The banking sector in New Zealand: aggregate banking supervision data

This article provides commentary on developments and conditions in the New Zealand banking industry based on aggregate data provided to the Banking System Department by registered banks. (A glossary of terms used is appended).

Introduction

In the five years to 1993, the New Zealand banking industry was required to respond to a number of challenges. The deregulation of the financial sector in the late 1980s intensified competition in the industry. This, together with a general decline in interest rates, has eroded banks' interest margins and underlying profitability. However, the predominant challenge over the last five years was a sharp increase in problem loans. The resulting charges for sub- and non-performing loans adversely affected banks' financial performance and ultimately the soundness of the New Zealand banking industry.

By 1993, interest margins were still under pressure but the industry appeared to have largely worked its way through the problem loan situation. Banks' asset quality had significantly improved, resulting in record profitability and a more robust banking system.

This article comments on developments in the banking industry over recent years, and in particular during 1993, with reference to the structure of the banking system, banks' profitability, asset growth, asset quality, exposure concentration, and capital adequacy. In addition, this article publishes for the first time aggregate data on banks' exposures to other banks and comments on banks' funds management activities.

Banking system structure

Following deregulation of the banking industry in the late 1980s the number of registered banks in New Zealand increased significantly as some overseas banks established operations in New Zealand and a number of non-bank financial institutions registered as banks. Intense competition, declining interest rates, and an economic downturn in the late 1980s made conditions in the banking industry difficult. By August 1990 the number of registered banks in New Zealand had peaked at 23. Since then some overseas banks which established operations following the deregulation of the New Zealand industry

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1 Balance sheet data are as at 31 December and income data have been annualised to a December year end. For banks with other than December balance dates, the data have been calculated on a 12 month running total basis. For banks not reporting to the Reserve Bank in December, annualised data from the previous reporting date have been used. For example, some banks report data half yearly, rather than quarterly. For these banks, annualised September data have been used for the purposes of this article. All data are reported on a consolidated basis (i.e. including bank subsidiaries).
have relinquished their New Zealand bank registrations and a number of banks have purchased other banks, in some cases with a view to merging the two.

This rationalisation continued in 1993 with National Australia Bank (NZ) Limited (NAB (NZ)) voluntarily relinquishing its bank registration in 1 October 1993. Following NAB’s purchase of the Bank of New Zealand group in December 1992, NAB owned three New Zealand registered banks: Bank of New Zealand Limited (BNZ), BNZ Finance Limited and National Australia Bank (NZ) Limited. In order to streamline the group structure and eliminate inefficiencies arising from duplication of banking operations, NAB(NZ) was deregistered and its operations merged with those of BNZ.

As a result, the number of registered banks fell by 1 to 19 in the year to 31 December 1993. The number of banking groups was unchanged at 15. Appendix 1 outlines the structure of the New Zealand banking system at year end 1993.

Further rationalisation of this type will occur in the future as banking groups seek to improve efficiency by streamlining multiple banking operations arising from past acquisitions.

There will also soon be a reduction in the number of banking groups in New Zealand as State Bank of South Australia has recently announced its intention to relinquish registration.

**Profitability**

Over recent years, the profitability of New Zealand banks has been adversely affected by a steady erosion of interest margins largely caused by the intensity of competition and by a general decline in interest rates. However, these influences have been overshadowed by the impact of problem loans. Banks’ problem loans reached record levels in the late 1980s as a consequence of a number of factors including less than prudent lending practices in the mid 1980s, the sharemarket crash in 1987 and the associated downturn in the commercial property sector. The subsequent charges (including provisions, abnormal and extraordinary charges) for sub- and non-performing loans over successive years since 1989 undermined banks’ profitability and ultimately the soundness of the New Zealand banking industry (see Table 1).

<table>
<thead>
<tr>
<th>Year</th>
<th>All Banks</th>
<th>Multipurpose (1)</th>
<th>Wholesale</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m (%</td>
<td>$m (%</td>
<td>$m (%)</td>
<td>$m (%)</td>
</tr>
<tr>
<td>Dec-89</td>
<td>(395.9)</td>
<td>(505.6)</td>
<td>(164.2)</td>
<td>273.9</td>
</tr>
<tr>
<td>Dec-90</td>
<td>406.1 (0.57)</td>
<td>276.3 (0.59)</td>
<td>17.7 (0.21)</td>
<td>147.5</td>
</tr>
<tr>
<td>Dec-91</td>
<td>340.1 (0.43)</td>
<td>297.2 (0.59)</td>
<td>207.4 (2.04)</td>
<td>268.1</td>
</tr>
<tr>
<td>Dec-92</td>
<td>313.3 (0.37)</td>
<td>188.6 (0.35)</td>
<td>41.5 (0.43)</td>
<td>137.4</td>
</tr>
<tr>
<td>Dec-93</td>
<td>694.7 (0.84)</td>
<td>507.7 (0.89)</td>
<td>57.7 (0.61)</td>
<td>232.5</td>
</tr>
</tbody>
</table>

Profits are shown as a percentage of Average Total Assets.
( ) denotes a negative figure
(1) As data are reported on a consolidated basis, profits of banks which are subsidiaries of a multipurpose bank are included in this category as well as their own.
Only in the past couple of years has it become evident that the New Zealand banking industry has largely put the burden of problem loans behind it. The positive effects of an improvement in asset quality were still emerging in 1992. In the year to December 1992, wholesale banks registered a profit for the first time since aggregate bank data were published by the Bank, due mainly to a reduction in provisions for problem loans. In that year, aggregate bank profitability declined slightly, principally due to abnormal charges for sub- and non-performing loans by one or two banks. However, these abnormal charges were primarily a result of banks applying more conservative criteria in classifying loans as sub- and non-performing rather than a reflection of a further deterioration in asset portfolios.

In 1993 there was clear evidence of improved asset quality. Aggregate bank profitability more than doubled in the 12 months to 31 December 1993, due principally to a marked reduction in charges for sub- and non-performing loans. Figure 1 shows that in the year to December 1993, aggregate net profit after tax and extraordinary items rose 122 percent to reach $695m, which is well above the previous peak aggregate profit figure of $406m recorded in December 1990. Banks’ net profit after tax and extraordinaries as a percentage of average total assets increased to 0.84 percent compared with 0.37 percent in the previous year.

![Figure 1. Bank Profitability](image)

Now that problem loans are back to more normal levels, profitability will be increasingly influenced by the intensity of competition in the industry, the prevailing low interest rate environment and the ability of banks to offset these adverse influences by improving operating efficiency and generating additional non-interest income. The net outcome to date is reflected in banks’ underlying profitability, i.e., net operating profit before provisions, abnormal and extraordinary items and tax. The three components of

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underlying profitability are interest income, other income and operating expenses. Figure 2 shows that underlying profitability has been declining steadily over the last three years.

Figure 2. Banks' Underlying Profitability (1)

(1) Profit before Loan Charges, Abnormal and Extraordinary Items as a Percentage of Average Total Assets.

Competition in the banking industry over recent years, particularly in the retail banking sector, has reduced interest rate spreads, i.e., the difference between income on interest bearing assets and the cost of interest bearing liabilities. Banks are competing to attract borrowing customers by offering mortgage finance at lower rates of interest. At the same time, they have had to offer attractive interest rates on their retail deposits to retain their lending customers. Compounding their difficulties in attracting deposits has been growing competition from unit trusts or managed funds. As interest rates decline, the relative performance of some managed funds (e.g., equity unit trusts) vis-a-vis interest bearing investments (e.g., bank deposits) has increased. As a consequence, in the last couple of years, savers have been placing significantly more funds into managed funds to obtain higher returns albeit, in some cases, at higher risk. This added competition, has probably had an impact on the volume and cost of banks' funding, with a consequent reduction in their underlying profitability.

The general decline in interest rates has also adversely affected banks' underlying profitability by reducing the margins on non-interest bearing funding. The benefits banks gain by obtaining non-interest bearing funds (principally shareholders' funds and non-interest bearing deposits) and investing these funds at market rates of interest generally decrease as interest rates decrease, reflecting an inherent exposure to interest rate risk.

The decline in banks' net interest income as a percentage of average total assets over the last four years and the associated decline in banks' margins is shown in Table 2. The decline in net interest income is more acute in the multipurpose and mainly retail sectors of the banking industry primarily because these banks are most affected by the intensity of competition in the retail mortgage market.
In an attempt to offset, or at least mitigate, the various adverse influences on profitability, banks have been attempting to generate additional income from sources other than their principal activity of borrowing and lending money. Several different strategies have been adopted in this regard. Some banks have attempted to increase income from money market and foreign exchange trading. Many have been attempting to increase fee income by engaging in activities such as leasing, insurance and, more recently, funds management (the latter is discussed in more detail below). The banks which are more active in these pursuits are generally the multipurpose and mainly retail banks which are facing intense competition in the retail lending market. While some banks have had more success than others in generating income from non-traditional banking activities, in aggregate, banks have not been able to generate sufficient ‘other income’ to offset the decline in underlying profitability arising from falling interest margins. Table 3 shows that banks’ other operating income as a percentage of average total assets as at 31 December 1993 is the same as it was at year end 1990.

Another strategy for countering margin pressures has been to seek improvements in operating efficiency. Banks’ efficiency is generally measured using two indicators, operating costs as a percentage of income (net interest income plus other income) or as a percentage of average total assets. (A decrease in these ratios indicates an improvement in banks’ efficiency.) In order to separate the operating cost effects from the income effects, we focus on the second measure of efficiency. Figure 3 shows the ratio of operating expenses to average total assets for the three sectors of the banking industry. The ratio of operating expenses to average total assets has generally trended down for all three categories of banks since 1989, reflecting an industry-wide improvement in efficiency, although this ratio rose slightly in 1993 in all sectors of the industry.

The wholesale banks’ aggregate operating expenses to average total assets ratio has decreased more rapidly than those of other sectors mainly because a number of wholesale banks have centralised their operations in Australia, allowing them to eliminate costs associated with providing stand alone ‘backroom’ and computer services for their New Zealand operations. The wholesale banks’ aggregate expenses ratio increased slightly over 1993 as a consequence of some one-off redundancy costs incurred by a couple of banks. In the absence of these one-off costs, operating expenses to average total assets would have declined in 1993 indicating that wholesale banks’ underlying costs are still falling.

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2 Ratios are not directly comparable across sectors because of differences in the nature of business conducted.

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Table 2. Net Interest Income

<table>
<thead>
<tr>
<th>Table 2. Net Interest Income</th>
<th>Dec-89</th>
<th>Dec-90</th>
<th>Dec-91</th>
<th>Dec-92</th>
<th>Dec-93</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Interest Income</td>
<td>$1,993.0m</td>
<td>$2,270.3m</td>
<td>$2,361.0m</td>
<td>$2,465.9m</td>
<td>$2,304.3m</td>
</tr>
<tr>
<td>Net Interest Margin</td>
<td>3.2%</td>
<td>3.4%</td>
<td>3.1%</td>
<td>3.0%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Net Interest Income/Average Total Assets</td>
<td>3.0%</td>
<td>3.2%</td>
<td>3.0%</td>
<td>2.9%</td>
<td>2.8%</td>
</tr>
</tbody>
</table>

Table 3. Other Operating Income

<table>
<thead>
<tr>
<th>Table 3. Other Operating Income</th>
<th>Dec-90</th>
<th>Dec-91</th>
<th>Dec-92</th>
<th>Dec-93</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Operating Income</td>
<td>$1,315.1m</td>
<td>$1,561.2m</td>
<td>$1,334.3m</td>
<td>$1,492.1m</td>
</tr>
<tr>
<td>Other Op. Income/Ave. Total Assets</td>
<td>1.8%</td>
<td>2.0%</td>
<td>1.6%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>
Multipurpose banks’ expense ratios are generally lower than those of retail banks because multipurpose banks do more lending to large corporates. This enables the multipurpose banks to generate a large volume of lending without incurring the overheads associated with processing large numbers of smaller loan applications. Multipurpose banks have been able to improve their efficiency by adopting a number of different strategies over recent years. A number of multipurpose banks have purchased other banks and then proceeded to streamline the retail branch networks by closing branches, reducing staff numbers, rationalising backroom operations and making better use of technology. Some have also attempted to improve efficiency by increasing volumes of business through existing branches. Multipurpose banks’ aggregate operating expenses to average total assets ratio increased slightly over 1993 as one or two banking groups had not completed the streamlining of their banking operations following purchases of other banks in 1992.

Retail banks have improved their efficiency over recent years principally by expanding their business at a faster rate than the increase in operating costs. In 1993, retail banks’ aggregate operating expenses to average total assets increased slightly as a result of some retail banks expanding their branch networks. This expansion has led to some increase in costs reflecting additional staffing and the costs of installing technology in new branches.

In sum, for the past few years New Zealand banks have been improving efficiency as a means of improving profitability in the face of declining interest margins. This is reflected in the general decrease in the operating expenses to average total assets ratio in all sectors of the industry since 1990. The slight rise in this ratio in 1993 is a reflection of a one-off increase in restructuring costs rather than a deterioration in banks’ efficiency.
Asset growth and composition

The New Zealand banking industry has been growing at a steady but modest rate since year end 1990 after a period of rapid asset growth in the late 1980s. In aggregate, banks' assets increased by an average annual rate of just over 3 percent over the two years to 31 December 1992. In the year to 31 December 1993, industry growth slowed slightly to 2.4 percent.

However, the modest growth in the aggregate banking data over recent years disguises the significant differences in growth experienced by the three sectors of the industry. The underlying growth rate of the multipurpose banks has been relatively slow, less than 2 percent per annum since year end 1990. In 1992, this sector recorded very rapid growth as a consequence of the National Bank’s purchase of the Rural Bank and ANZ restructuring its New Zealand banking operations, i.e., ANZ (NZ’s) purchase of its sister subsidiary Postbank. However, the underlying growth rate of this sector in 1992 was relatively modest. The most rapidly expanding activity of multipurpose banks over recent years has been mortgage lending.

Wholesale banks' assets have been in a general decline over the past few years, falling at an average annual rate of just over 3 percent since the end of 1991. However, the experience has not been uniform across all banks in this sector, with some having expanded while others have declined. The banks expanding are generally those which are diversifying into the retail or mortgage lending market. Wholesale banks' mortgage lending is small in comparison with other types of banks, but some wholesale banks have been able to expand their mortgage lending rapidly and have been important contributors to the competitiveness of the mortgage market.

Retail banks, unlike the other sectors of the industry, have continued to expand rapidly in the 1990s. Retail banks' assets grew at an average annual rate of 7 percent over the two years to December 1992. In 1993, retail banking sector growth increased to just over 11 percent. The expansion of residential mortgage lending has underpinned the growth in the banking industry over the past five years as consumer confidence improved and nominal and real interest rates declined. Banks' residential mortgage lending has also increased as a result of reintermediation, i.e., banks are taking an increasing share of the residential mortgage market at the expense of alternative providers of mortgage finance such as solicitors and the Housing Corporation. Banks have generally been keen to expand their mortgage books in order to improve the overall credit quality of their assets, and also because mortgage lending has offered the greatest growth opportunity in the last couple of years.

The relatively rapid growth in the retail banking sector is reflected in the changes in the composition of banks' lending. Figure 4 shows that mortgage lending as a percentage of banks' lending to the non-bank private sector has increased since 1990. As at 31 December 1990, mortgage lending represented 27 percent of total bank lending to the non-banking private sector. By 31 December 1993 this ratio had increased to 42 percent.

In contrast, banks' other lending (i.e., lending to the non-bank private sector excluding residential mortgage lending) as at 31 December 1993 was lower than that recorded at 31 December 1990. Table 4 shows that banks' other lending fell 10 percent over this period. The decline in other lending reflects generally subdued demand for credit from

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the corporate sector. In part, it also reflects the practice adopted by banks over recent years of using residential mortgages as security for other lending. That is, banks are increasingly requiring loans to small businesses and personal loans to be secured by residential mortgages rather than other assets. The decline in other lending may also reflect a general desire on the part of banks to reduce the size of their exposures to large corporate customers as a means of diversifying credit risk. (This is discussed below in more detail).

The other significant development in banks' activities over recent years is the expansion of non-traditional banking activities. Banks are increasingly providing customers with a broader range of financial services, including such products as insurance, superannuation, unit trust investments and other funds management services. As noted earlier, in the face of a general decline in interest rates, an increasing number of retail bank customers appear to be diverting a greater proportion of their savings away from interest bearing investments (e.g., bank deposits) in favour of investments which may offer higher rates of return (and risk), e.g., unit trust investments. Banks are responding to this trend by offering customers a broader range of products, including retail managed funds. This strategy not only protects their retail customer base, but also generates additional fee income which, as noted above, ameliorates the adverse effects of declining interest rates on banks’ profitability.
Table 5 shows that the value of net retail assets under management by fund managers has increased at an average annual rate of around 48 percent over the two years to 31 December 1993. Over the same period, retail funds managed by banks increased by an annual average rate of 102 percent. Banks’ unlisted unit trust activities account for most of the net assets under their management. However, banks’ retail superannuation activity also increased dramatically, particularly in 1993. This is probably related to tax changes in recent years which have made it less advantageous for companies to provide superannuation services for their employees. It appears that a substantial part of this business has been picked up by a few multipurpose and retail banks.

<table>
<thead>
<tr>
<th>Table 5: Retail Funds Management and Other Similar Activities</th>
<th>Dec-91</th>
<th>Dec-92</th>
<th>Dec-93</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Assets Under Management (1)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>All Surveyed Funds Managers</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unlisted Unit Trusts (2)</td>
<td>$1,503.0m</td>
<td>$2,052.6m</td>
<td>$3,182.8m</td>
</tr>
<tr>
<td>Insurance Bonds</td>
<td>$1,349.4m</td>
<td>$1,832.7m</td>
<td>$2,367.2m</td>
</tr>
<tr>
<td>Retail Superannuation Funds</td>
<td>$1,059.1m</td>
<td>$1,755.3m</td>
<td>$3,019.8m</td>
</tr>
<tr>
<td><strong>Banking Groups</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unlisted Unit Trusts (2)</td>
<td>$374.4m</td>
<td>$625.8m</td>
<td>$1,105.3m</td>
</tr>
<tr>
<td>Insurance Bonds</td>
<td>$111.9m</td>
<td>$206.6m</td>
<td>$235.2m</td>
</tr>
<tr>
<td>Retail Superannuation Funds</td>
<td>$72.7m</td>
<td>$288.7m</td>
<td>$939.6m</td>
</tr>
<tr>
<td><strong>Banks’ Market Shares</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unlisted Unit Trusts (2)</td>
<td>24.9%</td>
<td>30.5%</td>
<td>34.7%</td>
</tr>
<tr>
<td>Insurance Bonds</td>
<td>8.3%</td>
<td>11.3%</td>
<td>9.9%</td>
</tr>
<tr>
<td>Retail Superannuation Funds</td>
<td>6.9%</td>
<td>16.4%</td>
<td>31.1%</td>
</tr>
</tbody>
</table>

(1) Source: FPG Research Ltd
(2) Including Group Investment Funds.

Asset quality

The general decline in interest rates over the past few years, while adversely affecting banks’ underlying profitability, has not had an entirely detrimental effect on the New Zealand banking industry. Lower interest rates and the coincident upturn in economic activity, in particular the recovery in the commercial property sector, have enhanced the ability of banks’ borrowing customers to service loans and have generally contributed to a sharp improvement in banks’ asset quality.

The value of banks’ sub- and non- performing loans as at the end of 1993 was $1,813m, which is less than half of the value of sub- and non- performing loans two years earlier (refer to Table 6). The significant decrease in sub- and non- performing loans since December 1991 is a result of two consecutive years of large write-offs of problem loans, recoveries (either in part or in full) of loans for which provisions had been made in previous years, and a significant decrease in the number of new loans being classified as sub- and non- performing. This reduction in provisioning and, to a lesser extent, recoveries from earlier provisioning have contributed materially to the recent rise in bank profitability.
The improvement in the quality of banks’ assets has enhanced the soundness of the New Zealand banking system not only by improving banks’ profitability but also by increasing their capacity to absorb losses arising from counterparty default. This is reflected in the ratio of banks’ sub- and non-performing loans (net of provisions) to total capital. (A decrease in this ratio reflects an improvement in the ability of banks to withstand losses arising from credit risk.) This ratio is shown in Figure 5 for all non-branch banks as well as non-branch multipurpose and retail banks since 31 December 1990. The most dramatic decline in the ratio of net problem loans to total capital was in the multipurpose bank sector. This sector was particularly affected by problem loans subsequent to the 1987 sharemarket crash and downturn in commercial property prices. In contrast, the net problem loans to total capital ratio in the retail bank sector has remained at about the same level since 1990 reflecting the historically low and stable default rate on residential mortgages.

![Figure 5. Sub- and Non-Performing Loans (net of provisions) as a Proportion of Total Capital](image)

Given forecasts of continued economic growth, a low interest rate environment, a recovery in the commercial property sector and the maintenance of prudent lending criteria, further improvements in asset quality can be expected.

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Loan concentration

The soundness of the New Zealand banking system was also enhanced over 1993 by a reduction in the concentration of banks’ credit exposures to individual customers or groups of closely related customers. A reduction in the concentration of loan portfolios makes banks less vulnerable to losses arising from the failure of a single customer (or a group of closely related customers). Table 7 shows that the number of exposures to individual non-bank customers which exceeded a level equivalent to 10 percent of the individual lending bank’s capital totalled 49 as at 31 December 1993, compared with 71 and 85 as at 31 December 1992 and 1991 respectively. In some cases, this process of reducing loan concentration is being assisted by way of capital increasing faster than the expansion of lending.

<table>
<thead>
<tr>
<th>Table 7. Distribution of Non Branch Exposures to Corporates as a Proportion of Capital</th>
<th>Number of Exposures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dec-91</td>
</tr>
<tr>
<td>10% to 20%</td>
<td>56</td>
</tr>
<tr>
<td>Over 20% to 30%</td>
<td>13</td>
</tr>
<tr>
<td>Over 30%</td>
<td>16</td>
</tr>
</tbody>
</table>

Banks’ loan concentration to bank counterparties also decreased significantly over 1993. As shown in Table 8, the number of exposures to bank counterparties which exceeded a level equivalent to 10 percent of the individual lending bank’s capital declined from 123 as at 31 December 1992 to 56 as at 31 December 1993. While, in aggregate, interbank exposure as a percentage of banks’ capital has declined significantly, some specific exposures remain very high. In some cases, banks have credit exposures or limits to bank counterparties at levels which exceed the lending bank’s capital. However, the credit risk arising from interbank exposures is generally lower than that from non-bank corporate exposures for a number of reasons. These relate to the generally higher credit standing of banks relative to corporate counterparties and to the short-term nature of most interbank exposures. (The credit risk on a short term exposure is lower than that on a longer term exposure to the same counterparty because the probability of that counterparty defaulting before the loan is repaid is lower.)

<table>
<thead>
<tr>
<th>Table 8. Distribution of Non Branch Exposures to Other Banks as a Proportion of Capital</th>
<th>Number of Exposures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dec-91</td>
</tr>
<tr>
<td>10% to 20%</td>
<td>13</td>
</tr>
<tr>
<td>Over 20% to 30%</td>
<td>49</td>
</tr>
<tr>
<td>Over 30%</td>
<td>68</td>
</tr>
</tbody>
</table>

The nature of the interbank payment system arrangements and relationships produces inherently large short-term borrowing and lending between banks. Nevertheless, it is important that banks maintain prudent controls over interbank exposures so that financial difficulties of one bank do not flow on to other banks and threaten the stability of the banking system. Pending reforms to the payment system will have the effect of
reducing banks’ intra-day exposures\(^3\) to each other. This and the decline in the number of large interbank exposures should make it less likely that difficulties in one bank will be transmitted to the banking system as a whole.

Banks’ credit exposures to counterparties which are connected (i.e. related by ownership or effective control) to the lending banks also decreased over 1993. Table 9 shows that the number of exposures to connected counterparties which exceeded a level equivalent to 10 percent of capital fell from 10 as at 31 December 1992 to 8 as at 31 December 1993.

<table>
<thead>
<tr>
<th>Table 9. Distribution of Non Branch Connected Lending as a Proportion of Capital</th>
<th>Number of Exposures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dec-91</td>
</tr>
<tr>
<td>10% to 20%</td>
<td>2</td>
</tr>
<tr>
<td>Over 20% to 30%</td>
<td>1</td>
</tr>
<tr>
<td>Over 30%</td>
<td>6</td>
</tr>
</tbody>
</table>

**Capital adequacy**

The improvement in banks’ profitability in 1993 resulted in an improvement in the capital adequacy of the industry in terms of both the amount and the quality of capital held by New Zealand incorporated banks. This increase in capital boosted the industry’s capital adequacy ratio (the ratio of aggregate capital to aggregate risk weighted assets) from 9.9 percent as at 31 December 1992 to 10.8 percent as at 31 December 1993 (refer to Table 10).

<table>
<thead>
<tr>
<th>Table 10. Capital Ratios for Non Branch Banks</th>
<th>Dec-89</th>
<th>Dec-90</th>
<th>Dec-91</th>
<th>Dec-92</th>
<th>Dec-93</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier One Capital</td>
<td>$3,265.8m</td>
<td>$3,842.1m</td>
<td>$3,891.5m</td>
<td>$2,964.9m</td>
<td>$3,472.8m</td>
</tr>
<tr>
<td>Tier One Capital Ratio</td>
<td>7.5%</td>
<td>8.1%</td>
<td>8.4%</td>
<td>6.8%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Tier Two Capital</td>
<td>$799.5m</td>
<td>$1,361.9m</td>
<td>$1,265.0m</td>
<td>$1,353.6m</td>
<td>$1,368.1m</td>
</tr>
<tr>
<td>Tier Two Capital Ratio</td>
<td>1.8%</td>
<td>2.9%</td>
<td>2.7%</td>
<td>3.1%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Total Capital</td>
<td>$4,065.3m</td>
<td>$5,204.0m</td>
<td>$5,156.4m</td>
<td>$4,318.5m</td>
<td>$4,840.9m</td>
</tr>
<tr>
<td>Total Capital Ratio</td>
<td>9.3%</td>
<td>11.0%</td>
<td>11.1%</td>
<td>9.9%</td>
<td>10.8%</td>
</tr>
</tbody>
</table>

The quality of capital in the New Zealand banking industry also improved in 1993. Figure 6 shows that the increase in aggregate capital in the banking industry was due principally to an increase in Tier 1 capital which, in turn, largely reflects stronger profitability over 1993. As at 31 December 1993 Tier 1 capital accounted for 72 percent of aggregate capital compared with 69 percent the previous year.

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\(^3\) Intra-day exposures are not captured in Reserve Bank data on interbank exposures.
Conclusions

The improvement in the quality of banks’ assets over the past two years has resulted in a substantial increase in banks’ financial performance in the year to 31 December 1993 and has enhanced the soundness of the New Zealand banking industry. Banks’ provisions and other (abnormal and extraordinary) charges for sub- and non-performing loans have had a major adverse effect on their profitability up to year end 1992. Asset quality has been improving over the past two years as economic growth and lower interest rates have improved conditions for banks’ borrowing customers. The consequent reduction in provisions for sub- and non-performing loans and the absence of other charges for problem loans, increased banks’ profitability in 1993 to a new peak for the five year period covered by the figures.

The soundness of the banking industry has also been enhanced over 1993 by the reduction in the concentration of credit risk. The reduction in the number of large interbank exposures is particularly important in this regard because the failure of a single bank is less likely to undermine the stability of the banking system if banks’ credit exposures to other banks are well diversified. However, the magnitude of some interbank exposures remains high.

The major challenge facing the banking industry over the medium term is the intensity of competition. Competition has been a principal factor behind the declining trend in banks’ interest margins and underlying profitability and the rationalisation in the industry over recent years. In the four years to December 1993, six New Zealand banks have deregistered. More banks will deregister in the near future as banking groups rationalise their internal structures and the number of banking groups declines.

As competition in the industry together with low interest rates continues to compress margins, banks may attempt to maintain profitability by diversifying their lending
outside their core business or by extracting higher returns from existing business areas. Both these strategies could potentially reduce asset quality. Banks which diversify their lending outside their core business may end up taking on the poorer quality credits which have been turned down by the previously established lenders in that sector. Attempts to extract higher returns from existing business sectors may lead banks to take on higher risk credits. The challenge for banks in the near future will be to ensure that attempts to improve or maintain profitability in the short to medium term do not result in a deterioration in asset quality which might undermine longer term profitability and viability.
Appendix 1

Registered Banks as at December 1993

Multi-purpose Banks

ANZ Banking Group (New Zealand) Limited
Bank of New Zealand Limited
The National Bank of New Zealand Limited
Westpac Banking Corporation (B)

Banking Group
Australia and New Zealand Banking Group Limited
National Australia Bank Limited
Lloyds Bank Plc
Westpac Banking Corporation

Wholesale Banks

Bankers Trust New Zealand Limited
Banque Indosuez (B)
Barclays Bank Plc (B)
BNZ Finance Limited
Citibank NA (B)
Primary Industry Bank of Australia (B)
State Bank of South Australia (B)
The Hongkong and Shanghai Banking Corporation (B)

Bankers Trust New York Corporation
Banque Indosuez
Barclays Bank Plc
National Australia Bank Limited
Citibank NA
Bank of Western Australia Limited
State Bank of South Australia
The Hongkong and Shanghai Banking Corporation

Mainly Retail Banks

ASB Bank Limited
Countrywide Banking Corporation Limited
Post Office Bank Limited

Commonwealth Bank of Australia
Bank of Scotland
Australia and New Zealand Banking Group Limited
Lloyds Bank Plc
Trust Bank New Zealand Limited
TSB Bank Limited
Bank of Scotland

The Rural Bank Limited
Trust Bank New Zealand Limited
TSB Bank Limited
United Bank Limited

(B) Banks registered in New Zealand as branches of overseas incorporated banks
Glossary of Terms

Risk Weighted Exposures
Assets and off-balance sheet exposures are weighted according to broad categories of credit risk as determined by the risk weighting framework. For example, Government exposures of less than one year are weighted at zero, while commercial lending is weighted at 100 percent. Banks are required to hold capital against their risk adjusted credit exposures.

Capital
- The residual claims of owners on the assets of the bank once all claims of depositors and other commitments have been satisfied. Under the Basle framework capital is divided into Tier One and Tier Two capital.

Tier One Capital
Tier One Capital is shareholders' funds or net worth (primarily issued share capital and retained earnings). It represents that part of a bank's funding which is available to absorb unanticipated losses without the bank being obliged to cease trading and which is free from any fixed servicing obligations.

Tier Two Capital
Tier Two Capital comprises items which are not equity but which have some of the same characteristics as equity, for example, revaluation reserves, hybrid capital instruments such as subordinated debt and general provisions.

Total Capital Ratio
The Total Capital Ratio is the sum of Tier One and Tier Two Capital divided by Risk Weighted Exposures.