Can New Zealand's banks sustain strong performance and good lending growth?

pwc

Introduction

New Zealand's five major banks reported core earnings of $3,480 million in the first half of their 2015 financial years (1H15), up from $3,281 million for the previous six months (2H14). This was driven by increases in net interest income (up by $184 million) and a reduction in operating expenses (down by $49 million), while other operating income decreased by $34 million. Following an increase in bad debt expenses (up by $54 million), profit before tax was up 5 per cent (or $145 million) to $3,299 million and profit after tax was up 4 per cent (or $92 million) to $2,372 million.

The results show another strong performance by our major banks on the back of good lending growth to both the household and non-household sectors. The lift in lending by circa $10 billion over the past six months, combined with the $7 billion for six months earlier has generated the lift in net interest income growth of around $184 million. The demand for credit over this twelve month period has been very strong when compared to recent times.

The reduction in operating expenses also aided the lift in profitability for the period. However, this was more a story of higher costs in 2H14 due to one-off charges. Interestingly, the banks' operating expenses for the first half of their 2015 financial years was up against the comparable period twelve months ago.

The previous positive lift in other operating income has now slightly reversed which reflects our comments in our previous report – this isn't a quality income story but more reflective of gains and losses being recognised on financial instruments held at fair value. As we have previously said, this is effectively a zero-sum game from period to period and the swings in the fair value of financial instruments have contributed to the earnings volatility of our major banks.

One continuing trend from six months ago is further bad debt expenses being recognised when compared to the previous six months. When looking at the underlying asset quality of the lending portfolios, there has been a gradual deterioration in stressed loans as well as those assets that are 90-days past due (an early indicator for stressed loans).

Looking forward, it will be a question of whether this performance can be sustained. The strong economic conditions experienced over the past two years are predicted to slow in the short to medium term, but nevertheless comparably positive on a global scale. This combined with a hot property market in Auckland and difficult trading conditions for our rural community and those that service it, we are about to embark on an interesting journey.

This publication focuses on the major banks' (ANZ Bank New Zealand, ASB, Bank of New Zealand, Kiwibank and Westpac) performance for the first half of their 2015 financial years with reference to the previous six months.

This journey will be further enhanced by forecasted changes to the official cash rate (OCR) which will be of some benefit to New Zealand borrowers but, equally, it will be of little comfort to depositors should they experience falling deposit rates. This combined with volatility in the wholesale funding markets means the lending market will remain competitive but the inherent value of customer deposits will remain.

The technology race we've previously discussed will continue to evolve. It is a game changer to the global banking sector which, if harnessed correctly, will drive better customer experiences and outcomes.

This evolving technological world has already resulted in the explosion of financial technology (FinTech) entities in various regions around the world. It also means a global bank could potentially enter our local market without the need to invest in bricks and mortar. Instead, a global bank could leverage its brand and establish a presence through an online branch targeting a niche segment of our market.

Against the backdrop of technological enhancement, while any possible changes to the market will not be extensive in the short-term, it will have an impact across the New Zealand market in the longer term. In any sector or organisation, technology can be seen as a challenging disruptor or viewed as the key to unlock future value. From the perspective of New Zealand's major banks, which side of coin will be face up when this finally lands?

When looking at the underlying asset quality of the lending portfolios, there has been a gradual deterioration in stressed loans as well as those assets that are 90-days past due.

Five major banks' combined performance

Semi-annual results

Comparing 1H15 with 2H14 we see a 4 per cent rise in statutory profit from $2,280 million in 2H14 to $2,372 million in 1H15. Profit before tax increased by 5 per cent to $3,299 million in the same period.

The main driver for this increased profit is the 5 per cent increase in net interest income. Net interest income grew from $3,989 million in 2H14 to $4,173 million in 1H15. This growth of 5 per cent is positive for the banks which is driven by lending growth during the period of 3.2 per cent.

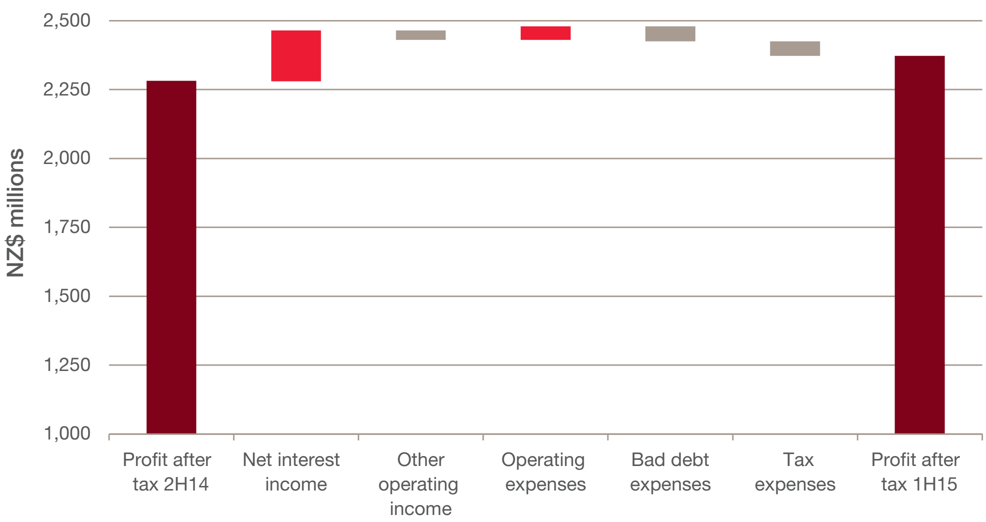
Other operating income continues to show volatility as a result of the revaluation of financial instruments carried at fair value with a 2 per cent decrease in 1H15. Operating expenses also fell 2 per cent in 1H15 to $2,197 million with each of the New Zealand majors either showing a stable or reducing cost base when comparing 1H15 to 2H14.

Bad debt expenses have shown another increase, up 43 per cent to $181 million, suggesting that we are now past the low point of bad debt expenses experienced during 1H14. However this should not be raising any alarm bells as this level of bad debt expense is still comparatively low compared to pre-2014 amounts.

Table 1: Half-year income statement comparisons (NZ$ millions)

	1H15	2H14	1H14	1H15v2H14	1H15v1H14
Interest income	10,661	10,030	9,333	6%	14%
Interest expense	(6,488)	(6,041)	(5,474)	7%	19%
Net interest income	4,173	3,989	3,859	5%	8%
Other operating income	1,504	1,538	1,360	(2%)	11%
Operating expenses	(2,197)	(2,246)	(2,136)	(2%)	3%
Core earnings	3,480	3,281	3,083	6%	13%
Bad debt expenses	(181)	(127)	(14)	43%	1193%
Profit before tax	3,299	3,154	3,069	5%	7%
Tax expenses	(917)	(864)	(835)	6%	10%
Outside equity interest	(10)	(10)	(8)	0%	25%
Statutory profits	2,372	2,280	2,226	4%	7%

Figure 1: Banks' change in profit after tax



Breaking down the numbers

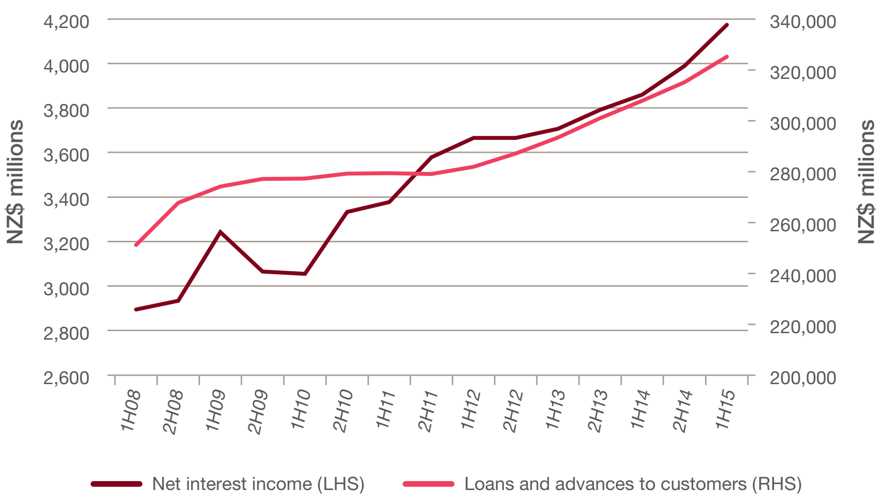
Net interest income

Net interest income continues to increase and is up 5 per cent from $3,989 million in 2H14 to $4,173 million in 1H15.

When analysing this, we note that interest income is up $631 million to $10,661 million for 1H15 and interest expense has increased by $447 million to $6,488 million. As can be seen in Figure 2, the growth in net interest income continues to be consistent with the growth in loans and advances to customers which has increased by $9,943 million (3.2 per cent) to $325,161 million in 1H15.

This continued growth in net interest income is due to the sustained growth in lending during the period and continuation of low funding costs.

Figure 2: Net interest in relation to customer loans and advances



Net interest margin

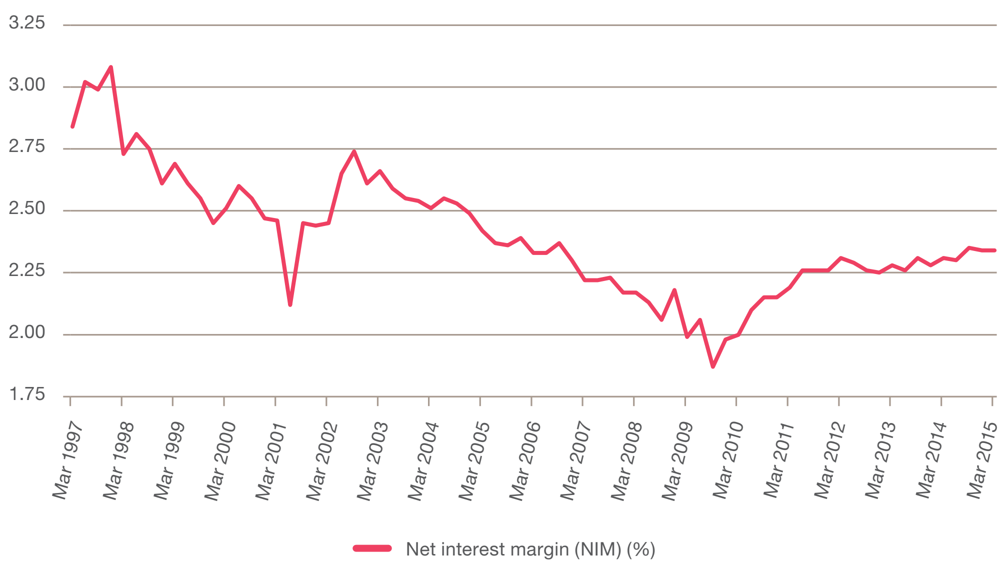
As Figure 3 shows, net interest margins continue to remain relatively flat with a decrease during 1H15 from 2.35 per cent to 2.34 per cent.

This is due to low wholesale funding costs and close interest rate management, partially offset by the continued change in lending mix. Customers prefer fixed-rate mortgages which typically have lower margins as well as competitive pressures for new lending which have lowered lending margins, especially in the residential mortgage market.

The outlook for 2H15 is mixed, in part due to intense competition for new lending hitting these margins, a decrease in short-term interest rates due to the Reserve Bank's decrease in the OCR and lower wholesale funding costs, with economic commentators forecasting further interest rate cuts for the rest of the 2015 calendar year.

This, in aggregation, indicates a continuation of low interest rates. At the time of this report, we are already seeing short to medium term mortgage carded and special rates considerably below 5 per cent, which are the lowest rates available for a number of years.

Figure 3: Net interest margins remain flat with a slight decrease



Source: Reserve Bank of New Zealand

Lending

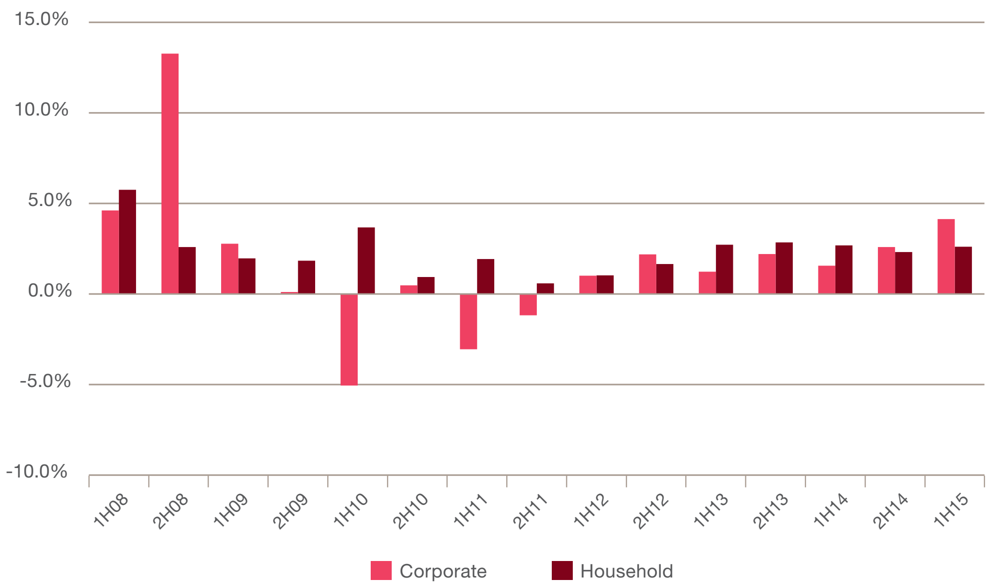
Gross lending stood at $325.2 billion at the end of 1H15 from $315.2 billion at the end of 2H14. This reflects a growth of 3.2 per cent in the six-month period.

What is most interesting is that corporate lending has continued to grow, up 4.1 per cent between 1H15 and 2H14, the highest since the late 2000s. This reflected the continued business and economic confidence at this time. The depreciation of the New Zealand dollar against the US dollar has helped provide relief to exporters along with the continued low interest rates being experienced. On the flip side, a weaker dollar will create pressure on import costs, which may manifest itself in rising domestic prices in the long term.

Household lending grew by 2.6 per cent during 1H15, increasing from $200.4 billion to $205.6 billion during the same period. This is up from the 2.3 per cent growth rate experienced during 2H14 and can be partially attributed to the low interest rates being offered for mortgages to drive volume growth, ongoing supply constraints and net immigration which have all continued to drive up property prices, particularly in Auckland. Many will be watching the Reserve Bank of New Zealand's (RBNZ) new asset class treatment for residential property investors and the impact it will have after it is expected to come into effect on 1 October 2015, particularly in regards to household lending growth. At this stage, the increasing residential property sector will continue to provide the tail wind for lending growth for the time being.

The proportion of household lending with loan-to-value ratios (LVR) above 80 per cent has decreased to 14.5 per cent in 1H15 from 15.9 per cent in 2H14. This further shows the impacts of the RBNZ's speed limits to high LVR lending as it aims to reduce the risks associated with any property price correction going forward.

Figure 4: Corporate and household lending growth



With the continued rising property prices in Auckland which has been seen as a cause for concern, the RBNZ is currently proposing amendments to LVR rules to come into effect on 1 October 2015:

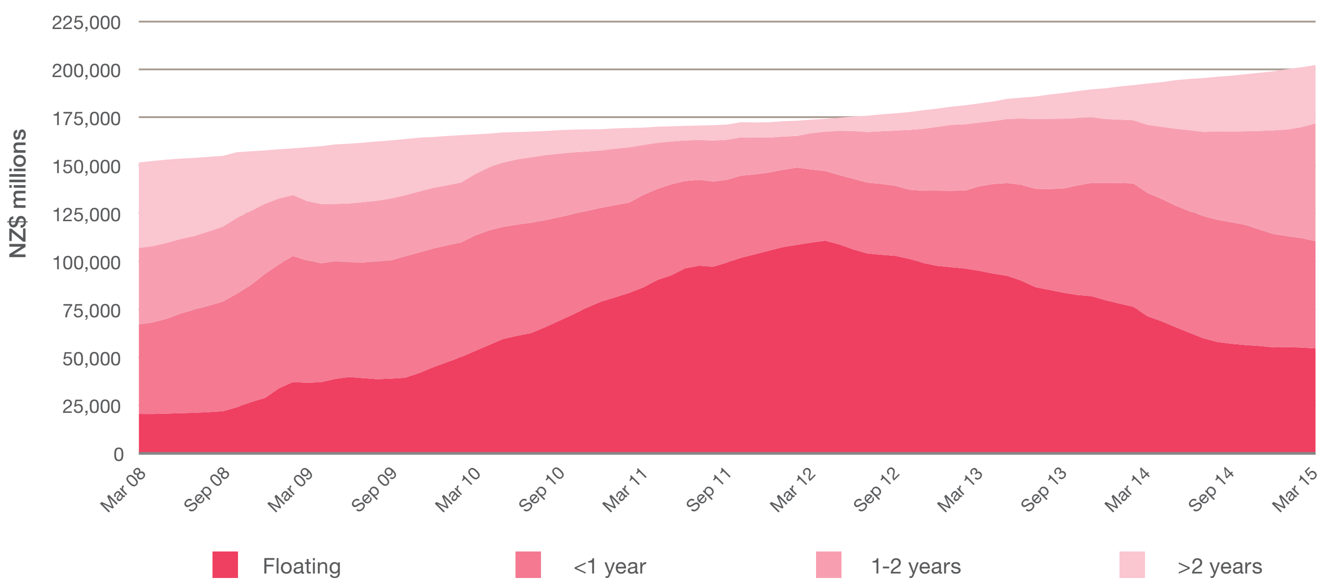
- require property investment residential mortgage loans in the Auckland region with an LVR of no more than 70 per cent;
- no change on the 10 per cent speed limit for other residential mortgage lending for Auckland with LVR above 80 per cent; and
- increasing the speed limit from 10 per cent to 15 per cent for residential mortgage lending with LVR greater than 80 per cent for home buyers outside of Auckland.

In addition to these LVR amendments, the RBNZ is proposing a new asset class treatment for capital adequacy for residential property investment loans. Under these rules, the banks would be expected to hold further capital for residential property investment loans.

The continued shift from floating to fixed-rate mortgages have continued into 2015. At September 2014, 14.8 per cent of the mortgage lending portfolio was at fixed rates over two years and this has remained in line with March 2015 at 15 per cent. The level of floating rate mortgages has decreased from 29 per cent at September 2014 to 27 per cent at March 2015.

Most interestingly, the biggest increase has been in the one to two year fixed rates which has increased from 24 per cent in September 2014 to 30.3 per cent at March 2015. This reflects the greater discounted rates being offered by the banks in the market to drive volume growth and borrowers locking in fixed rates in the short to medium term as well as keeping their options open should market speculation of further interest rate cuts eventuate.

Figure 5: The shift from floating to fixed-rate mortgages have continued into 2015



Source: Reserve Bank of New Zealand

Funding

The funding for the banks continue to grow from $333.0 billion at the end of 2H14 to $340.2 billion at the end of 1H15, which represents an increase of 2.2 per cent.

This increase in funding, consistent with recent periods, continues to be driven by continued growth in deposits from customers. Deposits from customers grew by $9.2 billion in 1H15 to $237.3 billion and this now represents 69.8 per cent of total funding (2H14: 68.5 per cent).

Interestingly, wholesale funding decreased by $2.1 billion during 1H15 to $102.9 billion which is largely because of a decline in amounts due to central bank and other financial institutions by $5.4 billion to $12.8 billion. This is partially offset by other money market deposits, bonds and notes which have increased by $1.7 billion to $74.3 billion.

As seen in Figure 6, the growth in deposits from customers in the period has not kept pace with the increase in loans to customers, which means the funding outflows have exceeded the inflows by $678 million, a continuation of the trend seen in 2H14. However this variance of $678 million is not large in the context of the total gross amount of funding and lending growth experienced by the banks during 1H15.

The banks retail deposit-to-loan ratio has increased from 72.4 per cent in 2H14 to 73.0 per cent in 1H15. With the second consecutive period of new lending outpacing new retail deposit funding, the banks will be required to rely on wholesale funding or retained earnings to fund further lending growth. The current deposit-to-loan ratio of 73.0 per cent is well above what was experienced by the banks prior to the 2009 with the ratio at 56.3 per cent in 2H08 due to the need to comply with RBNZ's liquidity policies and the push for retail funding to firm up their balance sheets.

Figure 6: More money ($678 million) was lent to customers than deposited in 1H15

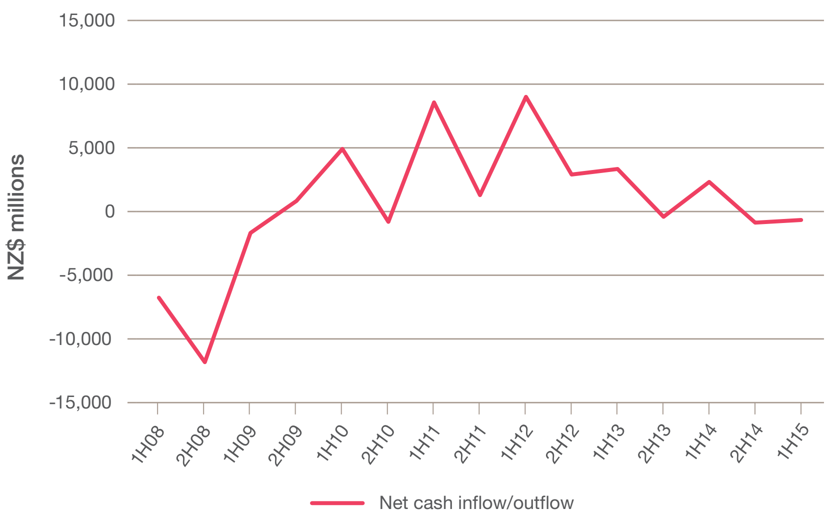


Figure 7: Deposits and wholesale funding continue growth

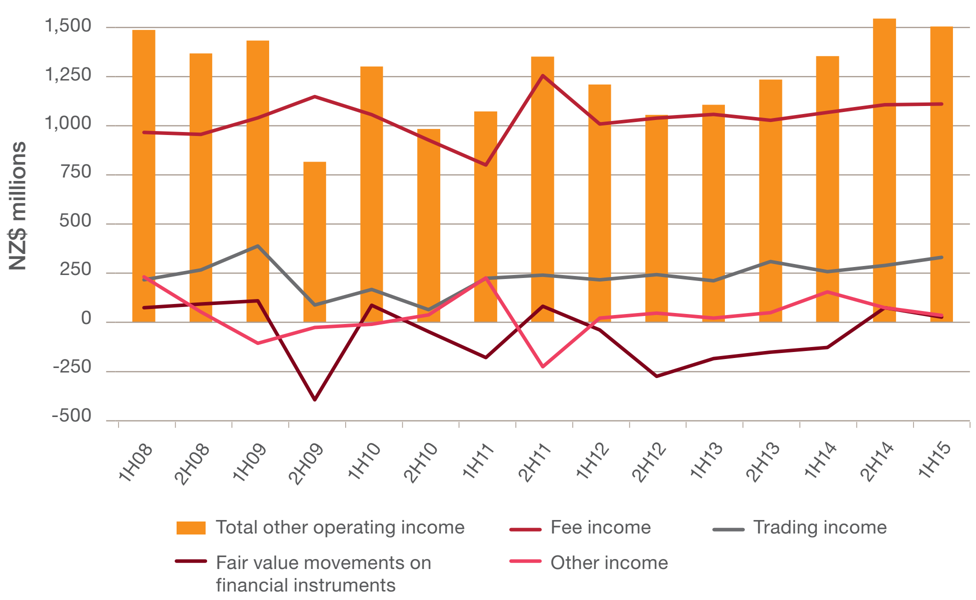
Other operating income

Other operating income fell 2.2 per cent from $1,538 million in 2H14 to $1,504 million in 1H15.

This decrease has been driven largely by a decrease in gains on financial instruments held at fair value and decrease in other income, partially offset by increase in trading income.

- Negligible change in fee income, slightly up by 0.8 per cent from $1,101 million in 2H14 to $1,110 million in 1H15.
- Trading income increased 14.5 per cent from $289 million in 2H14 to $331 million in 1H15.
- Gains on financial instruments held at fair value have decreased 63.5 per cent from $74 million in 2H14 to $27 million in 1H15.
- Other income decreased 51.4 per cent from $74 million in 2H14 to $36 million in 1H15. This is largely due to one of the banks recognising a one-off gain in the prior period on the sale of available-for-sale equity securities which were not repeated in 1H15.

Figure 8: Other operating income fell 2.2 per cent to $1,504 million in 1H15



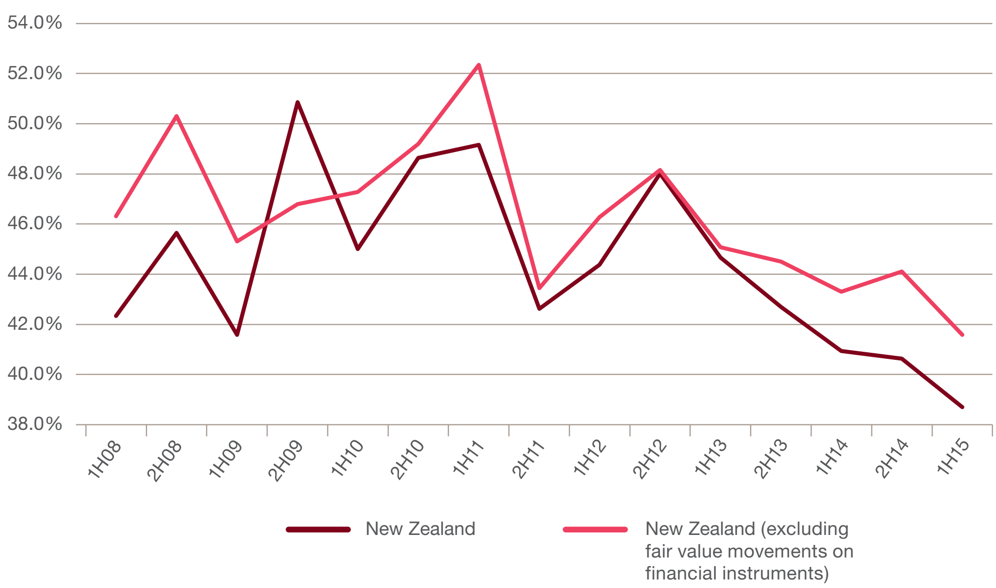
Expenses

Operating expenses have decreased 2 per cent from $2,246 million in 2H14 to $2,197 million for 1H15.

Maintaining and controlling expenses continues to remain a key focus for the banks while at the same time ensuring investment for technology costs. Part of the reason for the decreased expenses is due to the banks investments in digital technology which has enable productivity gains.

This reduction in costs coupled with the growth in net interest income and other operating income has reduced the cost to income ratio from 40.6 per cent in 2H14 to 38.7 per cent in 1H15. However, as we have previously pointed out, the changes in fair value of financial instruments carried at fair value has been a key influencer to the variability of the major banks' cost to income ratios. When you exclude the volatility of gain/losses on financial instruments recognised at fair value, the cost to income ratio for New Zealand has reduced from 44.1 per cent in 2H14 to 41.6 per cent in 1H15.

Figure 9: Cost-to-income ratios

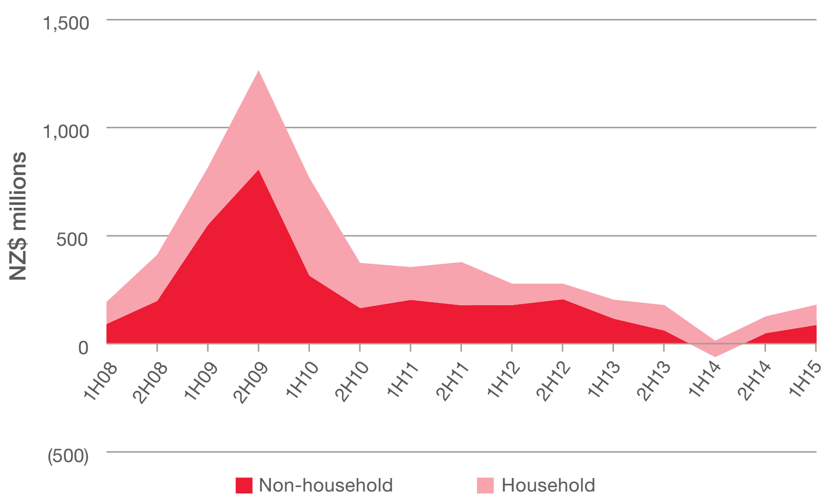


Asset quality

The combined bad debt expense for these New Zealand banks has increased to $181 million for 1H15, compared to $127 million in 2H14. However this increase should not be raising any alarm bells as we are coming off a low base in 2H14. The increase in bad debt expense is predominantly due to an increase in the non-household bad debt expenses which has increased by $38 million to $87 million in 1H15, while the household sector has increased by $16 million to $94 million in 1H15.

As shown in Figure 10, bad debt expense is coming off a low base from 1H14 and the low bad debt expense is a positive sign for the New Zealand economy. However, risks remain in the Auckland property market and low dairy commodity prices.

Figure 10: Banks' composition of bad debt expense



Escalating Auckland property prices have been a cause of concern, especially if there is any significant price correction which would have some impact on the overall economy and financial stability of New Zealand. The banks should be well secured and able to respond to such a scenario based on their internal stress testing. The RBNZ has recently proposed changes to the rules for high-LVR mortgages expected to come into effect from 1 October, where investors in Auckland property would generally need a 30 per cent deposit.

Additionally, the continued low dairy commodity prices are a cause for concern for not only the banks' exposures directly to the dairy industry, but also all the other industries which support the dairy sector. While the depreciation of the New Zealand dollar against the US dollar may partially offset any commodity price movement, the continued decrease in dairy commodity prices and market commentators forecasting prices to remain low would be expected to put stress on elements of the dairy sector (both directly and indirectly). It would not be surprising if some of the banks have included some additional provisioning for their exposures to the dairy sector as a result.

When we look at the asset quality, it has remained relatively consistent with 2H14 with:

- 90-day past due assets increasing from $582 million in 2H14 to $667 million in 1H15. However, it should be noted that the 1H15 result is the second-lowest since the Global Financial Crisis (GFC). Ninety-day past due assets as a percentage of gross loans and advances to customers at 1H15 is relatively stable compared to 2H14 at about 0.2 per cent; and
- impaired assets increasing marginally from $1,584 million in 2H14 to $1,590 million in 1H15. Again, the 1H15 result is the second-lowest since the GFC. Impaired assets as a percentage of gross loans and advances to customers is relatively stable at 1H15 compared to 2H14 at about 0.5 per cent.

The banks overall provisioning levels have increased by $100 million to $1,924 million in 1H15. Non-household provisions have increased by $106 million to $1,256 million at 1H15, and this is partially offset by household provisions which have decreased by $6 million to $668 million.

This $100 million increase in overall provision is largely driven by one bank that adopted the New Zealand Equivalent to International Financial Reporting Standard 9 (NZ IFRS 9) early during 1H15 and now recognises their impaired asset expenses based on an expected loss model. This resulted in their overall provisioning level increasing by about $49 million or 12.3 per cent on transition. It would be interesting to see the quantum of the impact of the other banks overall provisioning levels when they eventually adopt NZ IFRS 9.

With this change in provisioning approach, the ability to compare each of the bank's credit provisions will become more difficult until all banks adopt NZ IFRS 9. However, the directional movement in the overall provisioning levels should be the same across all the banks.

Figure 11: Asset quality and bad debt expense

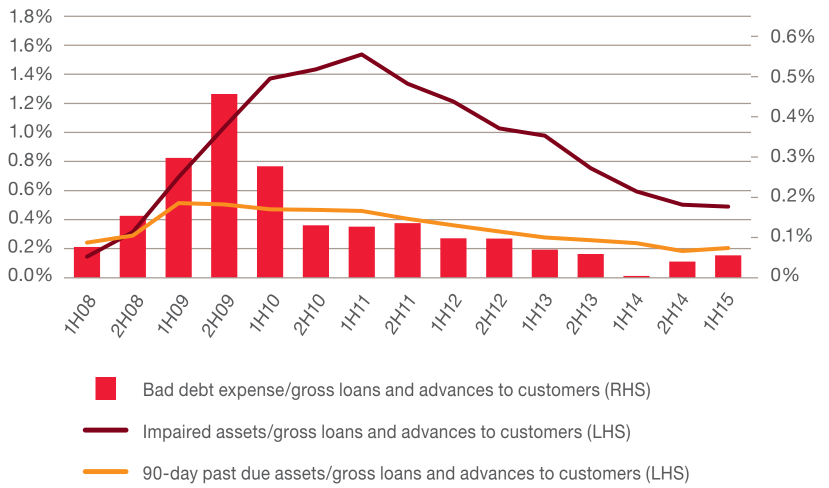
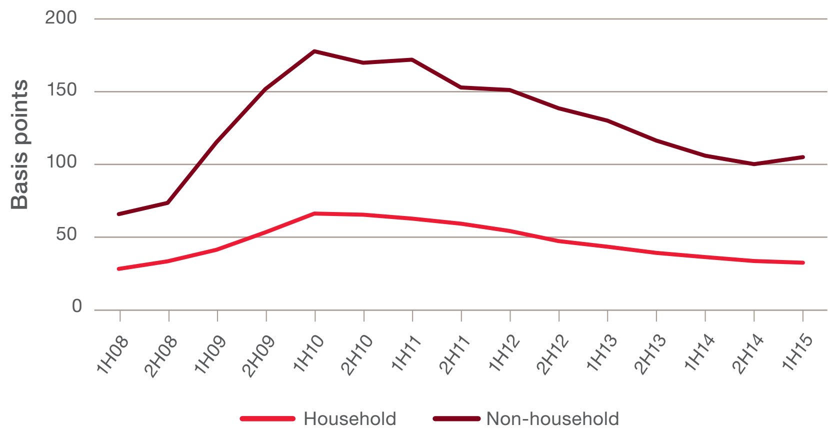


Figure 12: Basis point loan loss provisions



Capital

The major banks have seen an increase in their average total capital ratio which has increased from 12.4 per cent in 2H14 to 12.6 per cent in 1H15. The banks continue to be well capitalised and comfortably ahead of regulatory requirements.

The RBNZ has recently announced proposed new asset class treatment for capital adequacy for residential property investment loans which are expected to come into effect on 1 October. The effect of this is that the banks would be expected to hold further capital for residential property investment loans.

New Zealand's average return on equity has slightly increased from 16.4 per cent in 2H14 to 16.6 per cent in 1H15. This is driven by the increased profit during the period and is in line with 1H14.

Figure 13: Average capital ratios of the New Zealand major banks

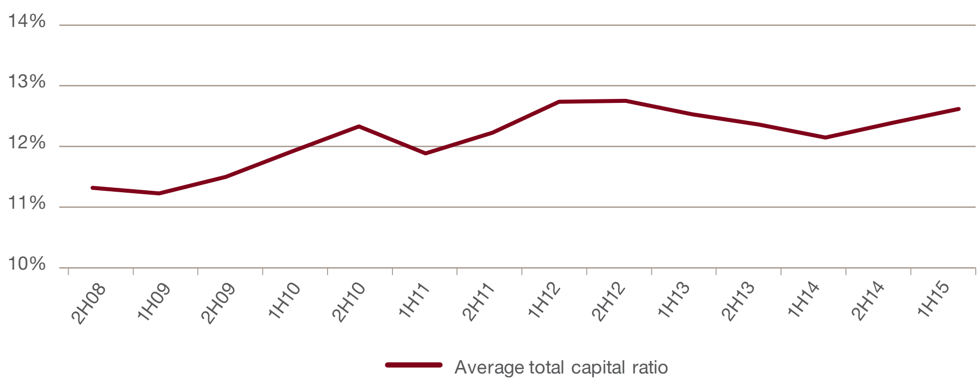
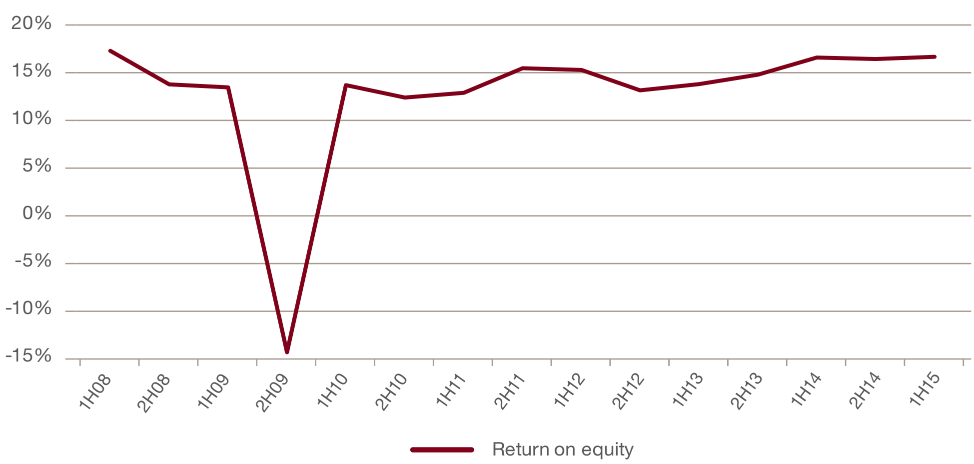


Figure 14: Return on equity of the New Zealand major banks



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