

# Opinion

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## The skinny on bank profits and margins

I was concerned to see recent commentary that bank profits are up due to an increase in the banks' net interest margin (NIM). It is just too simplistic to view margins in isolation, and to fail to take into account the changes in the cost of funding, global economic conditions, the quality of bank assets, and bank operating efficiency.

A strong, robust and secure banking system underpins New Zealand's economic development. We weathered the financial crisis well compared to other countries. Profits are an important part of our banks' strength, as is the basis of those profits.

NIM is a measure of the difference between the interest income generated by banks and the amount of interest paid out to their lenders (for example, deposits), relative to the amount of their (interest-earning) assets. It is similar to the gross margin of non-financial companies.

The NIM for the New Zealand banking sector has been trending slightly upwards over the past year by approximately eight basis points (2.16% average for the half year ended June 2011 and 2.08% average for the half year ended June 2010). This slight net increase in the margin has resulted from a combination of factors. It is at least in part due to our banks' relatively strong asset quality.

Essentially, New Zealand banks have been able to offset significant increases in their funding costs (stemming from the higher cost for retail deposits and wholesale term funding in recent years) through repricing (both for risk and the higher funding costs) and changes in portfolio composition, for example by customers choosing to switch from lower margin fixed rate mortgage products to higher margin variable rate mortgage products.

It is misleading to compare average bank mortgage rates to the wholesale 90 day rate (floating comparison) or two year swap rate (fixed comparison) and then conclude that bank margins on mortgages have significantly increased over the past five years.

This analysis has not factored in that retail funding spreads (the cost of raising retail funds relative to the benchmark wholesale 90 day rate or the OCR) and long-term wholesale funding spreads (the cost of raising long-term offshore debt relative to the swap rate or the OCR) have increased sharply since the global financial crisis.

These spreads are now considerably higher than the benchmark rates for short term funds. As a result, the banks' marginal funding costs have increased considerably over this period. In fact, the funding wedge has increased from around 20 to 30 basis points above the OCR, prior to the financial crisis, to around 150 basis points in March 2011.

The higher spreads for long-term debt have reflected a reassessment of term risk by international investors and increased issuance of term debt by banks, corporates and governments, while the higher cost of domestic deposits has largely reflected independent efforts on the part of local banks to increase their share of retail funds, as demanded by the Reserve Bank of New Zealand, investors and rating agencies.

A consequence of the RBNZ imposing a Core Funding Ratio (CFR) requirement is that it has tended to raise the cost of funding for any given interest rate because banks must make greater use of retail deposits and long-term wholesale debt, which are typically more expensive forms of funding. For example, moving from a 65% CFR to a 75% CFR adds around 10 basis points to funding costs assuming the various funding spreads did not change.

In his recent speech <http://www.rbnz.govt.nz/speeches/4487002.html> at the New Zealand Shareholders' Association Annual Meeting, RBNZ Governor Alan Bollard said RBNZ analysis suggests New Zealand banks have not earned interest margins that are particularly high relative to other countries, and supports the view that strong profitability was due to low operating costs rather than undue market power being exercised over customers. New Zealand banks are among the world's most cost-efficient. Something for New Zealand to be proud of.

Our banking system is robust and well regulated, which is good for New Zealand. Let's look at the whole picture when considering banks profits, including the cost of funding, the impacts of the financial crisis, quality of bank assets, and bank efficiency. Looking at interest margins outside this context does not help improve financial literacy in New Zealand.