and pushing along two different but topical areas in the financial services sector: Open banking and caps on interest rates.

Open banking

As we discussed in our *FIPS Review of 2017*, open banking is an emerging banking trend worldwide, embracing new technologies to maximise the value of data, for both the bank and customers' benefit. Hon. Kris Faafoi has recently told the payments sector that "progress must be made on innovation and open banking" and that "speed is of the essence and the status quo isn't an option". This follows on from his predecessor's, Jacqui Dean's, work, where she had written to Payments NZ asking about its work to increase competition in the retail payments space and to specifically advance open banking[8].

Hon. Kris Faafoi looks to follow principles set out in the Australian review into open banking, where as a result of the Review into Open Banking[9], the big four banks are being instructed by the Australian Government to make "open banking data" available for customers by July 2019 and is keen to realise the benefits of open banking for the banks, their customers and the wider community[10].

Open banking has already made an appearance in New Zealand, with the Opotiki District Council now being able to receive debit payments directly from Westpac customers rather than using credit or debit cards. This helps increase the security of the transaction by not involving third parties and also helps to reduce fees[11]. A pilot project is also underway that is being driven by Payments NZ to develop two payment-related Application Programming Interfaces, or 'APIs', which is hoping to allow for transactions to have not only more trust, but be more responsive and real-time[12].

In the RBNZ's May 2018 Financial Stability Report, the RBNZ discusses how open banking "could improve the soundness and efficiency of the finance system" and could also "increase competition", "reduce the cost of financial services" and "help financial services to be better tailored to customer requirements … reducing the risk that customers obtain loans that they cannot repay". However, the RBNZ does recognise that open banking comes with risks. The immediate risks is the impact on profitability on banks that are slow to adapt to new entrants. Longer term risks are numerous, from data risk, where "increasing the number of firms that handle sensitive customer data may increase the risk of data mishandling", to liquidity and money laundering risks[13].

Interest rate caps

Hon. Kris Faafoi has also led an effort to cap the amount lenders can earn on loans[14]. The consultation document from the Ministry of Business, Innovation and Employment considers three options; focusing on either a cap of total fees and interest over the life of a loan (100% of original loan principle), a cap per annum (30–50%), or a combination of both (200–300% per annum, capped at 100% of original loan principle). This is targeted at high cost lenders, with a target to prevent unmanageable and spiralling debt resulting from borrowing from 'predatory' lenders, the likes of pay-day lenders and truck shops, who have regularly been fined for breaches of various consumer laws[15].

Both change, no change and no change yet at RBNZ

Official cash rate (OCR)

The RBNZ has left the OCR unchanged at 1.75% in the three reviews since the last FIPS quarterly publication[16], with the last OCR change being a decrease in November 2016. The latest review stated that the RBNZ "are well positioned to manage change in either direction – up or down – as necessary" and they will feel they need to provide "continued supportive monetary policy for some time to come", indicating that the OCR was unlikely to move any time soon, and the eventual next move isn't necessarily up.[17]

Review of RBNZ Act

The RBNZ itself has also come under assessment recently, as the government looks to review the Reserve Bank of New Zealand Act, and the role the RBNZ plays in New Zealand. Policy decisions on phase 1 of the review were announced on 26 March 2018, with the key changes being:

- inclusion of supporting maximum sustainable employment alongside price stability as an objective of monetary policy; and
- monetary policy decisions to be made by a committee, which includes external members, with voting results from these decisions to be published.

Phase 2 of the review commenced on 7 June 2018 and has a very broad scope, looking at topics such as institutional governance and prudential regulation, to resourcing and funding.

The results of this review may have a significant impact on the operations and the role the RBNZ plays in the New Zealand economy in the future.

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Digital currency

Digital currency continues to be a topic de jour, with Bitcoin and other digital currencies continuing to create headlines and to have both vocal supporters and detractors. Given the impact that these digital currencies can have both on regulatory risks, such as money laundering, the ability of governments or otherwise to control, to an extent, their national currency, and also the benefits that come with a digital currency compared to physical cash, such as ease of transfer, it was only natural that governments themselves began to look to a 'national digital currency'. New Zealand was no exception. In June 2018, the RBNZ released their position on issuing an official digital currency, which was 'not now'. They discuss the various benefits that a digital currency would have, such as the currency being easier to distribute and efficiency of the system in the future, alongside the current risks and issues, such as that the current block chain structure would actually reduce efficiency of the payments system, the costs of the infrastructure of the system, and various risks that could impact financial stability[18]. Given that this technology and application is relatively new in the global economy, and that the technology is constantly evolving, it is understandable that there is no rush, but the question of a national digital currency is less likely a matter of if, but when.

Analysis of results

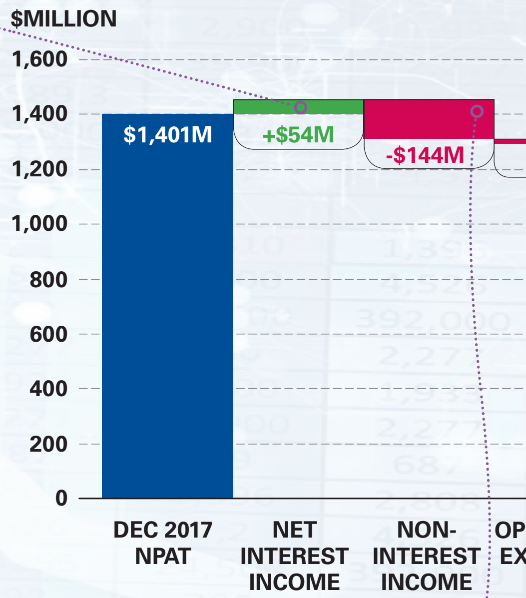
We have presented our analysis of the results for the quarter ended 31 March 2018 on pages 6 to 9. The highlight from this analysis is that net profit has decreased by 11.35% to $1,242 million off the back of record profit in the previous quarter. This has been driven by an increase in net interest income of $54 million being more than offset by a drop in non-interest income of $144 million, an increase in operating expenses of $16 million and an increase in impaired asset expenses of $122 million.

Loan growth has continued its slower path, with TSB's continued strong growth seemingly at the expense of net interest margin, given they have the lowest net interest margin, among the banks analysed in this publication, at 1.80%.

Asset quality has worsened slightly over the quarter, with both provisions and impaired asset expense increasing. Some of this impact will be driven by the adoption of NZ IFRS 9 *Financial Instruments*, but given the increase in individually assessed provisions, it appears some of this may be driven by other events. Whether this trend represents a turning point in the market cycle, or simply variability in results, remains to be seen.

Net profit after tax

Movement in net profit



Net interest income

2.23%

to $2,457 million

Driven by

Westpac

Heartland

BNZ

Net interest margin

24 bps

13 bps

10 bps

TABLE 1: Movement in interest margin

	31 Mar 18 quarter ended (%)[22]	Mvmt. during the quarter (bps)	Mvmt. for the 6 months (bps)	Mvmt. for the 12 months (bps)
ANZ	2.2%	1	2	6
BNZ	2.2%	10	-1	22
CBA	2.0%	-4	1	9
Heartland Bank	4.5%	13	1	15
Kiwibank	2.1%	5	15	28
SBS Bank	2.6%	-8	8	22
The Co-operative Bank	2.3%	1	6	5
TSB Bank	1.8%	0	-4	0
Westpac	2.2%	24	4	34

Non-interest income

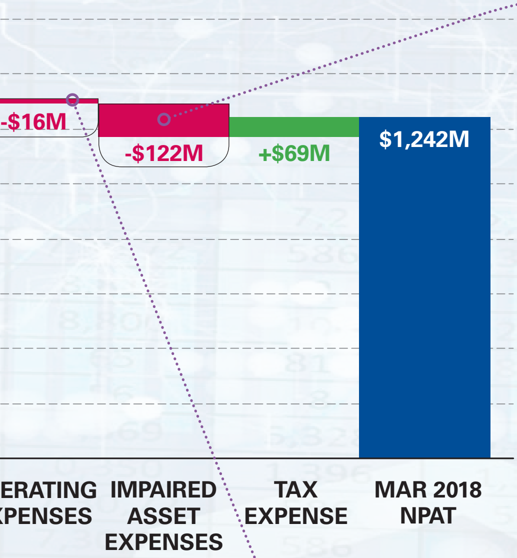
Driven by

ANZ

Westpac

11.35%

to $1,242 million



Impaired asset expenses

263%

up $122 million

Driven by

ANZ	$48M
BNZ	$38M
Westpac	$14M

16.35%

down $144 million

$77m

$70m

Operating expenses

1.21%

up $16 million

Driven by

BNZ	$56m
ANZ	$25m
Westpac	$17m

Lending

Loans

1.04%

to $405,811 million

Quarterly

TSB 2.95%

Heartland 2.48%

Westpac 1.79%

Year on year

TSB 13.96%

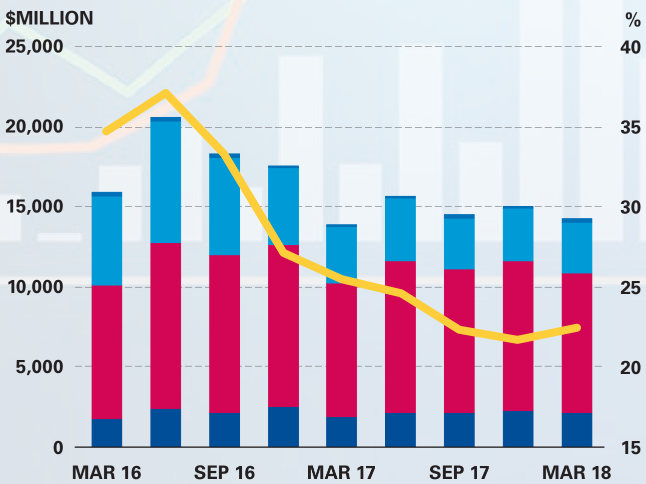
Heartland 12.22%

SBS Bank 11.60%

TABLE 2: Analysis of gross loans

Quarterly analysis	31 Mar 18 quarter ended $Million	31 Dec 17 quarter ended $Million	% Increase
ANZ	126,834	125,803	0.82%
BNZ	80,821	80,408	0.51%
CBA	84,612	83,801	0.97%
Heartland Bank	3,909	3,815	2.48%
Kiwibank	18,247	18,065	1.01%
SBS Bank	3,824	3,782	1.11%
The Co-operative Bank	2,297	2,270	1.21%
TSB Bank	5,335	5,181	2.95%
Westpac	79,933	78,527	1.79%
Total	**405,811**	**401,652**	**1.04%**
Annual analysis	**31 Mar 18 quarter ended $Million**	**31 Mar 17 quarter ended $Million**	**% Increase**
ANZ	126,834	123,404	2.78%
BNZ	80,821	77,154	4.75%
CBA	84,612	80,447	5.18%
Heartland Bank	3,909	3,484	12.22%
Kiwibank	18,247	17,870	2.11%
SBS Bank	3,824	3,427	11.60%
The Co-operative Bank	2,297	2,108	9.00%
TSB Bank	5,335	4,681	13.96%
Westpac	79,933	77,346	3.34%
Total	**405,811**	**389,920**	**4.08%**

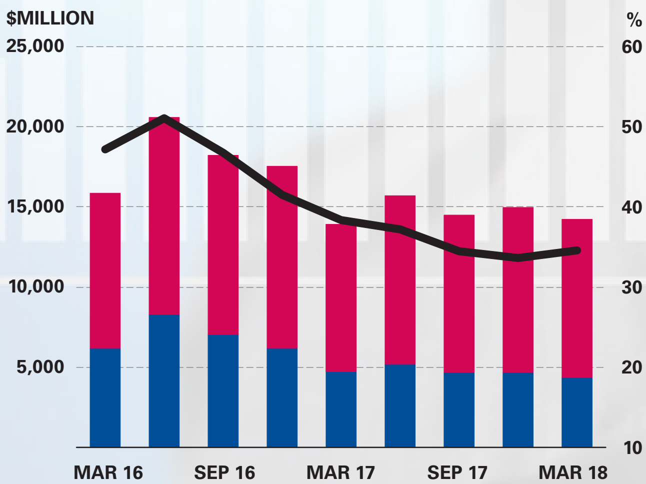
1 NEW MORTGAGE LENDING BY BORROWER TYPE



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

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

2 NEW MORTGAGE LENDING BY PAYMENT TYPE



INTEREST ONLY (INCLUDING REVOLVING CREDIT) (LHS)
PRINCIPAL AND INTEREST (LHS)
PROPORTION OF NEW LENDING INTEREST ONLY – INVESTOR (%) (RHS)

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

Asset quality

Individually assessed provisions

20%

up $67.7 million driven by ANZ $49.7 million

Collectively assessed provisions

3.41%

up $50.3 million driven by BNZ $60.7 million

3 MOVEMENT IN PROVISIONING

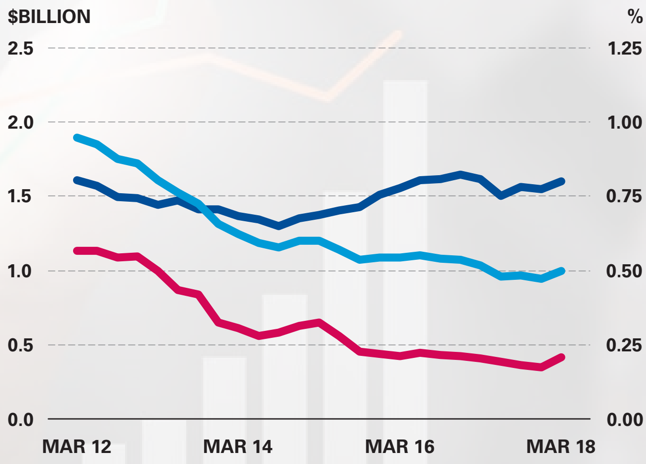
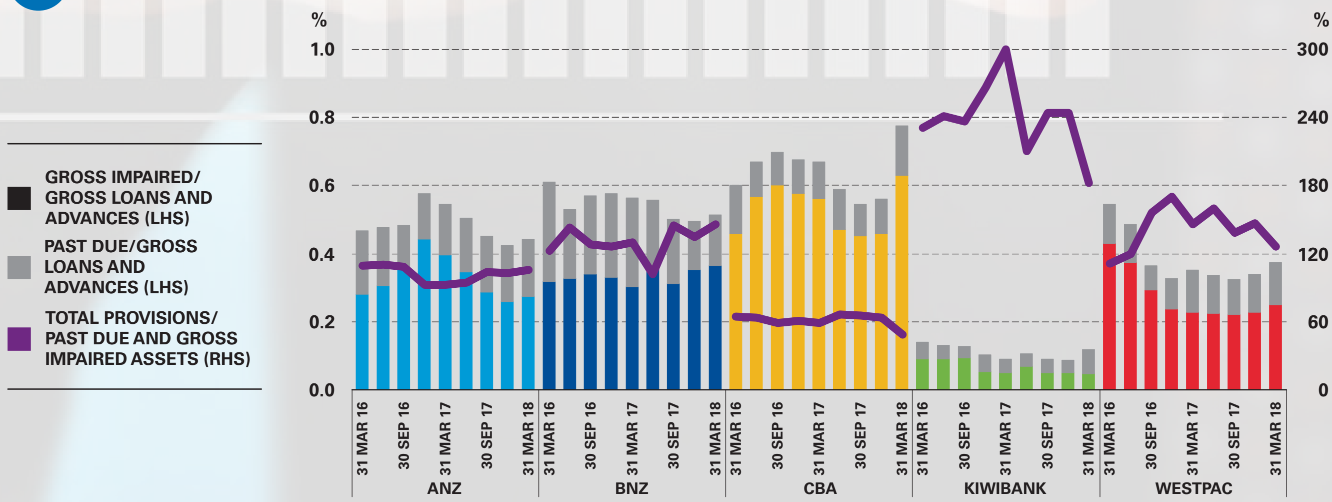


TABLE 3: Movement in impaired asset expense/Average gross loans

	31 Mar 18 quarter ended (%)	Movement during the quarter (bps)	Movement for the 6 months (bps)	Movement for the 12 months (bps)
ANZ	0.19%	15	16	18
BNZ	0.20%	19	-1	8
CBA	0.16%	4	24	11
Heartland Bank	0.60%	3	4	14
Kiwibank	0.03%	25	-22	-2
SBS Bank	0.55%	10	23	22
The Co-operative Bank	0.12%	1	2	1
TSB Bank	0.08%	-2	2	2
Westpac	0.10%	7	24	9
Average	**0.17%**	**12**	**14**	**12**

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

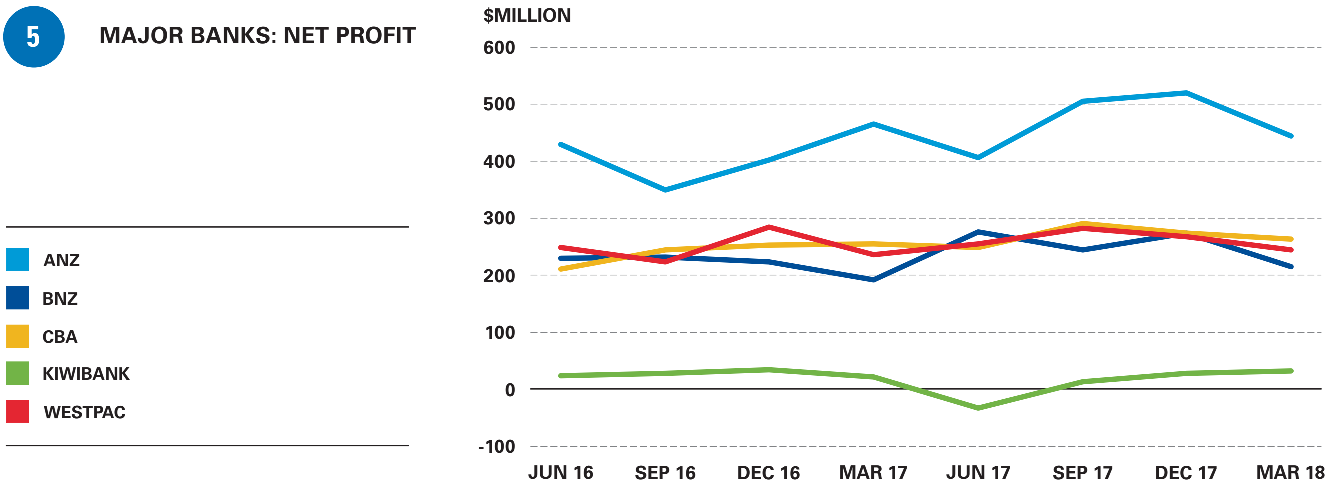


Major banks - Quarterly analysis

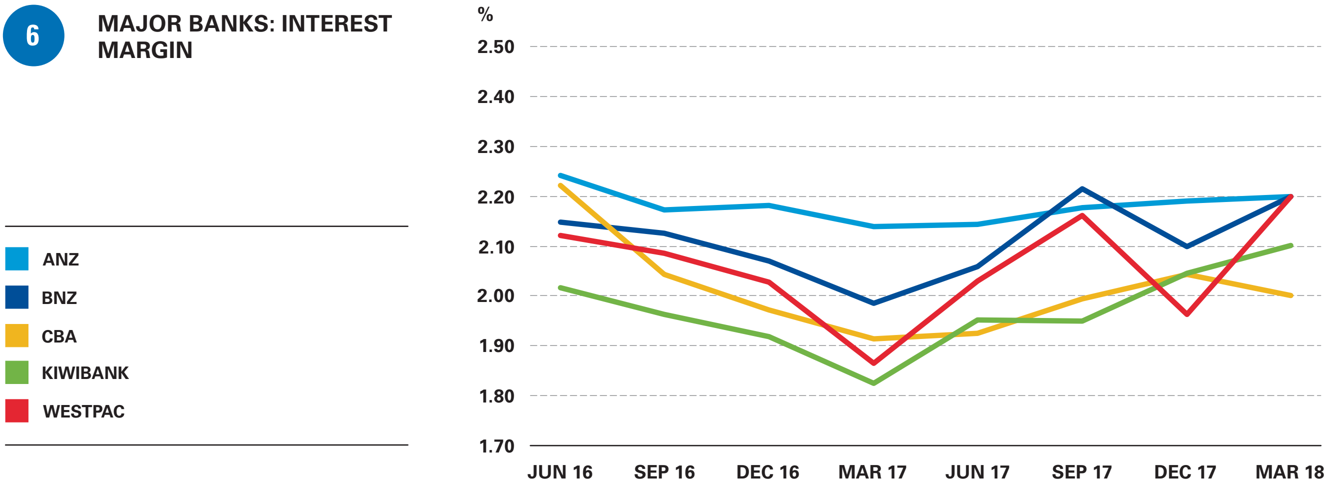
Entity	Size & strength measures							
	30 Jun 16	30 Sep 16	31 Dec 16	31 Mar 17	30 Jun 17	30 Sep 17	31 Dec 17	31 Mar 18
	Total assets[21] ($Million)							
ANZ	166,956	166,706	163,155	161,007	164,071	158,185	160,583	159,719
BNZ[19]	92,093	92,541	94,137	94,023	95,324	95,315	97,742	97,065
CBA	86,127	89,217	91,281	92,077	92,828	92,801	97,762	98,643
Heartland Bank	3,547	3,655	3,820	3,896	4,035	4,222	4,307	4,388
Kiwibank	19,357	19,540	20,008	20,428	20,616	20,449	20,381	20,498
SBS Bank	3,511	3,548	3,745	3,994	4,060	4,237	4,347	4,455
The Co-operative Bank	2,122	2,194	2,272	2,364	2,449	2,527	2,589	2,629
TSB Bank	6,475	6,522	6,629	6,803	6,958	7,072	7,278	7,416
Westpac	92,167	93,358	96,551	92,533	94,215	95,666	96,041	96,216
Total	**472,354**	**477,282**	**481,598**	**477,125**	**484,555**	**480,474**	**491,031**	**491,030**
	Increase in gross loans and advances (%)							
ANZ	1.94	0.43	0.99	0.90	0.93	0.64	0.36	0.82
BNZ[19]	1.80	2.46	2.08	1.19	1.86	1.68	0.63	0.51
CBA	2.38	3.43	1.58	1.06	1.37	0.82	1.93	0.97
Heartland Bank	3.29	4.01	2.93	3.62	2.64	3.78	2.81	2.48
Kiwibank	1.55	1.74	2.59	2.25	-0.08	0.21	0.96	1.01
SBS Bank	3.19	3.15	6.06	5.10	3.45	4.53	2.07	1.11
The Co-operative Bank	4.01	4.97	3.69	3.00	3.25	2.00	2.26	1.21
TSB Bank	3.26	5.32	6.70	4.79	2.97	4.16	3.21	2.95
Westpac	2.88	1.86	0.71	1.03	0.69	0.20	0.64	1.79
Average	**2.22**	**1.91**	**1.48**	**1.19**	**1.18**	**0.89**	**0.90**	**1.04**
	Capital adequacy (%)							
ANZ[20]	14.40	14.30	14.00	14.50	14.20	14.80	15.10	14.40
BNZ[19]	12.48	12.04	13.09	13.29	12.79	13.32	13.47	13.10
CBA[20]	14.30	12.70	13.70	13.80	14.20	14.10	14.80	13.60
Heartland Bank	13.78	12.71	12.96	13.19	13.56	13.04	14.76	14.10
Kiwibank	12.90	12.80	13.40	13.50	13.40	16.00	15.00	15.40
SBS Bank	13.50	13.63	13.27	12.56	11.91	11.35	11.80	12.80
The Co-operative Bank	15.50	16.10	17.50	16.90	16.60	16.60	16.70	16.80
TSB Bank	14.62	14.59	14.65	14.60	14.85	14.55	14.54	14.30
Westpac[20]	14.00	13.10	13.40	14.00	14.00	14.80	14.30	16.60
	Net profit ($Million)							
ANZ	430	349	403	466	406	505	520	444
BNZ[19]	229	233	223	193	276	245	275	215
CBA	211	245	253	255	248	292	275	264
Heartland Bank	15	14	15	16	16	16	15	18
Kiwibank	24	28	35	22	(32)	14	28	33
SBS Bank	7	7	6	6	7	6	7	7
The Co-operative Bank	2	3	3	2	3	3	3	1
TSB Bank	14	14	14	5	11	17	10	14
Westpac	249	224	285	237	255	282	268	246
Total	**1,181**	**1,117**	**1,237**	**1,202**	**1,190**	**1,380**	**1,401**	**1,242**

Entity	Profitability measures							
	30 Jun 16	30 Sep 16	31 Dec 16	31 Mar 17	30 Jun 17	30 Sep 17	31 Dec 17	31 Mar 18
	Interest margin[22] (%)							
ANZ	2.24	2.17	2.18	2.14	2.14	2.18	2.19	2.20
BNZ[19]	2.15	2.12	2.07	1.98	2.06	2.21	2.10	2.20
CBA	2.22	2.04	1.97	1.91	1.92	1.99	2.04	2.00
Heartland Bank	4.53	4.46	4.44	4.35	4.54	4.49	4.37	4.50
Kiwibank	2.02	1.96	1.92	1.82	1.95	1.95	2.05	2.10
SBS Bank	2.57	2.63	2.60	2.38	2.43	2.52	2.68	2.60
The Co-operative Bank	2.51	2.46	2.39	2.25	2.22	2.24	2.29	2.30
TSB Bank	2.02	2.12	2.18	1.80	1.82	1.84	1.80	1.80
Westpac	2.12	2.08	2.03	1.86	2.03	2.16	1.96	2.20
	Non-interest income/Total assets[21] (%)							
ANZ	0.61	0.36	0.47	0.62	0.45	0.72	0.82	0.62
BNZ[19]	0.59	0.55	0.58	0.35	0.74	0.54	0.65	0.63
CBA	0.46	0.62	0.66	0.63	0.61	0.64	0.64	0.56
Heartland Bank	0.44	0.26	0.48	0.37	0.30	0.18	0.39	0.32
Kiwibank	0.45	0.56	0.79	0.51	0.66	0.58	0.69	0.99
SBS Bank	1.00	1.00	0.93	0.79	0.77	0.78	0.85	0.85
The Co-operative Bank	0.93	0.98	0.96	0.58	0.95	0.84	0.89	0.67
TSB Bank	0.21	0.35	0.27	0.21	0.25	0.79	0.29	0.71
Westpac	0.65	0.70	0.67	0.68	0.73	0.57	0.78	0.48
Average	**0.58**	**0.53**	**0.58**	**0.57**	**0.60**	**0.63**	**0.73**	**0.60**
	Impaired asset expense/Average gross loans and advances (%)							
ANZ	0.18	0.14	0.12	0.01	0.04	0.03	0.04	0.19
BNZ[19]	0.15	0.08	0.11	0.12	-0.01	0.21	0.01	0.20
CBA	0.31	0.12	0.10	0.05	0.06	-0.08	0.12	0.16
Heartland Bank	0.63	0.49	0.36	0.46	0.47	0.56	0.57	0.60
Kiwibank	0.02	0.00	-0.05	0.05	-0.13	0.25	-0.22	0.03
SBS Bank	0.21	0.44	0.40	0.33	0.30	0.32	0.45	0.55
The Co-operative Bank	0.08	0.16	0.10	0.11	0.11	0.10	0.11	0.12
TSB Bank	0.07	0.12	0.13	0.06	0.08	0.06	0.10	0.08
Westpac	0.02	0.32	-0.19	0.01	-0.07	-0.14	0.03	0.10
Average	**0.16**	**0.16**	**0.05**	**0.05**	**0.01**	**0.03**	**0.05**	**0.17**
	Operating expenses/Operating income (%)							
ANZ	36.61	43.98	38.24	35.67	39.28	34.30	34.46	35.08
BNZ[19]	39.69	40.28	42.11	42.91	38.65	37.99	38.69	46.85
CBA	37.66	36.03	36.32	36.25	38.02	35.00	35.19	35.69
Heartland Bank	42.55	46.95	43.43	41.23	42.93	43.70	44.54	39.76
Kiwibank	71.30	67.80	64.62	73.04	138.17	78.74	79.41	69.43
SBS Bank	60.30	59.65	62.30	62.36	60.78	67.09	64.26	61.60
The Co-operative Bank	80.27	75.07	72.22	79.33	76.96	74.55	73.32	86.39
TSB Bank	45.26	47.36	48.60	77.37	55.00	47.54	59.48	53.44
Westpac	41.25	38.92	40.69	42.26	43.81	40.03	40.00	39.29
Average	**40.33**	**42.07**	**40.93**	**40.92**	**44.82**	**38.96**	**39.34**	**40.95**

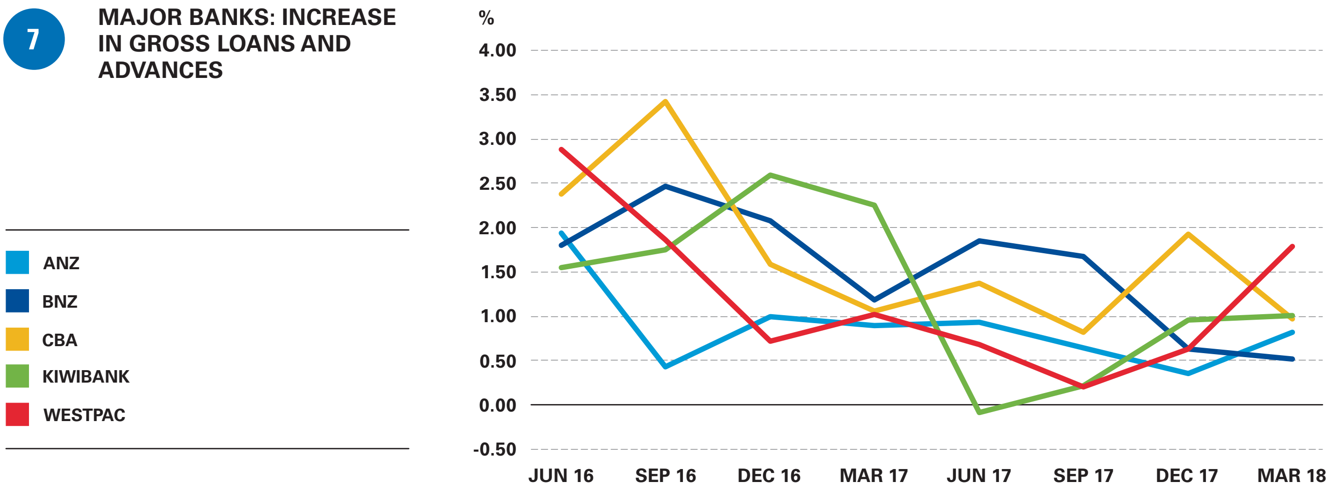
5 MAJOR BANKS: NET PROFIT



6 MAJOR BANKS: INTEREST MARGIN



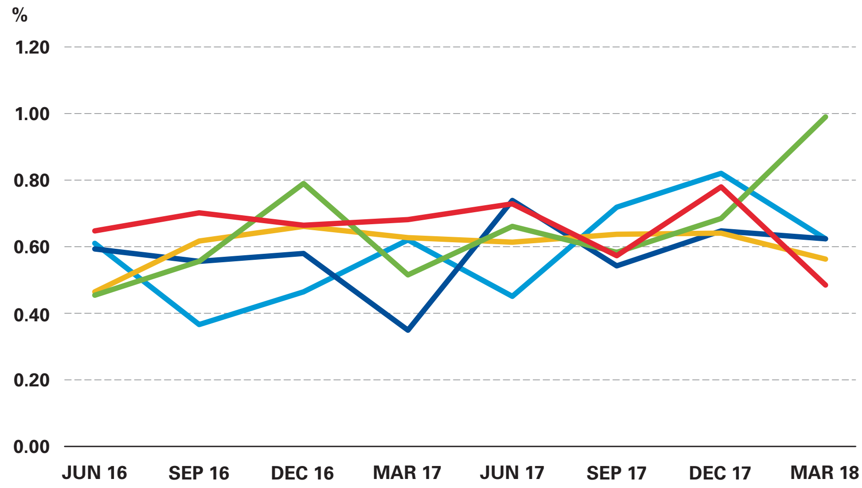
7 MAJOR BANKS: INCREASE IN GROSS LOANS AND ADVANCES



8

MAJOR BANKS: NON-INTEREST INCOME/ TOTAL ASSETS

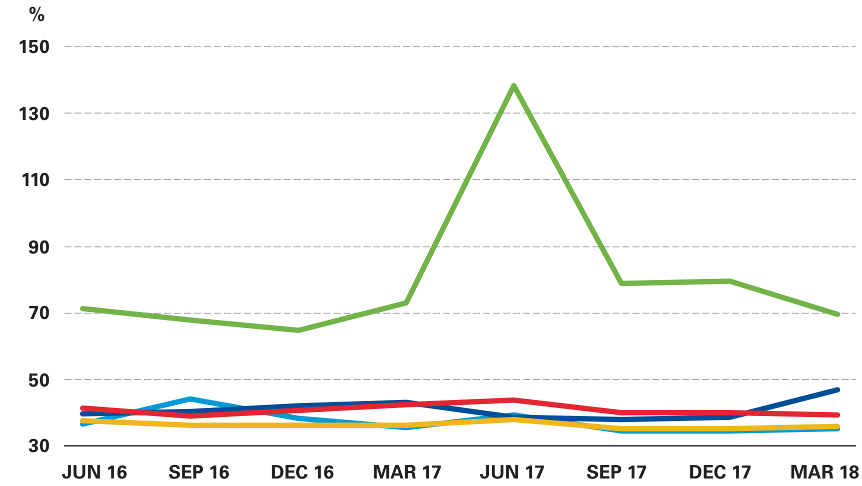
ANZ
BNZ
CBA
KIWIBANK
WESTPAC



9

MAJOR BANKS: OPERATING EXPENSES/ OPERATING INCOME

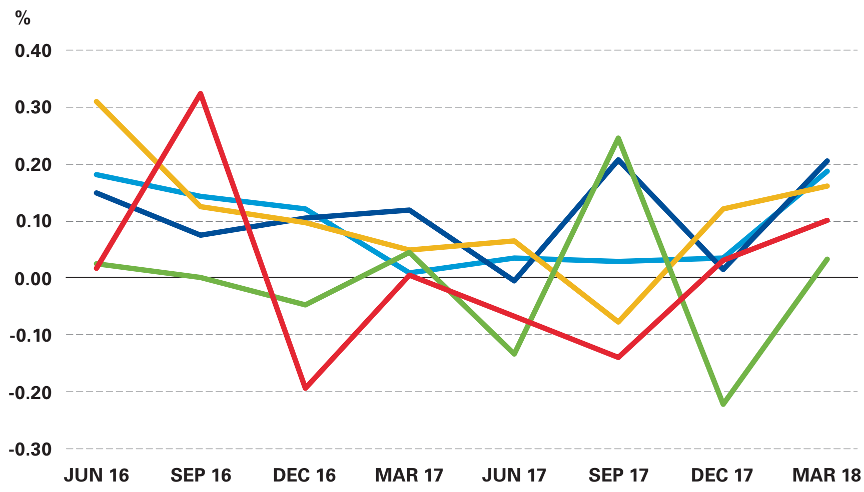
ANZ
BNZ
CBA
KIWIBANK
WESTPAC



10

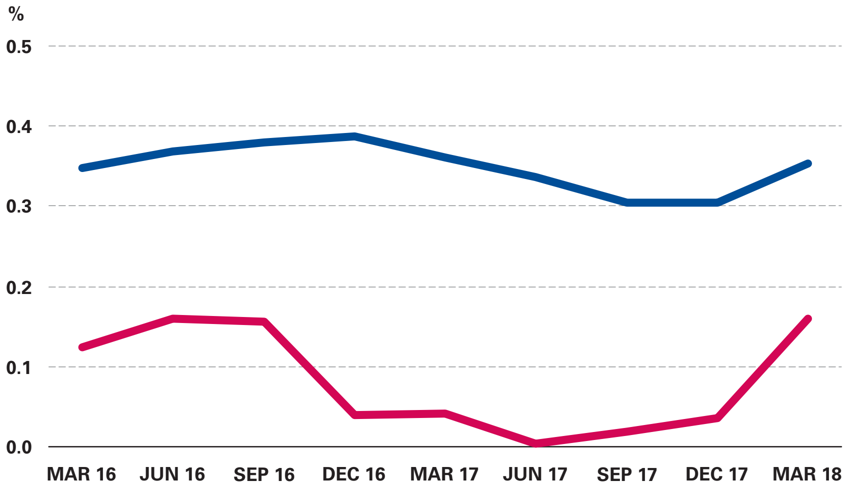
MAJOR BANKS: IMPAIRED ASSET EXPENSE/AVERAGE GROSS LOANS AND ADVANCES

ANZ
BNZ
CBA
KIWIBANK
WESTPAC



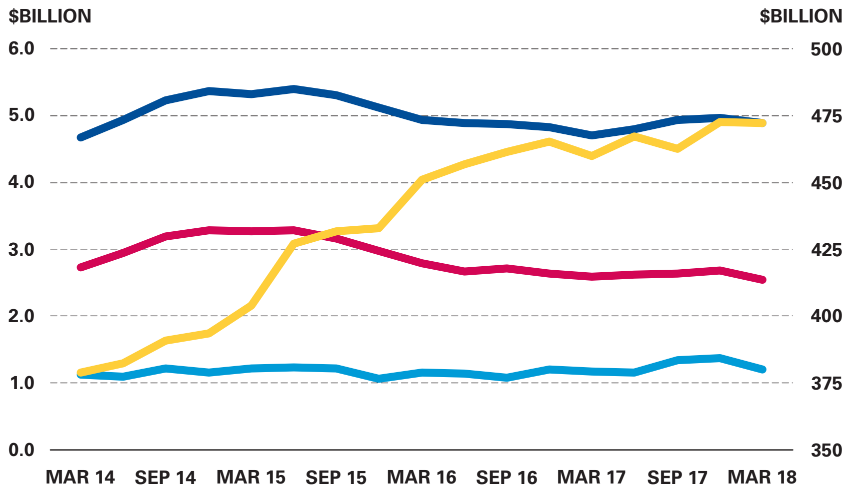
11 MAJOR BANKS: GROSS IMPAIRED VS. IMPAIRED ASSET EXPENSE

- GROSS IMPAIRED LOANS/ GROSS LOANS AND ADVANCES
- IMPAIRED ASSET EXPENSE/ AVERAGE GROSS LOANS AND ADVANCES



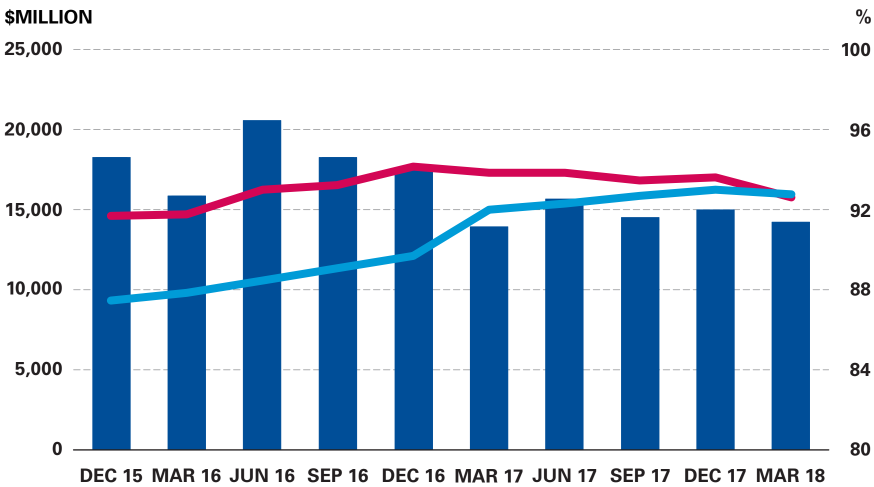
12 MAJOR BANKS: INTEREST EARNING ASSETS COMPARED TO INTEREST INCOME AND EXPENSE

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



13 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

Conduct, culture and achieving the high bar

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Ross is an Associate Director in KPMG's Auckland practice specialising in risk management. In his roles in practice and industry, Ross has worked closely with all three lines of defence across a range of financial services organisations to enhance their conduct risk management frameworks, bringing a wealth of practical examples from his time in the UK to New Zealand.

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Adele is an Associate Director in KPMG's Auckland practice specialising in conduct risk. Adele brings valuable insight and a rich range of experience in approaches to conduct risk across banking and general insurance through her extensive work in the regulatory practice at KPMG UK and her previous roles in the industry.

Since the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services (Royal Banking Commission) commenced public hearings in March 2018, customers of that country's biggest financial services organisations have absorbed revelations on an almost daily basis of standards and behaviours that fall short of "community standards or expectations".

The concept of community standards or expectations is not defined by a rulebook or terms of reference, and is based on an individual's own perception of what they believe is acceptable behaviour, often something that changes and evolves over time. As the fallout continues to occupy the columns of commentators and daily news bulletins, the question this side of the Tasman has turned to what this means to New Zealand, particularly with the country's four largest banks being Australian-owned. Given the nature of these relationships, should New Zealand launch its own Royal Banking Commission into financial services or, as has been suggested by some, is our banking culture so markedly different that the problems arising in Australia would not occur in Aotearoa?

The question itself led the Reserve Bank of New Zealand (RBNZ) and the Financial Markets Authority (FMA) to challenge ten locally incorporated banks to demonstrate how they have obtained assurance that the type of misconduct highlighted in Australia is not taking place in their organisations. Having gathered responses, the culmination of this initial exercise was a joint briefing to the Expenditure Select Committee, with the initial assessment being that, at this point in time, they have not seen evidence of widespread, systemic issues that warrant a commission of inquiry in New Zealand. This was however caveated with the statement that work being currently undertaken by both regulators may test this initial view.

As the FMA and RBNZ continue their work, including extending their request for information to the life insurance sector, the challenge remains for New Zealand's banks to meet the 'high bar' of the regulators' expectations in regard to good conduct and culture.

The 'high bar' and what we have learned from the Royal Banking Commission

When assessing the evidence submitted to the Royal Banking Commission and the content of the public hearings, the regulatory 'high bar' looks set to be raised across three key themes, namely:

- Fair treatment of customers;
- Banks culture, systems and controls; and
- Communication and cooperation with regulators.

Looking at each of the three in turn, we explore some of the issues identified and what any future 'high bar' might look like, based on experiences from banks in other regulatory jurisdictions which have undertaken their own uplifts in conduct and culture standards.

Fair treatment of customers

One of the core tenets of good conduct is ensuring customers receive appropriate outcomes for their circumstances and needs. The Royal Banking Commission's public hearings heard evidence of a series of different practices, in both its consumer lending and advice sessions, where customers received less than satisfactory outcomes, including the following:

- the charging of inappropriate and unexplained fees, including the headline grabbing story of dead customers being charged for services, in one case for a decade;
- charging for unsuitable or unusable add-on services, including where customers did not meet the eligibility criteria; and
- failing to recognise and react to vulnerable customers.

In raising the bar to achieve good customer outcomes, banks in other jurisdictions have had to tackle similar problems head on in the face of significant public and regulatory scrutiny.

In raising the bar to achieve good customer outcomes, banks in other jurisdictions have had to tackle similar problems head on in the face of significant public and regulatory scrutiny. The concept of 'we could but should we?' has been foremost in the mind of C-Suites of major banks, as management have wrestled with the trade-off of activity being legal under the black letter of the law, but outside of the spirit of treating customers in a fair and equitable manner.

This concept has meant revisiting their strategies to consider what is appropriate in areas such as fees and add-ons, with many opting to withdraw or reshape their offerings using the vehicle of robust, customer-focused product governance and review forums as the instrument of change. For fees, this has meant a shift to charging customers for the actual cost of the activity, rather than looking at them as either profit generators or loss-leaders. For add-ons, this has meant expanding the customer sales process to fully validate whether an offering is appropriate. Finally, policies and guidelines have been developed to provide staff with consistent and appropriate approaches for identifying and assisting vulnerable customers.

Bank's culture, systems and controls

W. Edwards Deming famously commented that "nobody goes to work to do a bad job" and that "85% of the reasons for failure are deficiencies in the systems and process rather than the employee". However, the evidence from the Royal Banking Commission has highlighted a series of failures across both culture and processes throughout the banking sector in Australia.

From a cultural perspective, this has included pressure sales to customers exacerbated by leaderboards, staff forging customer signatures and falsifying documentation to push lending through credit assessments, and suggestions of inappropriate behaviours around introducer payments. Moreover, the breakdown of systems and controls has resulted in customers being directly impacted.

Processes that allow conflicts of interest to emerge, failures in system controls to prevent unnecessary charges, and the untimely rectification of problems when they do arise, have all contributed to customers being poorly advised, overcharged and inconvenienced. Processes that allow conflicts of interest to emerge, failures in system controls to prevent unnecessary charges, and the untimely rectification of problems when they do arise, have all contributed to customers being poorly advised, overcharged and inconvenienced.

The Royal Banking Commission's findings highlight the interconnected nature of culture and controls, with weaknesses in one ultimately undermining the strengths of the other.

The Royal Banking Commission's findings highlight the interconnected nature of culture and controls, with weaknesses in one ultimately undermining the strengths of the other. Based on developments in countries who have experienced similar problems, going forward the 'high bar' will be a raising of the standard in both areas, with increased understanding of systems and controls by the business. Part of this will be ensuring adequate frequency of testing by individuals independent of the process, particularly where controls are deemed key to managing the risks. Identification of the right controls will also be a pre-requisite.

Equally critical is the push away from the culture of 'sales volume' to one that places merit on the delivery of good customer outcomes and feedback throughout the customer lifecycle. Maintaining commerciality will always be required, but that should not undermine the need to ensure customers receive products that are suitable for their particular circumstances and, when complaints do occur, that these are dealt with considerately and in a timely manner. In part, revisions of remuneration schemes from sales-based to balanced scorecard approaches should drive this cultural revision, along with rigorously assessed performance management processes, including conduct and behaviour gates.

Communication and cooperation with regulators

Some of the hardest hitting evidence from the Royal Banking Commission related to the relationships between financial services providers and their regulators, with the sliding scale of behaviour ranging from a failure to declare breaches in a timely manner, to an admission of misleading the regulator on multiple occasions.

Some of the hardest hitting evidence from the Royal Banking Commission related to the relationships between financial services providers and their regulators.

When similar issues emerged in the UK, the response was to build controls to address this problem into the Senior Managers & Certification Regime, with all in-scope financial services staff required to be 'open and cooperative' with UK regulators. This policy was augmented by implementing strict reporting deadlines for conduct rule breaches and requiring senior managers to "disclose appropriately any information of which the regulators would reasonably expect notice". Failure to comply as a senior manager covers a range of penalties including unlimited fines and, in more extreme cases, prison sentences of up to seven years. Australia's Banking Executive Accountability Regime includes similar principles within its 'Accountability Obligations' that will come into force from 1 July 2018.

While New Zealand has no 'Individual Accountability Regime' legislation in place or plans to create one of its own, the requirements set out in those created to date make a sound set of principles to follow in meeting the 'high bar'. Concepts of self-identifying and reporting issues at the point of discovery, and generating a culture of staff openness with regulators starting with senior management's 'tone at the top', go a significant way toward ensuring a fair and equitable bi-lateral relationship.

The immediate future

One significant comment in the FMA and RBNZ's feedback was that of mixed maturity in banks' approaches to conduct risk. This ranged from those proactively addressing it to others who have not begun to fully embed it. Noting that each bank will be on its own journey and will have its own set of challenges and priorities, they should not rest on their laurels in assuming that the same issues occurring in Australia do not exist within our current banking system. To this end they should consistently find ways of measuring, assessing and revisiting whether their activities continue to meet "community standards and expectations". With the regulators due to follow up progress, there is no time like the present for banks to assess whether they are equipped to hurdle the 'high bar'.

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19 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.

20 The capital adequacy ratio's reported are for the overseas banking group for quarters ended up to and including 31 December 2017. From 31 March 2018, the capital adequacy ratio reported reflects the ratio of the local registered banking group in line with the information disclosed in the RBNZ Dashboard.

21 For quarters ended 31 December 2017 and earlier, total assets excluded intangible assets. From 31 March 2018, intangible assets are no longer deducted as this information is not available in the RBNZ Dashboard.

22 In line with the information disclosed in the RBNZ Dashboard, the net interest margin is disclosed to 1 decimal place from 31 March 2018 onwards. As interest earning assets is not disclosed in the RBNZ Dashboard, average net interest margin cannot be calculated from 31 March 2018 onwards.

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