KPMG

FIPS

Financial Institutions Performance Survey

June 2016 Quarterly Results

Executive summary

Solid results delivered by a well-positioned banking sector

The banking sector continued to deliver strong results albeit at a slower pace with the quarterly net profit after tax (NPAT) for the sector contracting by 1.18% or $14.05 million, to $1.18 billion from the previous quarter. Profit growth was supported by a $70.29 million increase in net interest income as margins for the banking sector improved by 3 basis points (bps) to 2.20%, and $26.87 million in cost savings derived from lower operating expenses for the sector.

The banking sector continued to deliver strong results.

However, global market volatility and uncertainty in the first half of the year had an impact on profits as non-interest income for the sector declined by $81.66 million compared to March 2016, largely due to fair value losses from hedging activities and financial instruments. The $31.41 million increase in impaired asset expense during this quarter also impacted on the banking sector's profitability. The increase is however in line with a growing loan book.

Lending growth outpaced funding growth for the June quarter

Total tangible assets for the banking sector continued to expand during the June quarter, rising a further 1.29% or $5.96 billion. The quarterly growth of 2.22% or $8.08 billion in sector loans remains a main driver of this increase. However, this was only made possible by strong funding channels.

Total tangible assets for the banking sector continued to expand during the June quarter.

Amongst the major banks, lending grew by 2.18% or $7.69 billion whereas funding only rose by 2.08% or $7.43 billion. As the sector's asset book continues to grow, one key area to keep watch on is the sector's leverage ratio (i.e. total equity/total liabilities) which currently stands at 7.63%, down from a high of 8.06% in the second quarter of 2014.

Economic environment

The last quarter has been relatively quiet as central banks across the world are refocused on stimulating growth and meeting the inflation mandates for their respective economies. To this end, the U.S. Federal reserve (FED) stands out as the only central bank of a major economy that is considering an increase of its interest rate for a second time since the Global Financial Crisis (GFC). The issue is expected to be tabled in November when the FED is scheduled to meet and discuss this again, after having decided to

leave rates unchanged during its most recent meeting in September.

Closer to home, the central banks for both Australia and New Zealand have recently cut their interest rates in August for the second time for the year to a new low of 1.50% and 2.00% respectively, citing lower than expected inflation. With weaker than expected annual CPI inflation of 0.4% for New Zealand as at 30 June 2016[1] and a persistently strong NZD, analysts from the four major banks all expect another downward revision of the Official Cash Rate (OCR) rate by the Reserve Bank of New Zealand (RBNZ) in November.

The RBA and RBNZ continue to have two of the highest official cash rates amongst the central banks.

The post-GFC period has brought about a unique challenge for central banks within today's market as central banks of major economies around the world, including New Zealand, continue to miss their inflation mandates year after year post the GFC. The RBNZ continues to experience limited success in meeting its inflation target in New Zealand despite being in a low interest rate environment, and introducing successive interest rate cuts. Unlike the central banks of other developed economies whose interest rates have been reduced to levels close to 0% and some even into negative territory, at 2.00% New Zealand is still in a position to accommodate further interest rate cuts. However, continued interest rate cuts by the RBNZ can only last so long in an already historically low interest rate environment in New Zealand. This begs the question as to whether the central banks are looking at the right targets (i.e. CPI inflation) when evaluating the success of its monetary policy efforts. A recent report from a Westpac economist highlighted that despite the low CPI inflation for the first half of the year, the New Zealand economy has shown strong performance for the year as it remains on track to deliver GDP growth of approximately 3.2% in 2016[2].

Despite the recent OCR cuts, the RBA and RBNZ continue to have two of the highest official cash rates amongst the central banks, with other major economies' cash rates currently sitting at 0.50% and below[3].

The upcoming U.S. presidential election in November will continue to take the front line of the world stage for the second half of the year. It is anyone's guess how the new U.S. presidential administration could reshape U.S. foreign trade and economic policies. Some might ask, how is this relevant to New Zealand? The GFC has shown us that, thanks to the intertwining of global markets and economies, events that happen in countries as far away as the U.S. can cause flow-on effects onto its trading partners and ultimately New Zealand.

Dairy prices continued to show strong gains the month of September.

August came as an unexpected surprise to dairy farmers as the latest Global Dairy Trade Auctions saw the GDT price index increase by over 20.2% in the month of August alone[4]. The dairy market also continued to show strong gains during the month of September, with the GDT price index rising a further 8.76%[5]. This could be a signal of downward pressures on milk prices easing in the global market, with Fonterra Chairman, John Wilson, attributing the recent change to a possible decrease in supply from both Europe and New Zealand[6]. Wilson and a senior economist at Westpac have both warned that the latest rally should be taken with a grain of salt, and cautiously reminded farmers that after the solid price gains that came through in August/September last year, were followed by a series of consecutive declines in the following periods[7].

Following this development, Fonterra revised its Farmgate Milk Price by a further 50 cents to $5.25/kgMS. Taking this into consideration with the forecast earnings per share of 50 to 60 cents, the total pay out to farmers in the current season is forecasted to be $5.75 to $5.85/kgMS[8]. This puts the forecasted pay out well above the estimated breakeven price of $5.05/kgMS by Dairy New Zealand[9].

1. Annual CPI inflation
2. GDP growth
3. Official cash rates
4. Global dairy trade results in August
5. Latest global dairy trade results
6. Good news for dairy farmers
7. Uncertainty still ahead
8. Fonterra update
9. Forecasted payout

Regulation

The last quarter has been a relatively quiet period, with the RBNZ focusing on the upcoming visit by the International Monetary Fund (IMF) in August and November, and the finalisation of the following consultations that were closed in August:

1. Adjustment to restrictions on high loan-to-value ratio (LVR) residential mortgage lending;
2. Dual registration policy for small foreign banks; and
3. Review of the outsourcing policy for registered banks.

TABLE 1: Movement in Interest Margin	30 Jun 16 Quarter Ended (%)	Movement During the Quarter (bps)	Movement for the 6 Months (bps)	Movement for the 12 Months (bps)
ANZ Banking Group	2.24%	6	2	3
Bank of New Zealand	2.15%	-6	-6	-21
Commonwealth Bank of Australia	2.22%	13	10	2
Heartland Bank[12]	4.53%	-5	-65	10
Kiwibank Limited	2.02%	4	-5	-5
Southland Building Society	2.57%	-4	-6	-29
The Co-operative Bank	2.51%	-10	-20	-30
TSB Bank Limited	2.02%	-1	-6	-10
Westpac Banking Corporation	2.12%	1	-5	-20
Average	**2.20%**	**3**	**-1**	**-8**

The RBNZ announced a new round of adjustments to the LVR restrictions that targeted the risk of financial instability posed by property investor lending.

In July, the RBNZ announced a new round of adjustments to the LVR restrictions that targeted the risk of financial instability posed by property investor lending. This follows a recent statement by Graeme Wheeler, RBNZ Governor, stating the significant risk that property investors pose to the banking system as they account for over 40% of residential property sales in New Zealand[10]. The latest LVR adjustments are no longer focused on the Auckland area alone, but rather the house price inflation situation on a national level, given the attention it has attracted on the international stage. In a recent study released by the Real Estate Institute of New Zealand (REINZ), property prices all across New Zealand are experiencing double digit growth of 11.1% nationally[11]. The new LVR rules effective from 1 October 2016 will see banks restricting their lending to residential property investors across New Zealand with LVR of greater than 60% to no more than 5%, and no more than 10% of lending to an owner-occupier across New Zealand with LVR of greater than 80%.

All four major New Zealand banks have since announced that they have begun to enforce those restrictions well ahead of 1 October 2016[13].

The new LVR rules effective from 1 October 2016 will see banks restricting their lending to residential property investors across New Zealand with LVR of greater than 60% to no more than 5%.

While property investors may not be all too happy about the new restrictions as they came as an abrupt surprise[14], some banks on the other hand are welcoming the move as they see speculation resulting from supply imbalances as a large factor within house price inflation. Recent comments from ANZ NZ CEO David Hisco and The Co-operative Bank CEO Bruce McLachlan, went as far to say that tougher restrictions ought to be implemented, such as requiring a minimum deposit of 60% for property investors[15]. RBNZ estimates that the new set of restrictions would help reduce house price inflation by as much as 5% within a year[16].

In addition to the announcement of the LVR restriction adjustments, Graeme Wheeler, RBNZ Governor, has indicated that the RBNZ is currently working on potential debt-to-income

10. Significant risk from property investors

11. Growth in property prices
12. See footnote 40 on page 17.
13. Bank enforcement of new rules

14. New rules a surprise
15. Restrictions should be tougher
16. Rules seek to reduce house inflation

lending restrictions that could complement the LVR restrictions in cooling an already overheated property market.

On a slightly unrelated matter, the Financial Markets Authority (FMA) is currently undergoing its first funding review since its establishment in 2011. The review proposes to increase the FMA levy from financial service providers to help fund increased operational expenditures as a consequence of a more complex financial services landscape, and a growth in responsibilities with the implementation of the Anti-Money Laundering (AML) legislation and the Financial Markets Conduct (FMC) Act. The proposal could see an increase in levies paid by banks and non-bank deposit takers (with total assets greater than $50 billion) from $340,000 to as much as $540,000[17]. Though this may seem like a significant increase in costs, to quote the FMA, it is worth noting that although banks and non-bank deposit takers account for over 85% of New Zealand's financial assets the levy that they pay only represents 11.2% of the total levy collected.

What else is happening?

In August, Moody's Investors Service revised the credit rating outlook of New Zealand's four biggest banks from stable to negative, but reaffirmed their Aa3 credit rating[18]. This brings them in-line with a recent revision in July by Standard & Poor's (S&P) as to the outlook of Australia's sovereign credit rating and the credit rating of their respective Australian parents, from stable to negative[19].

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In August, S&P downgraded the Banking Industry Country Risk Assessment for New Zealand banks from 3 to 4, with 10 being the highest risk. S&P cited continuing growth in residential property prices as the main driving factor for the decrease[20].

According to the Managing Director of IDC Financial Insights Asia/Pacific, a global IT advisory firm, IT spending by New Zealand banks is on track to be the highest on record of approximately USD$2 billion for the year[21]. Most of which are focused on customer centricity projects that aims to better identify the needs of its customers and to develop products that meet those needs. One such example is Westpac's newly released app, CashNav. CashNav is a money management tool that helps its customers track and better manage their spending habits[22].

IT spending by New Zealand banks is on track to be the highest on record.

In response to the introduction of new capital requirement rules by the Australian Prudential Regulation Authority (APRA), the Australian parent of Westpac New Zealand announced in July an offer of $250 million of unsecured, subordinated, fixed rate notes with unlimited oversubscriptions[23]. The new rules require Australian banking parents to have no more than 5% of its level 1 tier 1 capital from Extended License Entity (ELE) non-equity exposures to New Zealand banking subsidiaries. As at 30 June 2016, Westpac Australia would need to reduce its non-equity exposures by approximately $0.8 billion to be in compliance with this new 5% limit[24].

In late August, ANZ New Zealand announced its intention to offer at least $200 million in fixed rate bonds for a term of five years and seven years, of $100 million each with unlimited oversubscriptions[25].

17. A review of FMA funding levies
18. Moody's revise outlook for big banks
19. S&P outlook downgrade
20. Property prices catalyst for downgrade
21. IT spending by banks
22. Money management tool
23. Westpac fixed rate note offer
24. Compliance needed for new rules
25. ANZ fixed rate bond offer

Quarterly analysis

Profits for the June quarter down despite increase in net interest income and reduction of operating expenses

The June quarter showed NPAT of $1.18 billion for survey participants, down from $1.19 billion reported for the March quarter. The increase in net interest income and reduction of operating expenditure during the quarter was not enough to counteract the decrease in non-interest income and increase in the impaired asset expense.

1 SEE FIGURE 1 – PAGE 8

Margins continue to be squeezed, with some relief coming from the funding side of the balance sheet. There has been an impressive recovery of the net interest income, increasing by $70.29 million for the June quarter. However, additional lending of $8.08 billion did not actually translate to an increase in interest income as interest income fell by $51.29 million for the quarter. Net interest margins improved by 3 bps during this quarter and was mainly driven by a $121.57 million reduction in interest expense, which continues to trend down for the fourth straight quarter.

TABLE 2: Movement in Impaired Asset Expense/ Average Gross Loans	30 Jun 16 Quarter Ended (%)	Movement During the Quarter (bps)	Movement for the 6 Months (bps)	Movement for the 12 Months (bps)
ANZ Banking Group	0.18%	10	9	8
Bank of New Zealand	0.15%	-8	-7	5
Commonwealth Bank of Australia	0.31%	14	17	23
Heartland Bank[26]	0.63%	22	29	1
Kiwibank Limited	0.02%	-8	-5	-1
Southland Building Society	0.21%	-46	-12	-10
The Co-operative Bank	0.08%	3	0	-8
TSB Bank Limited	0.07%	-24	-1	0
Westpac Banking Corporation	0.02%	-4	3	-6
Average	**0.16%**	**3**	**5**	**7**

Although the banking sector experienced a reduction in profitability for the quarter, six out of nine survey participants increased their profits over the quarter with only three participants showing a contraction compared to the previous quarter. BNZ showed the largest deterioration with a $30 million contraction in NPAT compared to the previous quarter, followed by $9 million from CBA and $5 million from Kiwibank.

14 SEE FIGURE 14 – PAGE 18

BNZ's decrease in NPAT for the quarter was attributable to a reduction in net interest income and non-interest income of $7 million and $22 million, respectively. While their impaired asset expense decreased by $13 million, operating expenses rose by 8.10% or $17 million, the largest seen among the survey participants.

CBA saw its non-interest income decrease by $19 million, while operating expenses and impaired assets expense went up by $5 million and $27 million respectively. This was partially offset by an increase in net interest income of $37 million that was fuelled by a 13 bps improvement in margins.

Kiwibank's net interest margin improved by 4 bps for the quarter, leading to a $2 million increase in net interest income. Impaired asset expense was $3 million lower than the previous quarter. However, a $9 million increase in operating expenses and a $4 million decline in non-interest income were the biggest drivers behind their reduction in profitability during the quarter.

13 SEE FIGURE 13 – PAGE 18

SBS and TSB were the front-runners during this quarter with a substantial increase in NPAT levels of 33.46% and

26. See footnote 40 on page 17.

TABLE 3: Analysis of Gross Loans	Quarterly Analysis			Annual Analysis		
	30 Jun 16 Quarter Ended $Million	31 Mar 16 Quarter Ended $Million	% Increase	30 Jun 16 Quarter Ended $Million	30 Jun 15 Quarter Ended $Million	% Increase
ANZ Banking Group	120,588	118,289	1.94%	120,588	113,863	5.91%
Bank of New Zealand	72,898	71,608	1.80%	72,898	67,275	8.36%
Commonwealth Bank of Australia	75,765	74,004	2.38%	75,765	69,269	9.38%
Heartland Bank[27]	3,140	3,040	3.29%	3,140	2,894	8.51%
Kiwibank Limited	16,744	16,489	1.55%	16,744	15,651	6.98%
Southland Building Society	2,980	2,888	3.19%	2,980	2,684	11.04%
The Co-operative Bank	1,880	1,807	4.01%	1,880	1,617	16.29%
TSB Bank Limited	3,975	3,849	3.26%	3,975	3,464	14.76%
Westpac Banking Corporation	74,626	72,537	2.88%	74,626	68,627	8.74%
Total	**372,596**	**364,512**	**2.22%**	**372,596**	**345,343**	**7.89%**

34.17% respectively. Further analysis reveals that this was mainly driven by reduced impaired asset expense for the quarter. For SBS, lower provisions for retail and corporate exposures contributed to reduced reduction in the impairment asset expense while TSB showed lower provision for residential mortgage loans and rural exposures.

From the major banks, ANZ and Westpac showed the strongest NPAT gains with increases of $14 million and $10 million, respectively. ANZ's increase in NPAT was mainly driven by lower funding costs as interest expense was $69 million lower than the previous quarter and operating expenses for the quarter declined by $68 million, which more than offset the reduction in interest income of $40 million, the increase in the impairment expense by $31 million, and the $49 million contraction in non-interest income largely due to fair value movements in its hedging activities and financial instruments.

Similarly, Westpac reported an increase of $8 million in net interest income that was largely attributable to a $21 million decline in the interest expense for the quarter. Non-interest income also improved by an additional $10 million due to an increase in foreign exchange trading; however, that was entirely offset by a $10 million increase in operating expenses.

A summary of the financial performance of the survey participants is as follows:

- net interest income improved by 3.13% or $70.29 million
- non-interest income contracted by 10.74% or $81.66 million
- operating expense reduced by 2.17% or $26.87 million
- impaired asset expense climbed by 26.40% or $31.41 million
- tax expense reduced by $1.86 million.

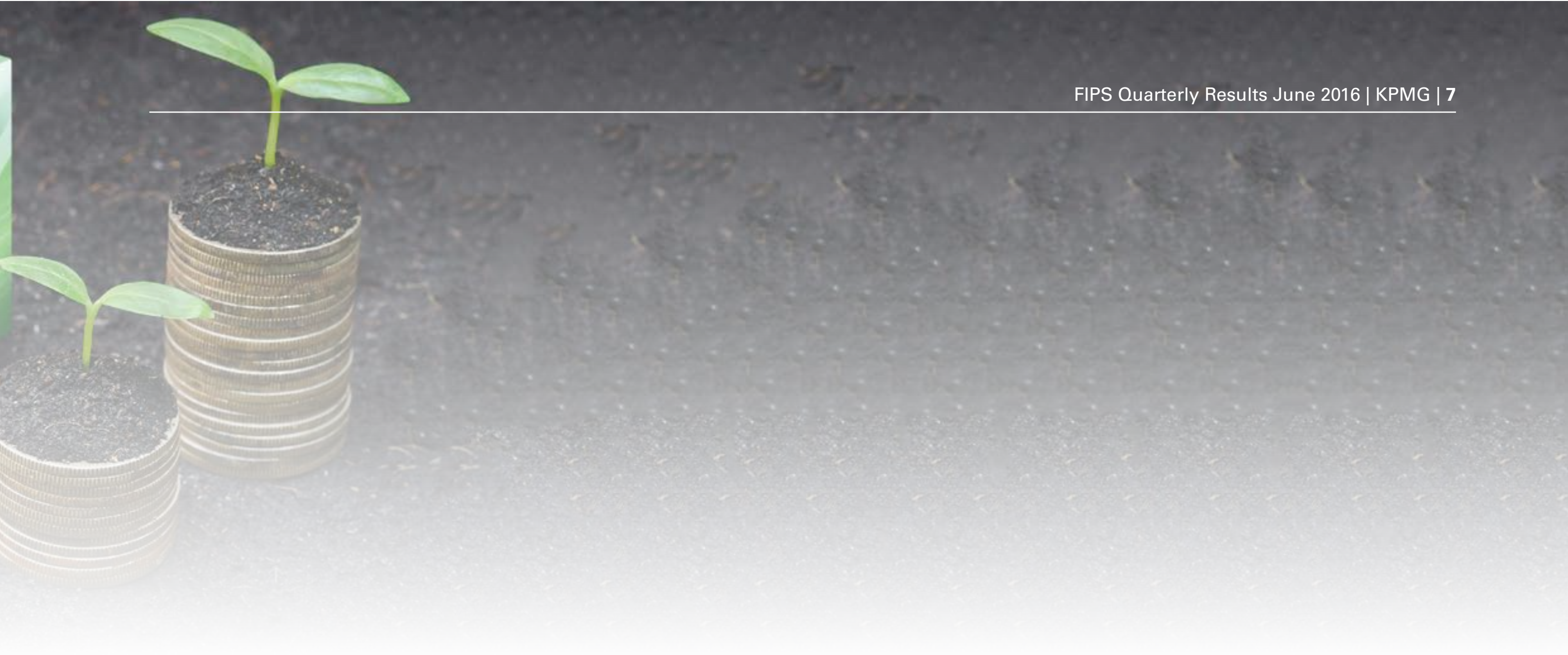
Operating costs ratio

Survey participants continue to have a disciplined approach towards their expenditure, with the banking sector improving its operating cost ratio (i.e. operating expense / operating income) once again this quarter as it reports a 74 bps reduction, down to 40.33% on the previous quarter. The $26.87 million decrease in operating expenses was driven by ANZ, TSB and Heartland. This helped overcome the $11.37 million decrease in operating income for the quarter.

Reduced operating income for the quarter was driven mainly by ANZ and BNZ with a total reduction of $49 million between the two. This reduction is largely attributable to decreases in non-interest income amounting to $71 million, which came from lower fair value gains reported this quarter.

ANZ was able to counteract the reduction in operating income with lower operating expenses of

27. See footnote 40 on page 17.



15.32% or $68 million, whereas BNZ experienced a $17 million increase in operating expenses. ANZ now has the lowest operating cost ratio at 36.61%, followed by CBA at 37.66% and then BNZ at 39.69%.

ANZ and TSB showed the most significant improvement in its operating cost ratio with declines of 580 bps and 640 bps, respectively, both owing to significantly lower operating expenses reported for the quarter.

Overall, five out of nine survey participants were able reduce their operating cost ratio this quarter. The impact from new lending regulations and the need for new innovations that deliver a higher quality of customer services are just some of the challenges that banks have to navigate through.

17 SEE FIGURE 17 – PAGE 19

There is a general consensus that personnel expenses alone account for a significant portion of operating expenses among the major banks in New Zealand. Realigning efforts and resources to core operations that are central to the banks' profitability and strategy are also very important factors in managing costs. In the current environment, banks have to constantly look for ways to reinvent themselves so as to remain agile, responsive to change, and relevant in today's market while maintaining cost discipline.

Margins have slightly improved driven by lower funding costs

Overall the net interest margin for the quarter improved by 3 bps to 2.20%. The most notable movements this quarter came from CBA and the Co-operative Bank. CBA saw their margins increase by an impressive 13 bps during the quarter to 2.22%. On the other hand, the Co-operative Bank saw a 10 bps decline in margins to 2.51% while still maintaining its position with the third highest margin. The remaining banks only saw a movement of 1-6 bps in their margins. See Table 1 on page 3.

Margin growth for CBA came from a combination of efforts that saw a reduction in interest bearing liability holdings and an increase in interest earning asset levels. This translated to a lower interest expense to average interest bearing liabilities ratio of 3.22%, an improvement of 4 bps from the previous quarter. At a time when majority of the banks are facing a declining interest income to interest asset ratio as a result of the OCR cuts and declining mortgage rates in recent quarters, CBA stood out as the only bank that improved its interest income to average interest asset ratio by 8 bps to 5.08%. The remaining banks saw their interest income to average interest earning asset ratio decline by approximately 12-32 bps.

With a lower earnings potential for each dollar of interest earning asset held by the banks due to competitive pressures in a prevailing low interest rate environment, lower cost of funding was the main driver for the modest improvement in margin levels by the banking sector compared to the previous quarter. As a sector, the ratio of interest expense to average interest bearing liabilities declined by 18 bps to 3.03% for the quarter. Lower funding costs, as measured by the level of interest expense relative to average interest bearing liabilities, were reported across all nine banks included in this survey with the extent of cost savings achieved varying from 2 bps by the Co-operative Bank to as much as 37 bps by TSB. Improvements in funding costs will be discussed in further detail under the funding section on page 10.

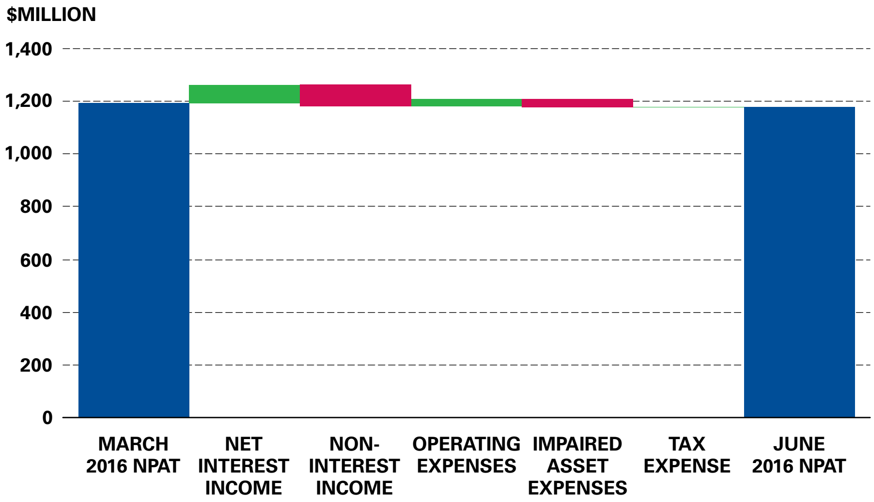
The most recent OCR cut to 2.00% in August[28] has drawn some attention towards the banking sector with media reports citing banks had held back a portion of the OCR cut. In a statement made to the press before the OCR revision, Prime Minister John Key expressed his sentiments about the need for banks to be good corporate citizens and pass on the full OCR cut to its customers[29]. However, Key also cautioned the public to refrain from passing judgement too quickly as the actions taken by a bank needs to be understood in context of a myriad of other factors that the public is not necessarily immediately aware of.

3 SEE FIGURE 3 – PAGE 8

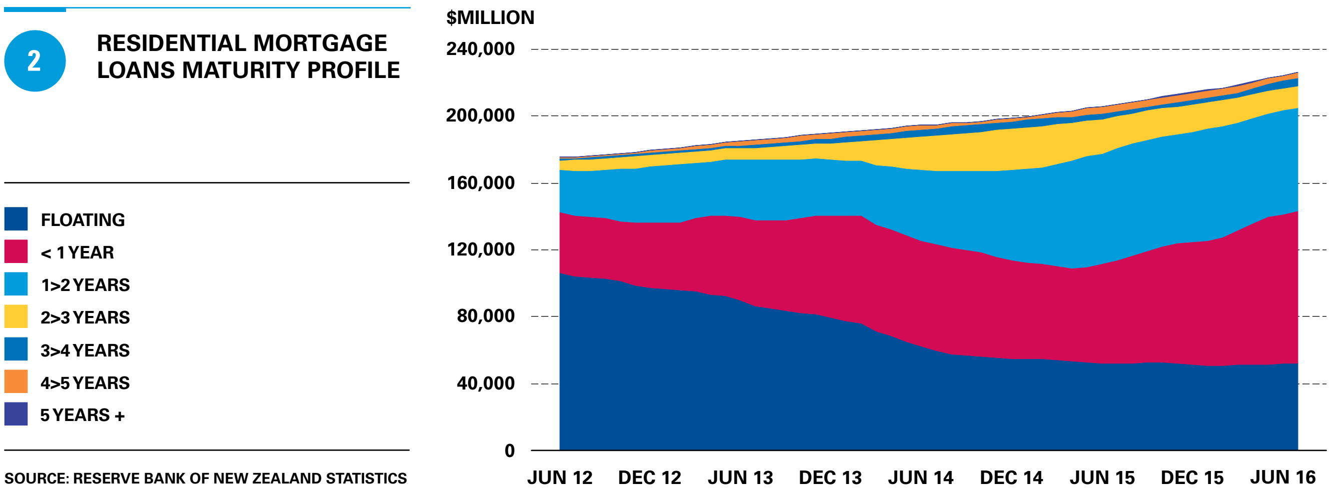
A review of the floating mortgage rates at the end of August revealed that, with the exception of Kiwibank which passed on savings of 20 bps to borrowers, the other four major banks passed on savings of 5-10 bps out of the full 25 bps OCR cut by the RBNZ

28. OCR decisions
29. Passing on OCR cuts

1 MOVEMENT IN NET PROFIT AFTER TAX

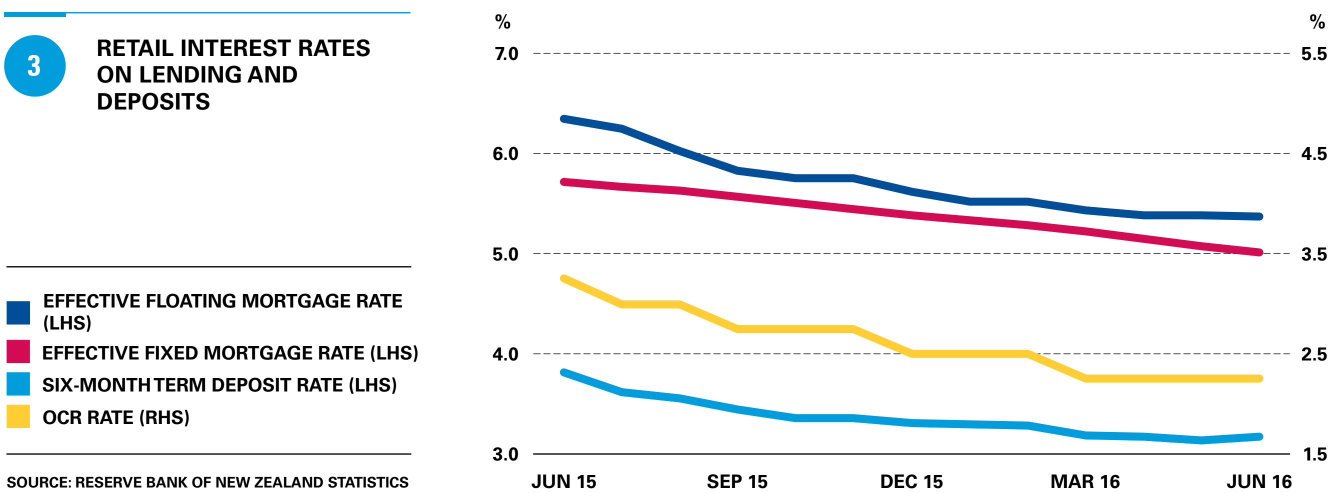


2 RESIDENTIAL MORTGAGE LOANS MATURITY PROFILE



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

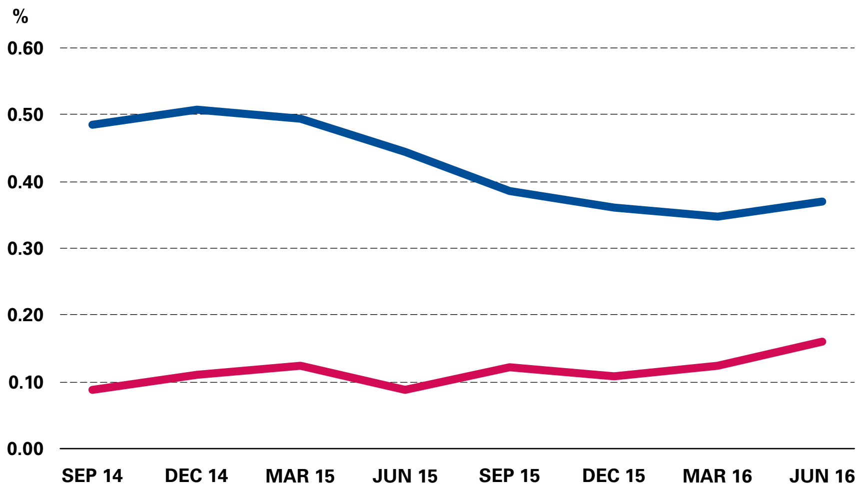
3 RETAIL INTEREST RATES ON LENDING AND DEPOSITS



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

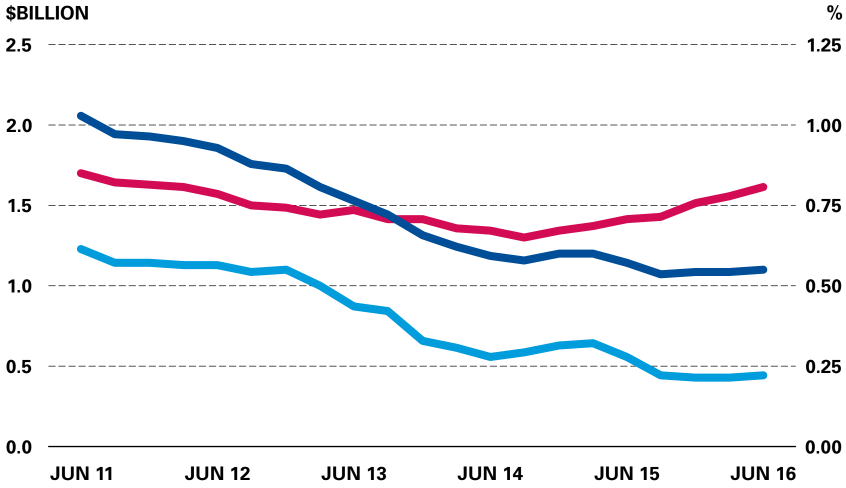
4 MAJOR BANKS: GROSS IMPAIRED VS IMPAIRED ASSET EXPENSE

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



5 MOVEMENT IN PROVISIONING

- TOTAL PROVISION FOR DOUBTFUL DEBTS/ GROSS LOANS AND ADVANCES (RHS)
- COLLECTIVE PROVISION (LHS)
- INDIVIDUAL PROVISION (LHS)



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

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

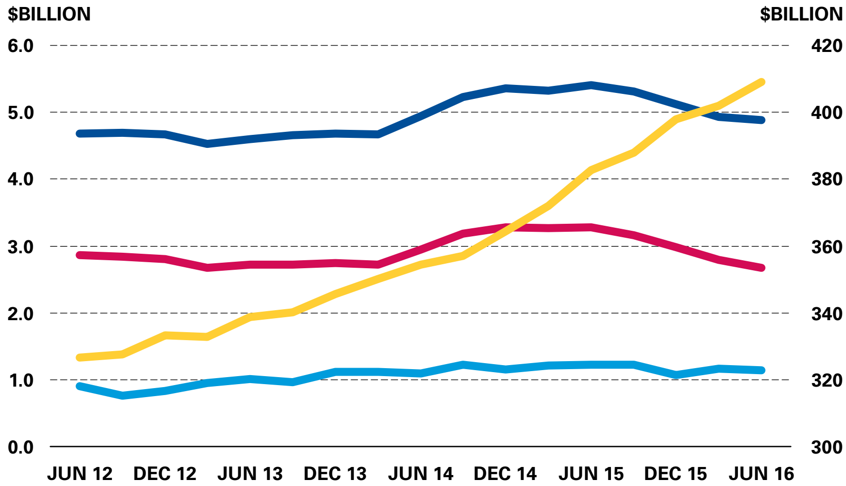


TABLE 4: Movement in Over 80% LVR Lending (On and Off Balance Sheet)								
	Quarterly Analysis				Six Month Analysis			
Quarterly Analysis	**30 Jun 16 $Million**	**31 Mar 16 $Million**	**Movement During the Quarter $Million**	**% Change**	**30 Jun 16 $Million**	**31 Dec 15 $Million**	**Movement During the Six Month Period $Million**	**% Change**
ANZ Banking Group	7,829	8,166	-337	-4.13%	7,829	8,286	-457	-5.52%
Bank of New Zealand	3,289	3,251	38	1.17%	3,289	3,201	88	2.75%
Commonwealth Bank of Australia	7,323	7,505	-182	-2.43%	7,323	7,688	-365	-4.75%
Heartland Bank[31]	21	23	-1	-5.97%	21	22	-1	-3.90%
Kiwibank Limited	1,592	1,862	-270	-14.50%	1,592	1,943	-351	-18.06%
Southland Building Society	314	316	-1	-0.44%	314	325	-11	-3.39%
The Co-operative Bank	210	196	14	6.90%	210	186	24	12.65%
TSB Bank Limited	392	383	8	2.16%	392	388	3	0.83%
Westpac Banking Corporation	7,690	7,664	26	0.34%	7,690	7,722	-32	-0.41%
Total	**28,660**	**29,366**	**-706**	**-2.40%**	**28,660**	**29,762**	**-1,102**	**-3.70%**

in August[30]. The latest adjustment sees Kiwibank with the lowest floating rate of the major banks at 5.25%, whereas the other four major banks were hovering around the 5.55% to 5.65% range[32]. An ANZ economist has fairly cited a number of factors for this, including credit growth outpacing funding growth, higher offshore funding costs, and funding pressures as possible reasons as to why banks were not passing on the full 25 bps cut[33]. In addition, it is also well understood that the cost at which funding is obtained by the banks is not solely based on the OCR rates alone, but a variety of other factors and borrowing sources that involves the bank paying some level of premium on top of the OCR.

A retrospective review of margins as far back as the fourth quarter of 2014, when margins were at 2.34% for the sector as a whole shows a steady decline to where they now sit at 2.20% as at June 2016. It is therefore understandable why banks were reluctant to pass on the full OCR cuts when they began in June last year. With economists expecting another OCR cut before the end of the year, it would be interesting to see if the recent attention and pressure from public opinion would be sufficient to convince the banks to share more of the savings with its customers.

Funding conditions continue to be favourable

In spite of market pressures and expectations from analysts, funding costs for the banking sector improved considerably for the sixth straight quarter as interest expenses relative to average interest bearing liabilities contracted a further 18 bps for the June quarter to a new low of 3.03%, post-GFC. Since the fourth quarter of 2014, the sector has brought down funding costs by as much as 26.46%, or 109 bps from 4.12%. During the same period, the OCR dropped 125 bps from 3.50% to 2.25%. All nine of the banks surveyed this quarter reported lower funding cost in the range of 2-37 bps.

The Co-operative Bank now has the highest funding cost per dollar of

30. Some OCR cuts passed on
31. See footnote 40 on page 17.
32. Adjusted floating rates
33. Why cuts not passed on

interest bearing liability at 3.85%, followed by Heartland at 3.81% which reported a 14 bps reduction in interest expenses relative to average interest bearing liabilities. Heartland continues to have the highest net interest margin at 4.53% as it continues to push efforts in a niche market and offering products that are not normally offered by any of the major banks. One such example of its efforts is the offer for reverse mortgages, for which only SBS is the competitor to it in this space[34].

7 SEE FIGURE 7 – PAGE 12

The five major banks were able to push total interest expenses for the quarter down by $117 million or 4.20%, all the while increasing its interest bearing liabilities by $3.34 billion or 0.95%.

Going forward the banking sector will face an uphill battle to reduce funding costs further given the increased competition arising from new market entrants in recent years, introduction of new capital restrictions by APRA that limits the amount of funding banks are able to receive from their Australian parent, and the substantial increase in market volatility and uncertainty in just the last 12 months alone. The U.S. presidential election in November is one event that financial markets around the world are paying particular attention to as to the outcome.

Funding continues to be a key component of a banks' growth strategy as banks are only able to lend as much as they are able to borrow, at a cost that is no less than what they borrowed at. An ANZ economist has pointed out that one critical issue banks are challenged to deal with at the moment is securing sufficient and affordable funding to appease New Zealand's appetite for more credit. A recent report from Westpac economists also showed that household debt relative to disposable income is on an upward trajectory, exceeding pre-GFC levels in the last year alone[35]. At the moment credit growth in the banking sector has notably begun to outpace funding growth over the last year. Among the major banks, lending grew by $7.69 billion during the June quarter while only $7.43 billion in additional funding was secured.

9 SEE FIGURE 9 – PAGE 12

According to RBNZ statistics, the core funding ratio for the banking sector continues to remain strong at 87.5% for the month of July 2016. Although this is a slight dip from 88.0% the year before, the overall upward trajectory of the core funding ratio paints a positive picture for increased financial stability in New Zealand.

Lending continues to grow at a fast rate

Sector lending continues to grow for yet another quarter, recording the highest and second fastest quarterly growth in the last five years of 2.22% or $8.08 billion. The major banks continue to gain momentum accounting for 95.17% of the $8.08 billion in total lending growth. Of the major banks Westpac achieved the greatest percentage growth of 2.88% or $2.09 billion, closely followed by CBA with 2.38% or $1.76 billion. The Co-operative Bank achieved the highest percentage growth rate of the banks at 4.01% or $72.50 million, while the smallest incremental percentage increase was reported by Kiwibank at 1.55% or $255 million. Intense lending growth reported in the last few quarters have indicated that previous LVR restrictions have not hampered lending growth in the banking sector, resulting in the RBNZ introducing tighter LVR restrictions in July, which are set to take effect as at 1 October 2016. According to RBNZ statistics, dairy lending accounted for $40.08 billion of total lending as of the end of June, equating to just over 10% of total lending for the nine banks included in the survey[36].

15 SEE FIGURE 15 – PAGE 18

Based on RBNZ statistics, the last quarter has seen a 29.87% or $4.74 billion increase in new residential mortgage lending by the banking sector. The largest part of the growth came from a 39.21% increase in new lending to investors, while new residential mortgage lending for first home buyers and other owner occupier mortgages increased by 30.89% and 23.91%, respectively.

Despite strong lending growth and increased interest earning assets of 1.83% or $7.64 billion, interest income has softened a further 1.00% or $51.29 million for the quarter as a result of lower mortgage lending rates that were largely fuelled

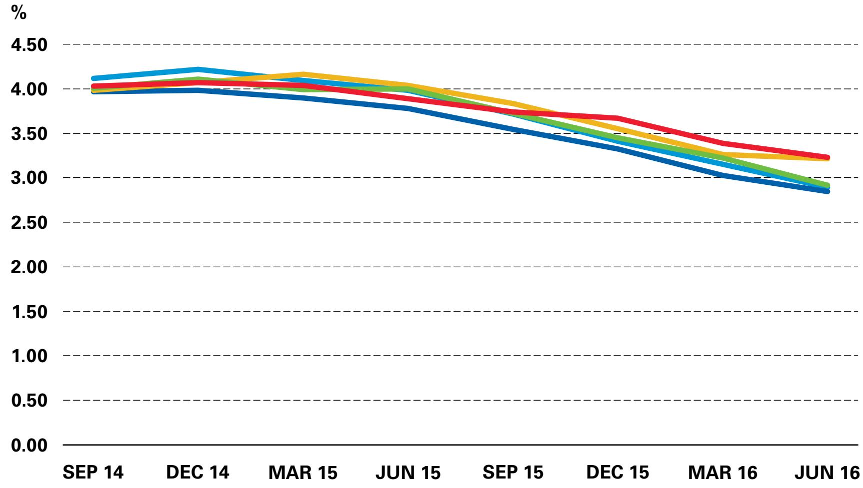
34. Reverse mortgages

35. Household debt vs disposal income

36. RBNZ Statistics

7 MAJOR BANKS: AVERAGE COST OF FUNDING

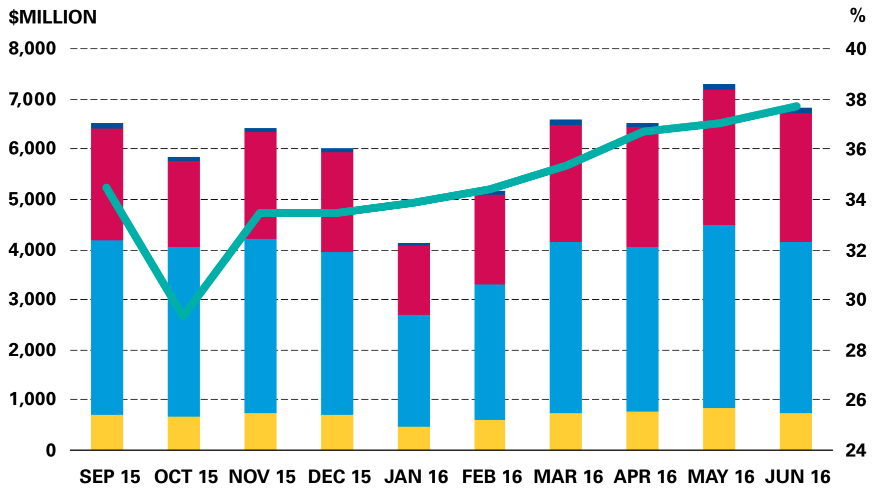
ANZ
BNZ
CBA + ASB
KIWIBANK
WESTPAC



8 NEW MORTGAGE LENDING BY BORROWER TYPE

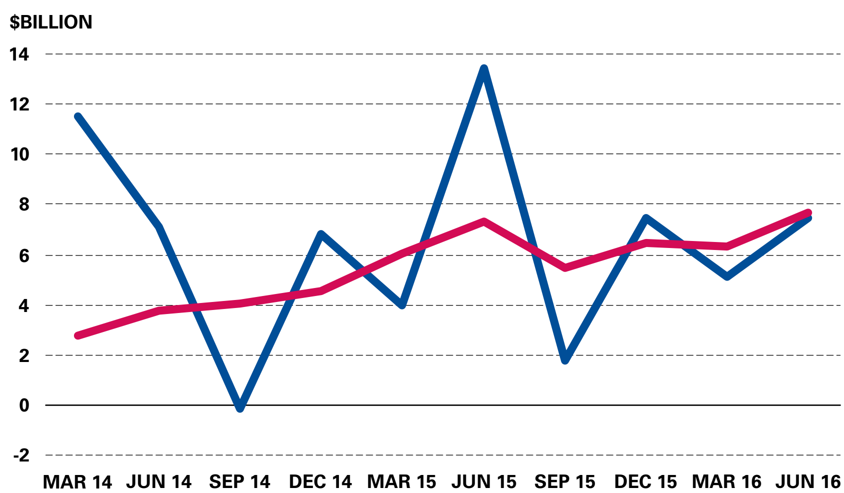
BUSINESS PURPOSES
INVESTOR
OTHER OWNER OCCUPIER
FIRST HOME BUYER
INVESTOR LENDING (%)

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

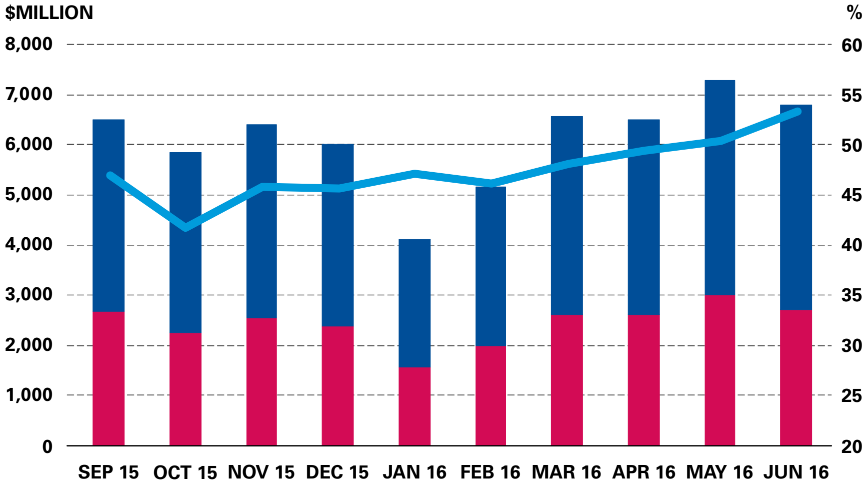


9 MAJOR BANKS: BORROWING GROWTH VS LENDING GROWTH

GROWTH IN BORROWING
GROWTH IN LENDING



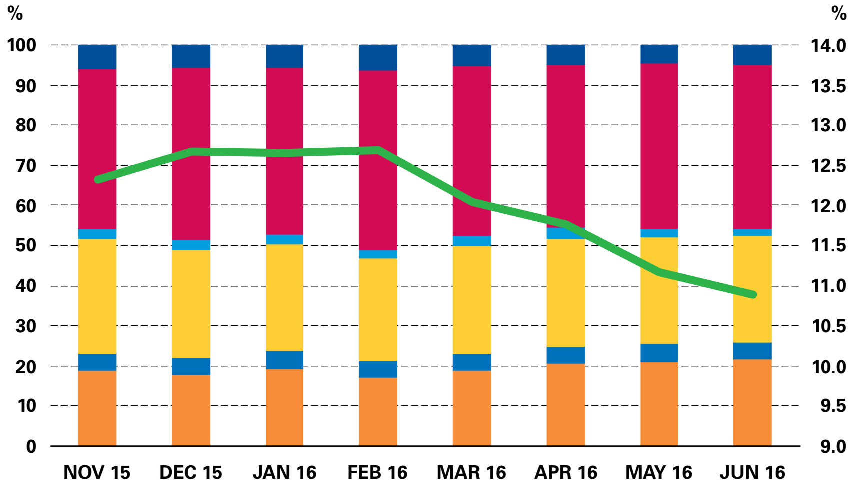
10 NEW MORTGAGE LENDING BY PAYMENT TYPE



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

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

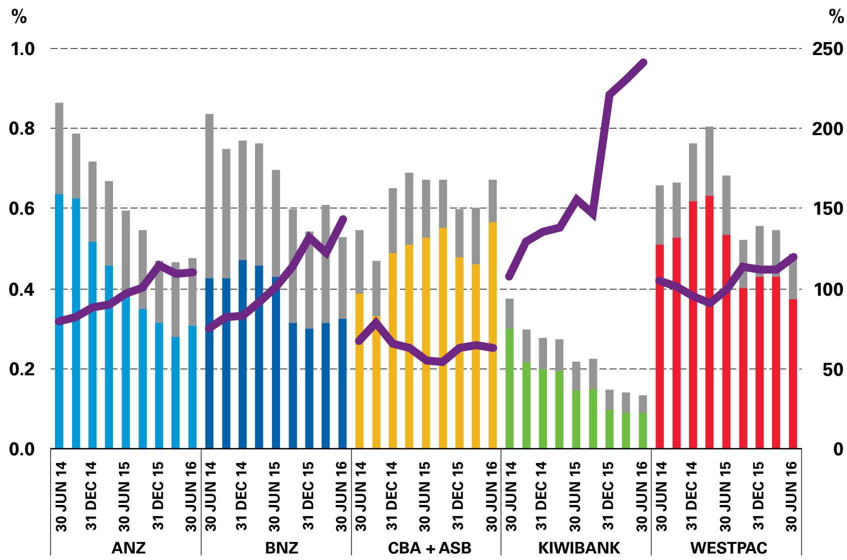
11 COMPOSITION OF LENDING BY LVR SPEED LIMITS



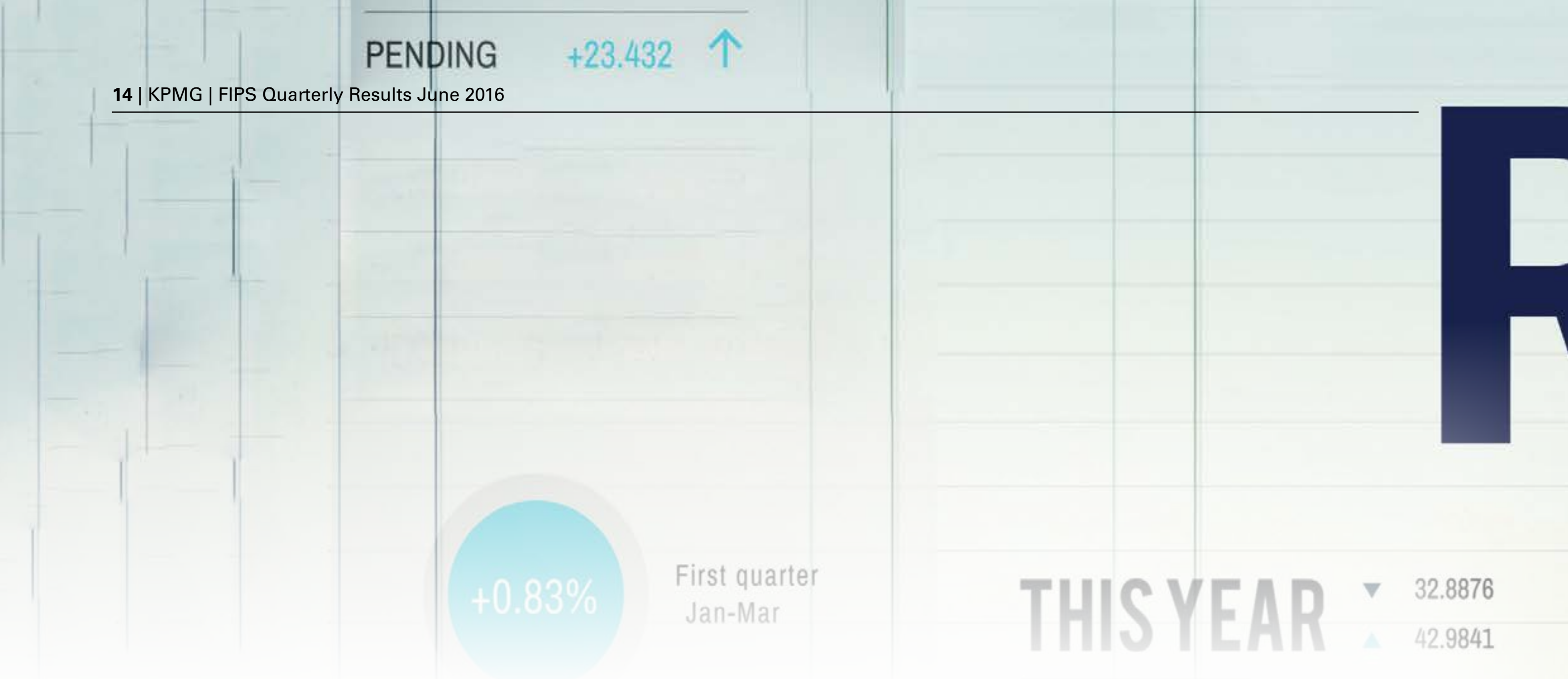
NON-AUCKLAND LVR > 80%
NON-AUCKLAND LVR < 80%
AUCKLAND OWNER-OCCUPIER LVR > 80%
AUCKLAND OWNER-OCCUPIER LVR < 80%
AUCKLAND INVESTOR LVR > 70%
AUCKLAND INVESTOR LVR < 70%
TOTAL LENDING OUTSIDE LVR SPEED LIMITS/TOTAL LENDING

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

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



GROSS IMPAIRED/GROSS LOANS AND ADVANCES (LHS)
PAST DUE/GROSS LOANS AND ADVANCES (LHS)
TOTAL PROVISIONS/PAST DUE AND GROSS IMPAIRED ASSETS (RHS)



by competitive pressures and a declining OCR.

8 SEE FIGURE 8 – PAGE 12

Asset quality showing some signs of deterioration

Impaired asset expense (i.e. movement in collective and specific provisions, excluding impact of bad debts written-off during the quarter if they have already been expensed in prior periods) for the quarter has increased by 26.40% or $31.41 million, driven mainly by ANZ and CBA reporting increases of $31 million (134.78%) and $27 million (87.10%) respectively. ANZ's movement was driven by a significant growth in impaired asset expense relating to non-retail exposures. On the other hand, BNZ and Westpac reported decreases in the impaired asset expense of $13 million (32.50%) and $7 million (70.00%) respectively for the quarter. Further analysis showed that the impaired asset expense relative to average gross loans and advances increased marginally by 3 bps to 0.16% for the June quarter for the survey participants. See Table 2 on page 5.

Past due assets have improved for the quarter by $106.33 million, entirely reversing the increase of the last quarter of $89.61 million. Driving this result were BNZ and CBA, who reported reductions of $63 million and $27 million respectively while Westpac disclosed no movement for the quarter.

Continued economic uncertainty from Brexit, China's slowing economic growth and a continued low forecast of milk pay-outs has seen the banks increase their total provisions by $72.88 million for the quarter. The largest drivers for this were ANZ, BNZ and CBA. CBA increased its total provision by $34 million as at 30 June 2016 compared to last quarter, while ANZ's total provision increased by $27 million driven by an increase in non-retail exposures. BNZ's total provisions increased by $17 million.

18 SEE FIGURE 18 – PAGE 19

The 3.68% increase in total provisions is largely in-line with the 2.22% increase in lending recorded by the banking sector for the quarter. However, looking at the trend over the last five years, it is noted that since the March 2011 quarter, total provisions relative to average gross loans and advances fell from 1.11% to 0.55% for the June 2016 quarter. It is not surprising that in a low interest rate environment, asset quality remains sound and could also be reflective of a banking sector that is striving to grow their loan books in a sustainable way, as banks have to now be more selective in who they lend to, given that lending growth continues to outstrip funding growth, and other lending restrictions (LVR rules) that are in place. In addition, a number of banks' CEO's have expressed caution as to where the lending trajectory could take the economy and counselled restraint.

Capital adequacy ratio

Four out of nine survey participants reported a slightly weaker capital adequacy position with declines of 10-30 bps to their total capital adequacy ratio for the quarter. On the other hand, ANZ, CBA and TSB Bank reported increases of 10-70 bps while Kiwibank and Westpac noted no change to their total capital adequacy ratio of 12.90% and 14.00%, respectively. ANZ reported the largest increase of 70 bps to 14.40% among survey participants.

At 15.50%, the Co-operative Bank continues to report the highest total capital adequacy ratio despite a 30 bps decline for the quarter. Overall the banking sector continues to be well capitalised and in a good position to meet its capital adequacy requirements. With lending continuing to increase at a fast rate, the banking sector will also need to continue monitoring that the growth of its capital reserves is keeping pace with the growth of its loan books.


ROI
+83.0
+41.9
+22.6
JAN-DEC
JAN-DEC
JAN-DEC
GLOBAL MAP

Major banks - Quarterly analysis

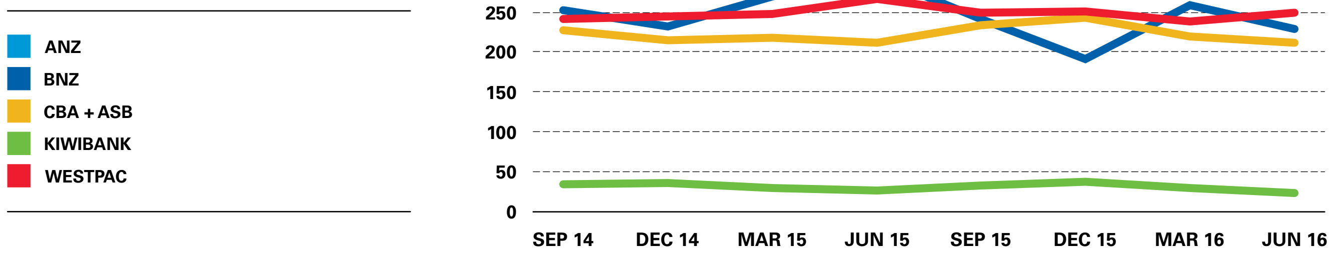
Entity	Size & Strength Measures							
	30 Sep 14	31 Dec 14	31 Mar 15	30 Jun 15	30 Sep 15	31 Dec 15	31 Mar 16	30 Jun 16
	Total Assets[37] ($Million)							
ANZ[37]	135,074	135,290	140,253	150,664	152,038	152,289	160,801	163,538
BNZ	79,522	79,658	81,926	85,657	86,629	86,819	89,913	91,906
CBA + ASB[37]	73,483	74,149	76,994	80,147	81,321	81,785	86,012	85,678
Heartland Bank[40]	2,431	3,112	3,148	3,308	2,825	3,290	3,334	3,489
Kiwibank	16,882	17,064	17,948	18,228	18,686	18,858	19,227	19,199
Southland Building Society	2,825	2,826	2,858	3,094	3,163	3,286	3,408	3,506
The Co-operative Bank Limited	1,704	1,770	1,795	1,838	1,896	1,971	2,029	2,109
TSB Bank Limited	5,736	5,908	5,908	5,991	6,208	6,299	6,424	6,475
Westpac[37]	80,963	82,442	82,087	87,455	88,203	88,416	90,309	91,518
Total	**398,619**	**402,219**	**412,917**	**436,382**	**440,968**	**443,014**	**461,455**	**467,418**
	Increase in Gross Loans and Advances (%)							
ANZ[37]	1.31	1.53	1.75	3.60	0.86	1.51	1.47	1.94
BNZ	0.93	1.16	1.57	1.01	1.72	2.35	2.24	1.80
CBA + ASB[37]	1.87	1.19	2.75	2.04	2.29	2.53	1.87	2.38
Heartland Bank[40]	3.15	33.06	1.55	3.65	-16.53	22.19	3.02	3.29
Kiwibank	0.66	2.20	2.04	1.50	2.24	2.51	0.53	1.55
Southland Building Society	-0.10	2.88	2.50	11.34	2.71	2.04	2.67	3.19
The Co-operative Bank Limited	2.74	2.93	2.19	3.24	4.28	4.23	2.87	4.01
TSB Bank Limited	0.20	3.04	1.73	5.27	3.39	4.57	2.80	3.26
Westpac[37]	1.24	1.67	1.51	1.57	1.99	1.38	2.22	2.88
Average	**1.30**	**1.68**	**1.88**	**2.34**	**1.51**	**2.09**	**1.85**	**2.22**
	Capital Adequacy (%)							
ANZ[37, 38]	12.70	11.80	12.60	12.50	13.30	13.30	13.70	14.40
BNZ	12.04	12.28	12.90	12.59	12.67	13.26	12.58	12.48
CBA + ASB[37]	11.10	12.70	12.10	12.70	13.30	14.10	13.70	14.30
Heartland Bank[40]	14.09	13.76	13.36	12.86	12.85	14.46	14.01	13.78
Kiwibank	13.20	13.30	12.40	13.40	12.80	12.80	12.90	12.90
Southland Building Society	16.02	16.07	15.61	14.59	14.21	14.27	13.76	13.50
The Co-operative Bank Limited	16.80	16.50	16.50	16.30	16.20	15.80	15.80	15.50
TSB Bank Limited	14.98	13.48	13.85	13.71	15.77	14.86	14.52	14.62
Westpac[37, 38]	12.30	11.60	12.10	12.40	13.30	13.90	14.00	14.00
	Net Profit ($Million)							
ANZ[37]	468	425	452	427	467	347	416	430
BNZ	252	232	270	295	241	192	259	229
CBA + ASB[37]	227	214	218	212	234	243	220	211
Heartland Bank[40]	10	14	13	12	10	15	14	15
Kiwibank	35	36	29	27	33	38	29	24
Southland Building Society	6	5	4	6	4	5	6	7
The Co-operative Bank Limited	2	3	2	2	3	3	2	2
TSB Bank Limited	12	-18	16	13	25	13	10	14
Westpac[37]	242	244	247	266	249	251	239	249
Total	**1,254**	**1,154**	**1,251**	**1,261**	**1,266**	**1,107**	**1,195**	**1,181**

37. 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.
38. The capital adequacy ratio's reported are for the overseas banking group.
39. Total Assets = Total Assets - Intangible Assets.

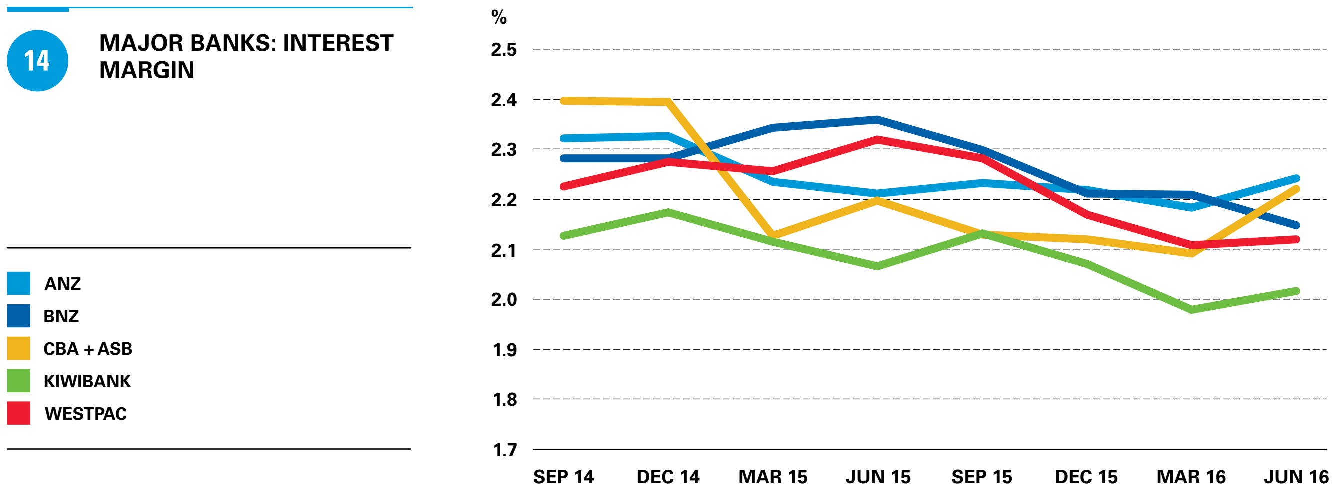
Entity	Profitability Measures							
	30 Sep 14	31 Dec 14	31 Mar 15	30 Jun 15	30 Sep 15	31 Dec 15	31 Mar 16	30 Jun 16
	Interest Margin (%)							
ANZ[37]	2.32	2.33	2.23	2.21	2.23	2.22	2.18	2.24
BNZ	2.28	2.28	2.34	2.36	2.30	2.21	2.21	2.15
CBA + ASB[37]	2.40	2.40	2.13	2.20	2.13	2.12	2.09	2.22
Heartland Bank[40]	4.99	5.46	4.45	4.43	4.39	5.18	4.58	4.53
Kiwibank	2.13	2.17	2.12	2.07	2.13	2.07	1.98	2.02
Southland Building Society	2.97	2.97	2.93	2.86	2.67	2.63	2.61	2.57
The Co-operative Bank Limited	2.95	2.90	2.80	2.81	2.77	2.71	2.61	2.51
TSB Bank Limited	2.30	2.15	2.15	2.12	2.14	2.08	2.03	2.02
Westpac[37]	2.23	2.28	2.26	2.32	2.28	2.17	2.11	2.12
Average	**2.32**	**2.34**	**2.26**	**2.28**	**2.25**	**2.21**	**2.17**	**2.20**
	Non-interest Income/Total Tangible Assets (%)							
ANZ[37]	1.00	0.79	0.90	0.76	0.80	0.33	0.77	0.62
BNZ	1.06	0.63	0.94	0.97	0.83	0.42	0.71	0.59
CBA + ASB[37]	0.58	0.63	0.70	0.53	0.66	0.77	0.57	0.47
Heartland Bank[40]	0.33	0.87	0.53	0.66	0.36	0.89	0.45	0.45
Kiwibank	0.72	0.73	0.57	0.57	0.59	0.62	0.55	0.46
Southland Building Society	0.93	0.96	1.03	0.98	0.95	1.03	0.97	1.00
The Co-operative Bank Limited	1.14	1.13	0.24	1.00	0.99	1.02	0.64	0.94
TSB Bank Limited	0.38	0.35	0.40	0.24	0.38	0.20	0.21	0.21
Westpac[37]	0.78	0.73	0.66	0.73	0.69	0.63	0.62	0.65
Average	**0.86**	**0.71**	**0.80**	**0.74**	**0.74**	**0.51**	**0.67**	**0.58**
	Impaired Asset Expense/Average Gross Loans and Advances (%)							
ANZ[37]	0.04	0.05	0.07	0.10	0.06	0.09	0.08	0.18
BNZ	0.12	0.02	0.26	0.10	0.38	0.22	0.23	0.15
CBA + ASB[37]	0.10	0.29	0.14	0.08	0.09	0.14	0.17	0.31
Heartland Bank[40]	0.36	0.54	0.38	0.62	0.50	0.34	0.41	0.63
Kiwibank	0.08	0.16	0.08	0.03	0.08	0.07	0.10	0.02
Southland Building Society	0.35	0.43	0.79	0.31	0.62	0.33	0.67	0.21
The Co-operative Bank Limited	0.08	0.07	0.05	0.16	0.04	0.08	0.05	0.08
TSB Bank Limited	0.85	6.06	0.04	0.07	-1.47	0.08	0.31	0.07
Westpac[37]	0.13	0.12	0.07	0.08	0.01	-0.01	0.06	0.02
Average	**0.10**	**0.17**	**0.13**	**0.09**	**0.11**	**0.11**	**0.13**	**0.16**
	Operating Expenses/Operating Income (%)							
ANZ[37]	37.81	39.02	36.61	38.03	36.34	43.30	42.41	36.61
BNZ	43.07	39.67	32.91	34.47	35.81	42.26	34.94	39.69
CBA + ASB[37]	37.66	37.04	37.60	41.19	37.73	36.76	37.98	37.66
Heartland Bank[40]	49.15	50.77	48.02	50.52	49.94	49.59	43.96	42.55
Kiwibank	56.78	54.10	62.07	67.52	59.84	59.35	62.39	71.30
Southland Building Society	62.83	66.27	62.82	60.39	67.73	70.22	57.43	60.30
The Co-operative Bank Limited	82.85	77.95	78.63	80.40	77.65	73.38	81.41	80.27
TSB Bank Limited	38.20	37.95	43.59	44.68	42.50	47.83	51.65	45.26
Westpac[37]	37.70	38.97	37.89	38.95	43.11	40.48	40.80	41.25
Average	**40.20**	**40.04**	**37.92**	**39.84**	**39.52**	**42.52**	**41.07**	**40.33**

40. Operating income for Heartland includes net interest income, net operating lease income, other income and fee income. Heartland Bank Limited's amalgamation with one of its wholly owned subsidiaries was effective from 31 December 2015. Data and ratios on September 2015 and its prior year comparative that have been used for the purpose of analysis do not reflect the amalgamation as September 2015 restated financials are not publicly available. Ratios calculated in this Survey may differ if September 2015 and its prior year comparative had been used for the purpose of analysis.

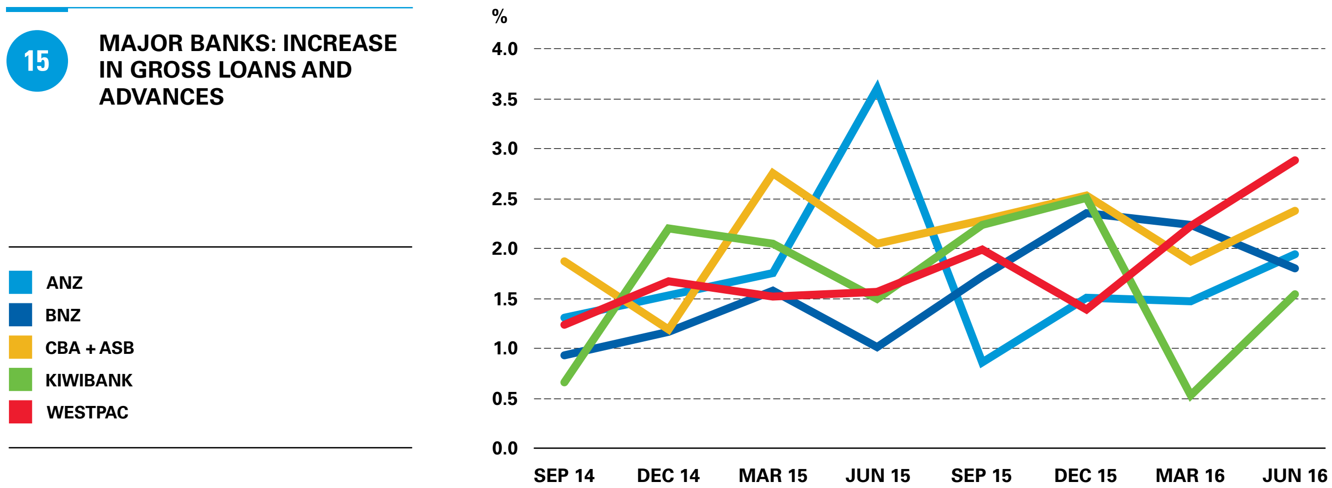
13 MAJOR BANKS: NET PROFIT



14 MAJOR BANKS: INTEREST MARGIN

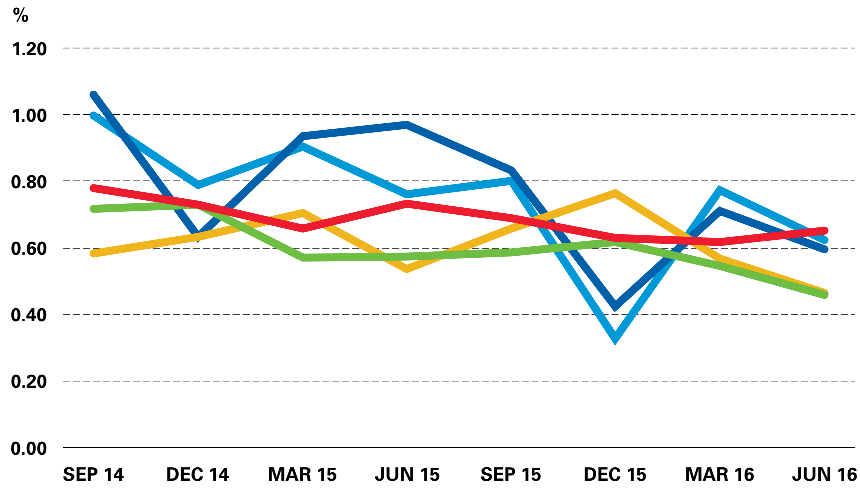


15 MAJOR BANKS: INCREASE IN GROSS LOANS AND ADVANCES



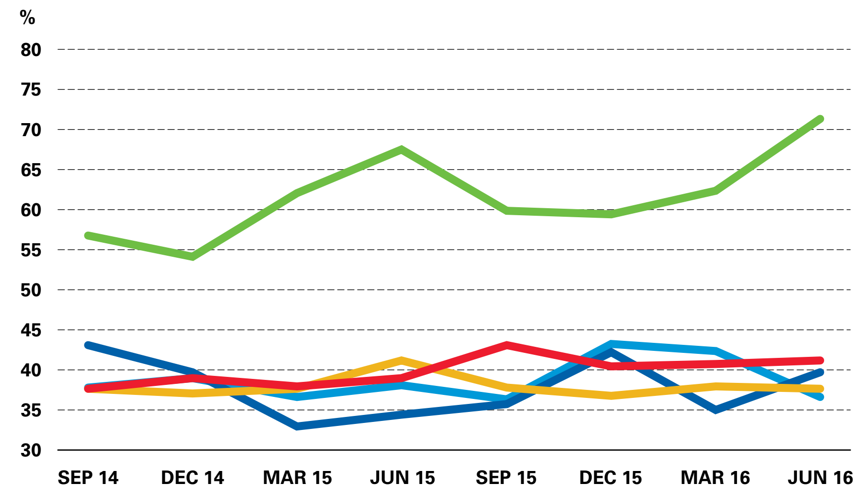
16 MAJOR BANKS: NON-INTEREST INCOME/ AVERAGE TOTAL ASSETS

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



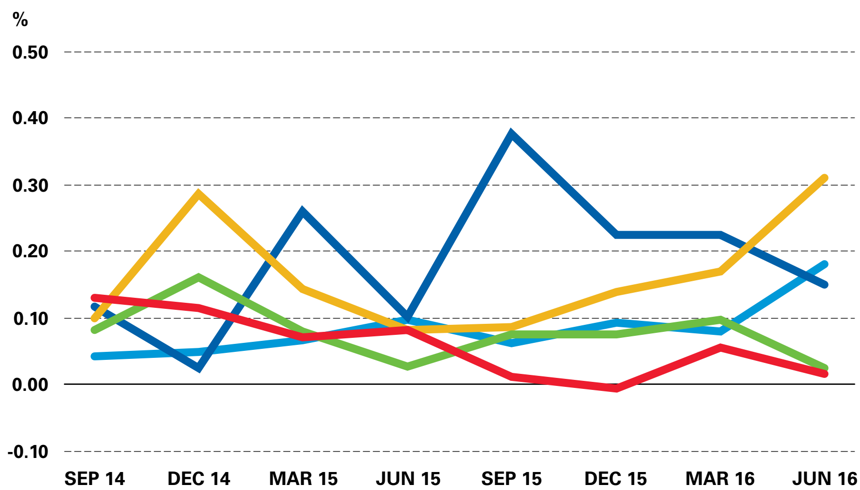
17 MAJOR BANKS: OPERATING EXPENSES/ OPERATING INCOME

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



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

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



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