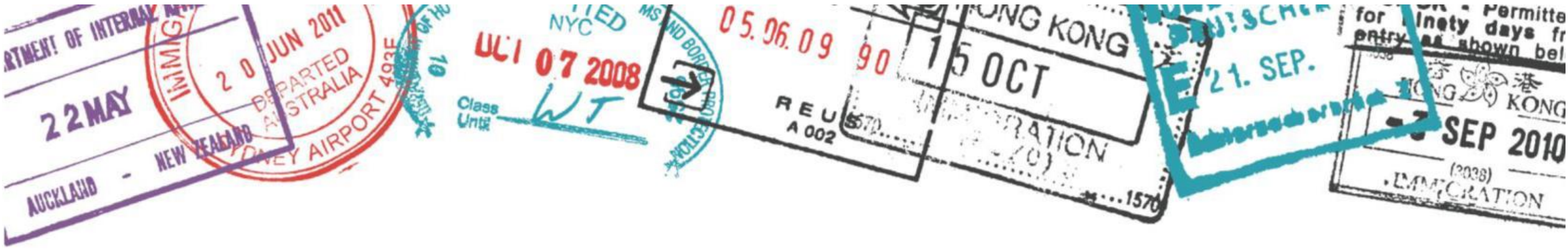

On the road.

With Alphinity Investment Management.

alphinity INVESTMENT MANAGEMENT

New Zealand Financials Research Trip

Who: Andrew Martin, Portfolio Manager | Where: New Zealand | When: March 2019

Where have you been and why?

I recently went to New Zealand to research the Financial sector. I was visiting banks and insurance companies, as well as seeing the regulators and getting insights into the NZ economy more broadly. Many Australian financial companies own material NZ based businesses, so it is important to keep on top of their activities in that market. Australian listed insurers IAG (through State and NZI primarily), and Suncorp (through Vero and AA), dominate the NZ insurance market. On the banks side, the same four Australian owned majors dominate NZ as well through ANZ, Westpac, BNZ (NAB owned) and ASB (CBA owned).

It was also good timing as the Reserve Bank of New Zealand (RBNZ) recently released a consultation paper on potential increases to bank prudential capital requirements that could materially impact the NZ businesses of the major Australian banks, and potentially the economy. Therefore finding out on-the-ground how the regulator is thinking and how the banks are responding is crucial.

What did you learn?

Economy: Whilst there are no major concerns and economic growth remains reasonable (2-2.5%), it is clear that things are softening at the margin, not dissimilar to Australia. The RBNZ recently announced a shift in interest rate outlook to more of a downside bias. Like many western countries, NZ continues to have low unemployment, as well as low inflation and wages growth. Even more so than Australia, the NZ economy relies heavily on immigration and with net immigration easing and likely to ease further this could put more pressure on the economy. Finally, being a relatively small, export lead economy they can be impacted by offshore economic conditions which have been slowing. While Australia has been materially helped by hard commodity exports - like iron ore to China - holding up, NZ relies on a different mix such as dairy and other agricultural products.

Insurance: On general insurance we heard that the market continues to be very favourable in terms of both pricing (continued strong pricing outcomes, even if a bit lower than the very strong last few years) as well as relatively benign loss environment (on the back of better weather for one – although some flooding was occurring in the South Island as we arrived!).

The strong pricing from the last few years in both personal lines and commercial lines insurance is now flowing through to improved earnings and returns. Whilst returns are strong and improving in NZ no one was complacent given the last earthquake is fresh in everyone's mind and the risks remain high. The pressure to hold or improve returns further was still evident. The government and regulator accept higher returns near-term knowing insurers need to build up buffers for when the inevitable large loss occurs. They are more concerned to ensure there is adequate supply of insurance in the high-risk regions. There was a lot of talk about restricted insurance capacity in both personal lines and commercial lines into Wellington given earthquake risks. It will be interesting to see if this develops to a point where the regulator has to take some action. Unlike the bank sector, it appears as if the regulator is comfortable with the level of capital in the insurance sector for now. Overall the tone amongst the insurers was that things are going very well at the moment.

Banks: For the banks the tone was more mixed. Existing conditions are reasonable, if slowing a bit in line with the economy. Credit quality risks remain very low in NZ and the prospects for any material loan losses seem a way off. However it is hard to see things getting much better. The dairy sector has improved but it was clear that many of the major banks were continuing to try to lower exposure to the sector over time. Much like a number of Australian cities, Auckland in particular has a housing affordability issue. While house prices have softened a bit, it is nothing like what we are seeing in Sydney and Melbourne. They are seeing small single digit type declines. Net immigration is still positive which helps and Auckland has a lower supply of housing relative to what we've seen in Australia (especially apartments). Furthermore unemployment remains very low.

The main talking point however was around the proposed new prudential capital regulations put forward by the RBNZ recently. This could see materially more capital required to be held in NZ than current rules. Importantly it would require a significantly higher percentage to be held in NZ relative to the size of the loan book, than required in Australia. The changes would put NZ near the top of required banking capital levels globally (and you would think the subsequent lower returns that go with that).

The Reserve Bank believes this is justified because:

- NZ is a riskier economy compared to Australia and more susceptible to trade shocks. They see banks as being very geared vs other sectors and the extra capital they are proposing is 'just a little more' relative to their balance sheets (~$20bn for the system, so a decent amount more in reality!).
- In a banking crisis, the RBNZ wants to make sure NZ's deposit holders are protected and this can only be guaranteed if the extra capital actually sits in NZ rather than relying on the Australian parent banks to inject more capital if required (especially if you have a dual crisis in Australia at the same time).
- A five year transition period should be accommodative (however a number of other changes around risk weights will raise capital requirements much sooner than that and generally banks want to get to required levels ASAP).
- The cost of bank crises these days is potentially bigger than in the past, which needs to be taken into account.
- Making banks safer will see NZ risk premia go down and that is positive for the country (unless making the changes causes economic issues of course).
- More capital will lead to more lending over time (I can only assume this is a comment indicating banks will feel more comfortable lending in a more conservatively capitalised environment – I would suggest returns will be as great a consideration for banks).

The RBNZ believe banks should be getting around 10-11% ROE's in NZ which is 2-3% below those being achieved in Australia. They see this as being acceptable to investors who should be willing to take a lower return reflecting the lower risk. This raises an interesting conundrum for the banks and their investors given they already have a lot of capital invested in NZ. If you are forced to hold more capital in a country and therefore have your returns fall, do you (or can you): reprice your product to fully recover those returns; accept lower returns because risk is lower; or, ration credit availability in that country if you can't get your required returns (or have options to get better returns elsewhere like Australia). Another option of course is you could look to extract yourself entirely from that country given a structurally lower returning region now.

On the final point first, the consensus view is that at best one of the smaller big four banks could 'maybe' list or dual list their NZ division on NZ market, but certainly not all and not the bigger ones. The listed market is just too small to absorb that size. Partial listing doesn't work from a capital point of view, and there is unlikely to be an external buyer of those assets (especially as returns would be under further pressure).

The RBNZ acknowledges that some repricing will occur, but believe they can offset that by lowering the official cash rate (I question how fully effective that is if they are already thinking about having to cut rates for a weak economy). However there is a material difference between what the banks feel they need to reprice loans by to offset the extra capital, and what the RBNZ believe will actually happen. RBNZ feel that competitive forces over time will restrict the ability of banks to fully offset the capital impact with price, or to withdraw credit availability. As such they do not see a material impact on the economy.

The risk is that they are wrong just when the economy is weakening. Banks, on the other hand, would like to think they could fully reprice, but that is unlikely given the size required. At the same time, I don't think that investors will just accept a lower return given the extra capital won't materially lower the risk or volatility in equity investors eyes I suspect. Banks are ultimately very geared and when they fail, they don't usually fail by a little bit. The banks will have to tread carefully around their response with price and credit availability, versus impacting the economy to the extent they get credit losses or face customer backlash.

The answer is likely somewhere between the two views with it being a little worse for the banks than they expect and a little worse for the economy than the RBNZ thinks. Interestingly the issues aren't really widely known or discussed in NZ yet outside of those companies directly impacted (the press has not yet seen it as a compelling story). I wonder what will happen politically once 'mums and dads', and companies (like the dairy industry) realise they either can't get the loans they want or the price is potentially going materially higher.

How has this trip influenced your thinking on the Alphinity portfolio?

The trip confirmed for us the strong outlook for the insurance companies being bolstered further by strong NZ earnings. This is likely to play through for a number of periods. IAG and Suncorp dominate the insurance market in NZ. The Alphinity portfolio retains an overweight position to the insurance sector.

At the margin I was left more negative the banking sector. Whilst timing and quantum remain uncertain, clearly the Australian banks are going to have to hold materially more capital in NZ. This will further pressure already falling returns and in some cases will depress or slow growth in dividends further for a time. It appears unlikely that the Australian banks will extract many, if any, concessions from the regulator. As such we also came away more concerned about how these changes to capital levels – and how the banks respond - could negatively impact the broader NZ economy, which appears to already be softening. The implications could therefore be bigger for the banks, whose fortunes are ultimately tied to the performance of the economy through lending volumes, interest margins and credit quality (i.e. how many loans get repaid). The portfolios remain underweight the banking sector.