

NEW ZEALAND ECONOMICS ANZ PROPERTY FOCUS

FEBRUARY 2011

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ONE STEP FORWARD, TWO STEPS BACK

SUMMARY

Our monthly *Property Focus* publication is aimed at providing an independent appraisal of recent developments in the property market. This month we look at the likely consequences of the Christchurch earthquake for the economy, fiscal/monetary policy and financial markets.

THE MONTH IN REVIEW

Just when it looked like the worst was behind us, a second and more violent earthquake caused widespread destruction across Christchurch. The effort to rebuild will be delayed at the very least by six months, while economic activity in the region will also be sorely dented in the near-term, and beyond.

PROPERTY GAUGES

With most of the series showing little change over the end of last year, the focus was turning to how 2011 will shape up. But that was last week's news and the earthquake has turned everything on its head. The devastation and rebuild from the quake will be felt for years to come, in some form or another.

MORTGAGE BORROWING STRATEGY

Mortgage rates have not changed over the past month, but they are set to fall dramatically. Indeed, as a result of the recent Christchurch earthquake, we expect the RBNZ to cut the OCR by 0.25 percent in both March and April. Floating mortgage rates will fall one for one with the OCR, taking them back to last year's levels. Fixed rates are also set to fall dramatically, particularly for shorter terms like the 2 and 3 year. Indeed, wholesale interest rates have plunged (the wholesale 2 year rate has fallen 40 basis points since the quake), and continue to fall, and this will be reflected in fixed mortgage rates as soon as market rates stabilise. Given this outlook, we see no rush to fix, and prefer to literally see how the dust settles before making a decision.

FEATURE ARTICLE – THE CHRISTCHURCH EARTHQUAKE

The fallout from the earthquake will affect New Zealand as a whole. The impact on the nationwide economy will be significant, with at least a 0.5 to 1 percent hit to Q1 GDP growth. Adverse effects on confidence and delays in returning to normality will exacerbate this in Q2 and beyond. The rebuild effort will be huge, but it will be protracted (five years plus) and stymied by resource shortages. The broader impacts on the nationwide economy (confidence, net migration, resource shortages, insurance industry responses, asset values, tourism) are much more difficult to project. But they will be substantial, and long lasting. Sensible heads are required thinking strategically about the policy response.

THE MONTH IN REVIEW

Just when it looked like the worst was behind us, a second and more violent earthquake caused widespread destruction across Christchurch. The effort to rebuild will be delayed at the very least by six months, while economic activity in the region will also be sorely dented in the near-term, and beyond.

CHRISTCHURCH EARTHQUAKE - FEBRUARY

Large scale devastation from the second shake.

We had been detecting an improvement in anecdotes across the country, though the housing market was a laggard. **Momentum was building and things were shaping up nicely for 2011. But February's destructive earthquake has seen us slash our projections for 2011 and beyond.** This will dent sentiment and activity and could delay the economic recovery by around six months. We had previously factored in a strong earthquake rebuilding effect from Q2 this year, but **reconstruction work will now be delayed.** We still expect a boost to activity from the rebuild and repairs, but it will come later. Household balance sheets will also be weaker as property values around Christchurch will have taken another hit as a result.

STATISTICS NZ, BUILDING CONSENTS - DECEMBER

Residential construction will take even longer to recover.

Building consents plunged 19 percent in December. Such weakness suggests there will not be much new dwelling construction activity over the first half of this year. Even on an ex-apartment basis, consents were down 11.3 percent, the sixth consecutive monthly decline. Consents are at a depressingly low level, and cannot remain this low given ongoing population growth.

RBNZ, CREDIT GROWTH – DECEMBER

How low can it go?

The level of housing credit was unchanged in December. The annual percent change has dropped to a new low of 1.8 percent, while the three monthly annualised rates of change has **sunk to a new low of only 0.4 percent.**

ANZ ROY-MORGAN, CONSUMER CONFIDENCE - FEBRUARY

Will surely suffer following the big one.

The ANZ-Roy Morgan Consumer Confidence measure **dropped nine points to an 18-month low** in February. While the decline in the month appears discouraging, seasonal factors account for the drop in sentiment. If we remove the seasonal factor apparent in consumer confidence, headline confidence was down only a point. Nevertheless, the index has been on a declining trend since early 2010.

REINZ, HOUSING DATA – JANUARY

The housing market's fragile recovery is now in jeopardy.

In seasonally adjusted terms, **the number of house sales fell 6.9 percent**, more than reversing the 3.8 percent increase in the previous month. House prices, according to our seasonal adjustment, fell between 0.5 percent and 1.4 percent, depending on which measure you use. Compared to a year ago, house prices are off close to 3 percent.

STATISTICS NZ, NET MIGRATION - DECEMBER

For some it will be a decisive factor to leave NZ for good.

Permanent and long-term arrivals fell by 1.6 percent in December (s.a.), while departures declined by a larger 3.8 percent. **Net inflows remain well below 2009 levels, due primarily to a big pick-up in departures to Australia.**

ASSESSMENT

January's data showed little housing related momentum. And we now have another shock to deal with. The next few months look set to be difficult, and the data will be very noisy.

PROPERTY GAUGES

With most of the series showing little change over the end of last year, the focus was turning to how 2011 will shape up. But that was last week's news and the earthquake has turned everything on its head. The devastation and rebuild from the quake will be felt for years to come, in some form or another.

We use ten gauges to assess the state of the property market, and for signs that changes are emerging.

AFFORDABILITY. For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (adjusted for interest rates), and mortgage payments as a proportion of income.

SERVICEABILITY / INDEBTEDNESS. For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

INTEREST RATES. Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.

MIGRATION. A key source of demand for housing.

SUPPLY-DEMAND BALANCE. We use dwelling consents issuance to proxy supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

CONSENTS AND HOUSE SALES. These are both key gauges of activity in the property market.

LIQUIDITY. We look at growth in Private Sector Credit relative to GDP to assess the availability of credit in supporting the property market.

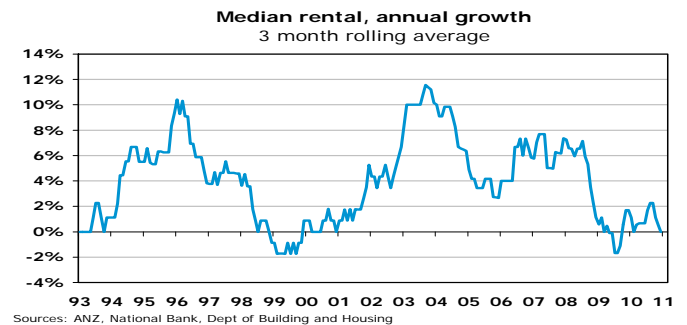
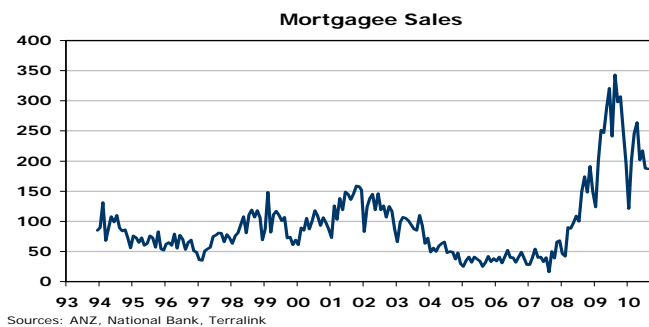
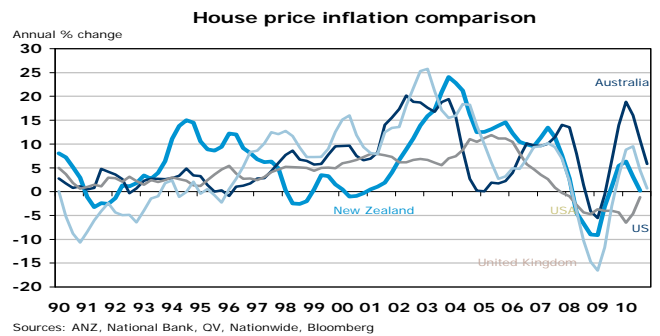
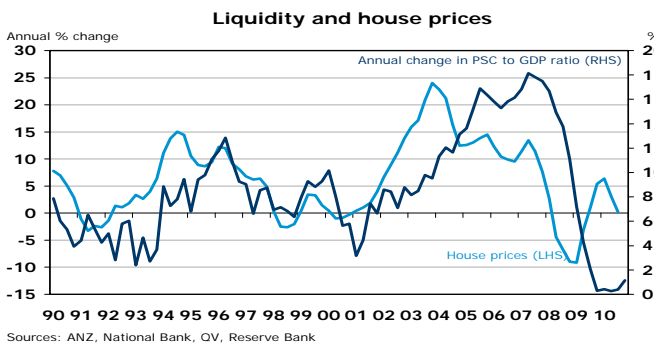
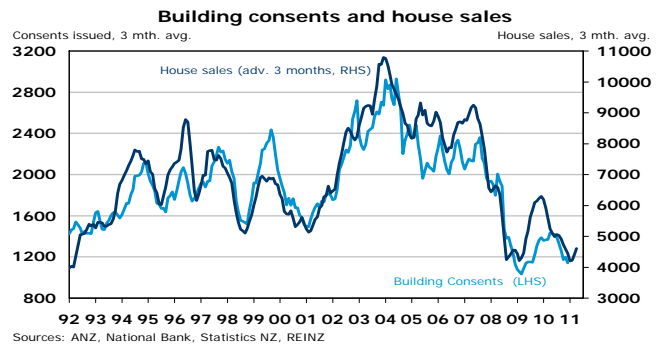
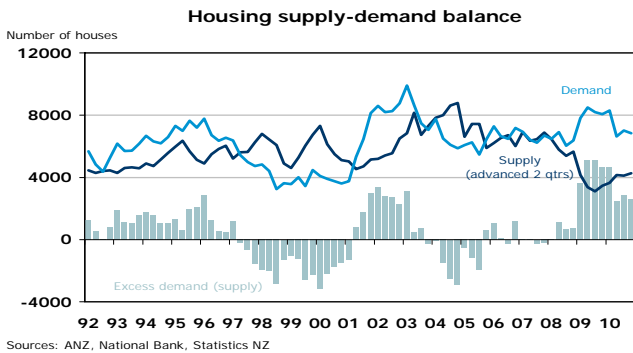
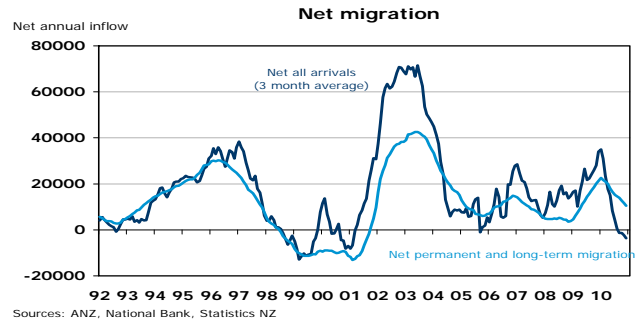
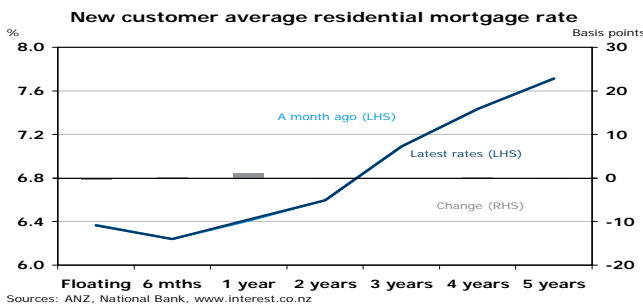
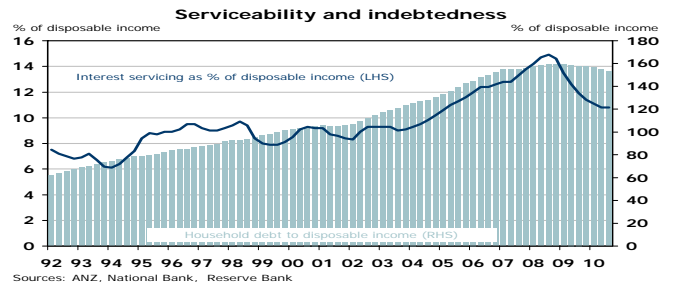
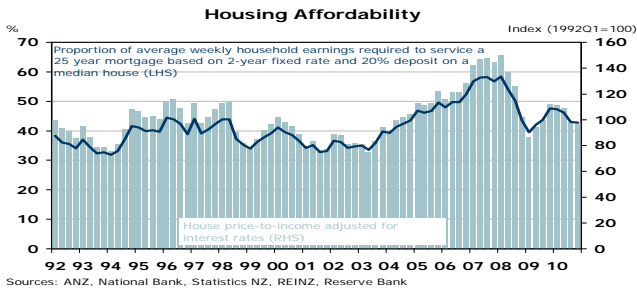
GLOBALISATION. We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that globalisation is playing in NZ's property cycle.

MORTGAGEE SALES. We look at how mortgagee sales are tracking for an indication of distress in the property market.

RENTAL GROWTH. We look at growth in the median market rent as an indication of whether it is a better time to buy versus rent, and how rental yields are shaping up for the property investor.

Indicator	Level	Direction for prices	Comment
Affordability	Slow to improve	↔	Affordability was virtually unchanged between September and December, but the trend over the last 12 months is encouraging.
Serviceability / indebtedness	Deleveraging is the key	↓	The ratio of debt to income is at a 5-year low, and dropping.
Interest rates	Unchanged	↔	Virtually no change in the past month.
Migration	Easing	↔	Australia is increasingly becoming a magnet for Kiwis.
Supply-demand balance	Gap still persists	↔/↑	The latest figures showing the gap between housing supply and demand in December was very similar to September, with excess demand still at elevated levels.
Consents and house sales	Lifting but very low	↔/↑	The rolling three month average of the number of house sales has picked up, but not so for residential consents.
Liquidity	Tick up	↓	The ratio of credit to GDP is showing its first tentative sign of turning around.
Globalisation	Flat-lining	↔	Global annual house price growth is converging towards the zero axis, most from above it and one from below it.
Mortgagee sales	High but dated	↔	Remains high but the data is not timely, with September the latest observation.
Median rent	Patchy rise	↔	A hesitant rise but for how long? Watch this space.
On balance		↔/↓	The flicker of a turnaround over the start of 2011 has now been snuffed out.

PROPERTY GAUGES



MORTGAGE BORROWING STRATEGY

Mortgage rates have not changed over the past month, but they are set to fall dramatically. Indeed, as a result of the recent Christchurch earthquake, we expect the RBNZ to cut the OCR by 0.25 percent in both March and April. Floating mortgage rates will fall one for one with the OCR, taking them back to last year's levels. Fixed rates are also set to fall dramatically, particularly for shorter terms like the 2 and 3 year. Indeed, wholesale interest rates have plunged (the wholesale 2 year rate has fallen 40 basis points since the quake), and continue to fall, and this will be reflected in fixed mortgage rates as soon as market rates stabilise. Given this outlook, we see no rush to fix, and prefer to literally see how the dust settles before making a decision.

OUR VIEW

We should highlight from the start that this month's commentary is unusual. Markets are on the move courtesy of seismic events, and we won't pretend to know with accuracy how much further they will run. The past three days has fundamentally altered the outlook for the economy and interest rates as well. Based on our forecasts, we believe wholesale rates will continue moving lower in the days ahead. This means we need to get ready for substantially lower mortgage rates, with fixed mortgage rates potentially moving lower even before the RBNZ cuts the Official Cash Rate (OCR) on 10 March. Whether rates will in fact move lower before the RBNZ acts isn't important in the grand scheme of things – the reality is they haven't moved yet because market rates have moved so fast and banks have not had the opportunity to assess the implications for mortgage rates. But when you consider that benchmark market rates, like the 2 year wholesale rate, have plunged 40 basis points since the Christchurch quake, mortgage rates will clearly follow.

The question for borrowers will be – will impending cuts in mortgage rates be an opportunity to lock in a fixed rate for a longer period? We are keeping an open mind. For one, wholesale interest rates are still on the move, and we don't know where mortgage rates will settle. If the disruption from the quake becomes more elongated or more significant, rates may move lower yet. We therefore urge caution, and would not be jumping to hasty conclusions once rates do fall. We're also mindful of the potential for the value proposition to change markedly, and once again, without knowing where fixed rates (or even the floating rate) will settle, we do not want to jump to conclusions. But if we look at what's happened to wholesale rates as a guide, the floating rate (i.e. the 3 month bank bill rate) and the 2 year have fallen by more than the 5 year rate. This means that when rates do settle down, the incremental cost to fix will grow. That is, relatively speaking, it will be much cheaper to remain floating.

With the whole suite of mortgage rates set to move lower, breakeven analysis offers no real value. Indeed, as the table below shows, breakevens all show that rates need to head higher in order for there to be any value in fixing at the moment. With rates set to move lower, there is no point considering fixing right now.

Mortgage Rates		Breakevens			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	6.20%				
6 months	6.35%	6.55%	6.75%	6.95%	7.78%
1 year	6.45%	6.65%	6.85%	7.36%	8.00%
18 months	6.55%	6.75%	7.16%	7.65%	8.11%
2 years	6.65%	7.01%	7.43%	7.82%	8.25%
3 years	7.10%	7.43%	7.78%	8.09%	8.40%
4 years	7.45%	7.73%	8.01%		
5 years	7.70%				

More than anything, we would urge caution with respect to making decisions on mortgage rates, and we will continue to monitor the situation closely. Indeed, we suspect it will be at least a month before the full impact of the Christchurch earthquake can be understood, and before interest rate markets stabilise. Only then can we offer informed analysis. Watch this space.

FEATURE ARTICLE – THE CHRISTCHURCH EARTHQUAKE

SUMMARY

- Early estimates of the direct cost of the earthquake in terms of destroyed infrastructure and buildings are in the range of \$5 to \$12 billion. It is likely to be at the upper end of this range, and this comes on top of the \$5 billion bill from the September quake.
- The near-term impact on the economy will be significant. As a starting point, we are assuming a minimum 0.5 percent hit to Q1 GDP growth, but this is based on some fairly conservative assumptions. Numbers closer to 1 percent seem more intuitive. Adverse effects on confidence could exaggerate this further and impact on Q2 as well.
- The rebuild effort will be huge, but it will be significantly delayed, protracted (five years plus), and stymied by resource shortages. Not everything that was destroyed will be rebuilt.
- Our expectations of the economy being at a turning point in Q1 2011 have been pushed out by six months. We are back to square one in terms of the rebuild effort. There will again be significant unavoidable bureaucratic delays to getting work underway, although having experience and people on the ground from the September quake should help. Instigating a state of emergency signals a faster response time.
- The broader impacts on the economy (nationwide confidence, net migration, resource shortages, insurance industry responses, asset values, tourism) are much more difficult to estimate. But they will be negative, substantial, and long lasting.
- The financial burden of the earthquake will be massive. The Government will return to surplus much more slowly. A credit downgrade seems inevitable, though we are talking about margins of excellence in terms of AA versus AA+ (foreign currency rating).
- We are encouraged by the coordinated responses we are seeing. But this must be viewed in context of the need: this event is bigger than *Ben Hur*. Watch for business sector initiatives to support fiscal policy too.
- Fiscal policy and aid on the ground needs to do most of the work in regard to responding to Tuesday's events. We expect a sizeable package next week. Immediate attention needs to turn to

microeconomic policies that could assist in helping the reconstruction effort. This includes greater incentives to get people into skilled trades.

- Monetary policy plays second fiddle to fiscal policy in events like this, but should still do its part. The RBNZ has every justification to cut the OCR. We believe they should cut rates by 50bps, with at least 25bps of this coming at the March *Monetary Policy Statement*. We see little prospect of policy restarting a process of normalisation until 2012.
- Financial markets have responded quickly and appropriately, with the exchange rate and interest rates down sharply. We expect to see the yield curve steepen further.

THE STATE OF PLAY

THE CURRENT SITUATION

At 12:51pm on Tuesday February 22, a magnitude 6.3 earthquake occurred 10km south-east of Christchurch. While this was smaller than the magnitude 7.1 earthquake that struck on September 4 last year, its shallower depth (focal depth of 5km versus 10km) and closer proximity to Christchurch (10km versus 40km) created more significant damage to Christchurch City. So far, more than 100 aftershocks have been measured since the Tuesday earthquake, four of them magnitude 5 or greater.

A state of national emergency was declared on Wednesday. There are reports of widespread building collapse (especially in the central city). Police are imposing tight restrictions in central Christchurch for public safety reasons amidst fears of further building collapses.

At the time of writing 113 fatalities have been confirmed but this figure is expected to rise markedly. All hospitals are operating, with an estimated 60 percent of medical centres open. Welfare centres have been set up around the city to cater for support, advice or accommodation needs. Schools and most workplaces in the city are closed until further notice. Service stations and supermarkets in various parts of the city have opened, with a number of ATMs operational to provide cash withdrawal facilities.

FEATURE ARTICLE – THE CHRISTCHURCH EARTHQUAKE

About 200 police have been mobilised as part of the immediate response, with another 130 expected in the next few days. Nearly 1,500 New Zealand Defence Force personnel are providing support, with more than 600 emergency workers, from six countries, assisting rescue efforts.

Basic infrastructure in the city has been significantly damaged. Currently 80 percent of Christchurch is without reticulated water and 80 percent of trunk sewers are damaged. Water tankers are being dispatched across the city to meet immediate needs. Power has been restored to 60 percent of the city, with Eastern areas worst affected by cuts. Phone services are sporadic, with widespread network damage.

Transport links have also been badly affected. Christchurch Airport is operational. The rail network in Canterbury has been largely cleared and rail operations are set to resume in a number of areas. Main roads out of the city are now open. However, damage and rubble have closed many city roads, particularly those between the CBD and the Eastern suburbs. Lyttleton tunnel is closed, except to emergency vehicles, with sections of SH74 closed. Moderate damage to Lyttleton Port was sustained, with the oil berth expected to be operational by Saturday and container services fully operational within approximately 10 days.

Initial assessments have largely been contained to key infrastructure and the CBD. But beyond this, key parts of the city and the Eastern suburbs have been materially damaged. Areas in and around Christchurch (such as Woolston) are key manufacturing hubs and have been impacted. Unlike the September affair, this episode looks set to involve direct production losses, on top of outright wealth destruction.

Early estimates of the direct physical damage to buildings and infrastructure range between \$5 and \$12 billion. Even if we do a simple back of the envelope calculation, the numbers are staggering. For the sake of argument, assume that 10 percent of the 160,000 dwellings in Christchurch city are completely destroyed (average rebuild cost of \$250,000), with moderate damage (\$50,000 average repair bill) affecting 25,000 dwellings, and more minor damage (\$20,000 average cost) occurring for another 25,000. Assume also that 50,000 residential sections are in need of significant repair, at an average cost of \$20,000. Under these assumptions, the total cost for residential damage alone would be in the region of \$7 billion. If we further assume that damage to

infrastructure and non-residential buildings is twice that of the estimated impact of the September quake (i.e. \$2 billion each), then the total extent of damage is in the region of \$11 billion. Of this, the Government is assumed to fund \$8 billion of the damage: \$5 billion of the damage to residential property via EQC, all of the damage to infrastructure and half of the damage to industrial and commercial buildings.

The non-monetary cost is not measurable but far more significant.

THE ECONOMIC IMPACT

ESTIMATING THE IMPACTS

There are three broad channels by which the earthquake will influence the economy.

- The near-term hit to GDP.
- The rebuild, which will be a large undertaking and take years.
- The interaction between the headwinds that will arise from the earthquake, and the rebuild and policy response.

THE NEAR-TERM HIT TO GDP

The Canterbury region accounts for between 10 - 18 percent of the NZ economy on a range of economic metrics. **Christchurch City accounts for roughly two-thirds of the Canterbury region, and is New Zealand's second largest city.** Therefore, as a rough guide, **the Christchurch economy accounts for around a tenth of New Zealand's GDP.**

There will be an immediate direct negative impact on 2011 Q1 GDP from the disruptions caused by the earthquake, which we estimate to be at least 0.5 percent. There is now a fairly high probability of a negative quarter. There will also be a negative effect on Q2 GDP to a lesser extent – this depends on how quickly Christchurch businesses and residents can get back to some sense of "normality".

FEATURE ARTICLE – THE CHRISTCHURCH EARTHQUAKE

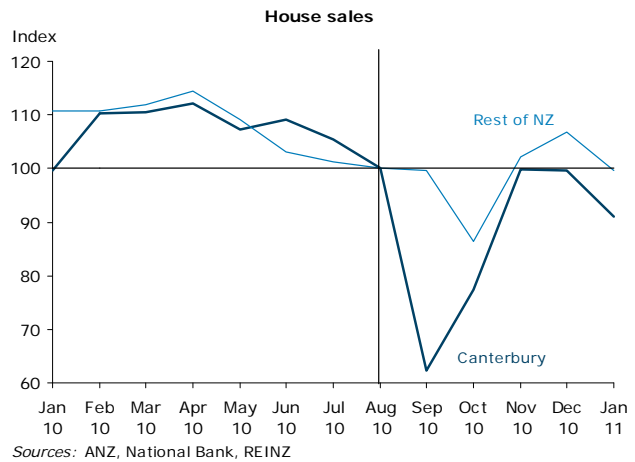
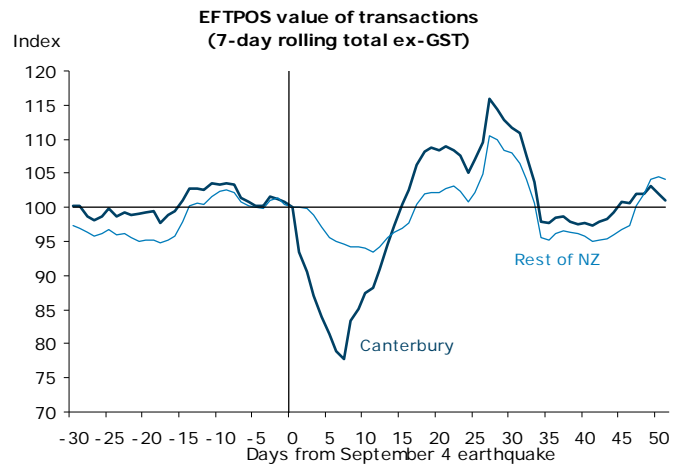
Estimates for key metrics (2010 year)	Canterbury region	% of NZ
Regional GDP (\$b)	27	15
Population (000)	566	13
Number of business enterprises (000)	65	13
Retail sales (\$b)	8.5	13
Employment (000)	335	15
House Sales	7903	14
Expenditure by international visitors (\$b)	1.5	16
Expenditure by domestic visitors (\$b)	1.8	14
Visitor guest nights (m)	5.1	16
Overseas visitor guest nights (m)	2.4	18
Value of sea freight (\$b)	7.2	10
Value of air freight (\$b)	2.1	14
Passenger movements at Christchurch Airport (000)	1578	17

Sources: ANZ, National Bank, Tourism Research Council, NZIER, REINZ, Statistics NZ.

Even if we use conservative assumptions, it is easy to arrive at a 0.5 percent hit to Q1 GDP.

Following the September 4 earthquake last year, the value of EFTPOS transactions fell around 20 percent after the first week, but recovered to pre-earthquake levels by the end of the second week. The number of house sales fell almost 40 percent, and while they recovered over the next two months, they have underperformed the rest of the country. Given the more extensive damage this time – including pockets of the manufacturing sector – the economic disruption will be more significant. We conservatively assume a 30 percent drop in economic output in Christchurch in the week of the disaster, with the impact progressively diminishing in subsequent weeks. We assume the level of activity is back near pre-earthquake levels by the end of March, which is on the heroic side. Even with these optimistic assumptions, we end up with estimates upwards of 0.5 percent. Earthquake demolition work will provide some near-term support to economic activity, but only a small offset – especially since it replaces rebuilding work from the September quake that otherwise would have been ongoing.

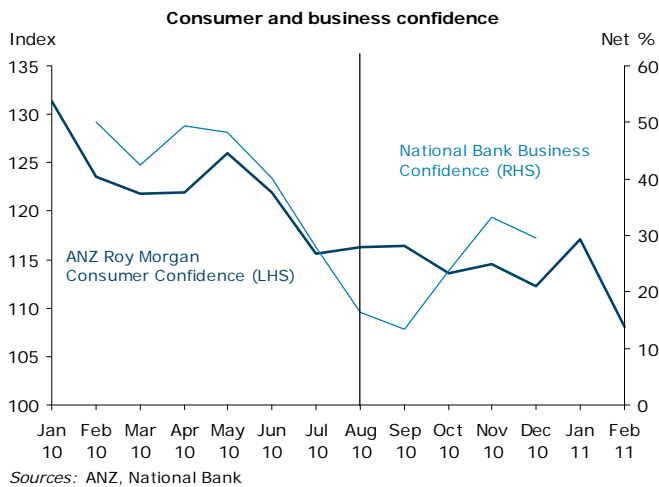
If we assume a longer delay before a return to the new “normality”, whatever that may look like (i.e. a return to pre-earthquake levels by late April), we get something closer to a 1 percent drag to Q1 GDP growth, and spillover into Q2. These higher numbers have some appeal, given the reputed numbers of people leaving Christchurch, and the damage to core infrastructure.



For a lot of businesses, Tuesday’s event is going to be the last straw. Even those that survive have limited prospects for an exit strategy (i.e. buyer prospects).

A big uncertainty is the impact that the earthquake will have on confidence. Last year’s earthquake did not result in a sharp fall in business or consumer confidence. This time, though, given the severity of the damage, including a significant loss of life, we expect a more material hit to confidence around the country, not just in Christchurch. This is likely to flow through into economic activity, though it is hard to measure how much of an impact that would have. **The economy looked to have been building a better base in Q1 2011, but this is unlikely to be sufficient to absorb the earthquake impact. Q2 is looking on shaky ground as well.**

FEATURE ARTICLE – THE CHRISTCHURCH EARTHQUAKE



THE REBUILD

The estimated cost of last year's September 4 earthquake is around \$5 billion. If we add on the cost of Tuesday's earthquake of between \$5 and \$12 billion, then **we are looking at a sizeable rebuilding effort of at least \$10 billion, which is equivalent to 5 percent of GDP or 1.7 percent of the nation's capital stock.**

There is currently an abundance of construction resources to absorb the initial stages of the recovery process. Residential building consents issued last year totalled only 15,500, and the pipeline for non-residential work is relatively short.

But the story gets trickier beyond one year. That rate of building consent issuance is opening up supply-demand imbalances, particularly in Auckland. The construction sector was stretched six years ago dealing with 30k residential consents per year. Assuming a base level of demand of 20k for the core housing stock (i.e. a modest improvement from current levels), this leaves only 10k resources per year of rebuild capacity – not taking into account that capacity is quite possibly not what it was six years ago. The same applies to non-residential construction, which totalled \$4.9 billion in 2010 (and the pipeline for 2011 looks below that). It peaked at \$5.6 billion in 2008/09. There will be a natural pipeline of non-residential and infrastructure work that will emerge as the economy recovers, but actual work will be some way off.

When we look at the potential rebuild requirement, and what the industry can feasibly absorb each year, we are talking an extended multi-year reconstruction process. This is going to impact not only on the rate

of GDP itself (we assume a 1 percent boost to GDP for the next five years at least), but also on the mix of growth. **Essentially, for the economy to meet this demand for resources, output will have to be sacrificed elsewhere.** Mechanisms by which this will occur include higher prices for construction related labour and capital, and reshuffling of government spending.

While the rebuild will act to boost economic activity once it gets underway, there is uncertainty over the timing. Reconstruction efforts from last year's earthquake had already hit delays, and the extensive nature of this week's quake suggests it may not be until Q3 2011 that major work can really get underway. With the EQC still processing claims from the September earthquake (126,000 of 183,000 claims paid out so far, totalling \$0.8 billion), we should not kid ourselves into thinking that it will not be a long and hard road ahead. If severe aftershocks continue, it will further delay any rebuilding effort. **We expect the reconstruction effort, once it gets underway, to take a number of years.**

Our key view for 2011 was that the economy was at an inflection point. Prospects in 2011 were looking fundamentally better than the close of 2010. Some of the key themes still apply: financial conditions are supportive, commodity prices are at record highs and the global economy is recovering nicely. But the earthquake is a game-changer.

When the circumstances change, so must our economic view. Our expectations of the economy being at a positive turning point in Q1 2011 have been pushed out by six months. We are back to square one in terms of the rebuild effort, and there will be significant unavoidable bureaucratic delays from here, although experience and resources on the ground from the last earthquake will help.

BROADER INTERACTIONS

A basic analysis of the earthquake's economic impact suggests a negative near-term hit, followed by a boost to activity. But there are also other interactions to bear in mind. **The earthquake has adversely affected balance sheets.** Insurance will mitigate the losses to some extent, but higher insurance premiums and more uninsurable premises are likely to be the result. The earthquake is also likely to deliver a further hit to residential property values and household balance sheets in the region, weighing on consumer spending.

FEATURE ARTICLE – THE CHRISTCHURCH EARTHQUAKE

We can expect a strong policy response, with the Government already declaring a national state of emergency and marshalling all available resources to Christchurch. We also expect the RBNZ to provide further policy accommodation in order to shore up confidence. However, **the rest of the country will end up picking up some of the tab for the earthquake costs; directly, via higher insurance premiums or levies across the board, and indirectly, from a weakened Government fiscal position.**

The earthquake may exacerbate resource and skill shortages. Competition for scarce resources is set to be a major problem as Christchurch looks to rebuild. Not only has the second quake caused more devastation (and in different areas), but it has come at a time when Australia is looking to rebuild after floods. Christchurch was already calling on tradesmen and the like from other regions around the country. Having suffered a second significant quake, migrant workers (and indeed some locals) may be less willing to stick around, preferring to head to Australia instead.

All up, the inflection point theme we had been running for the economy is history. H1 2011 growth will be soft, coming off a flat H2 2010. While we still expect growth to pick-up in H2 2011, and for activity to be supported throughout 2012 and into 2013 from the reconstruction effort, it won't be the feel-good kind of growth. This highlights the inadequacy of GDP as a measure of economic well-being – it does not capture the hit to the nation's wealth.

SOME KEY UNCERTAINTIES

There are a lot of other uncertainties that go beyond the initial physical and psychological impact.

- What is the impact on asset values, and where are the buyers if you want to leave town? We are talking massive emigration potential out of the region, and quite possibly out of the country. Immigration is likely to fall as well.
- How long will tourists stay away? Can Christchurch host the Rugby World Cup quarter-finals?
- What proportion of people is not insured? The familiar moral hazard question rears its ugly head again, but government support for the uninsured will be required.

- What are the prospects for getting insurance cover going forward? Are we going to end up with some sort of Government model if offshore re-insurers balk after now having had to pay up twice?
- While insurance cover including EQC is significant, what proportion of the damaged capital stock will not be replaced? We can see instances already where the replacement cost of a building would require a far higher rent, and tenants balk at the prospect. The endgame is a lot of car park space.
- Someone has to ask the question: should Christchurch really be rebuilt in the same place at all, or should it be centred inland on firmer ground which is less prone to liquefaction?
- What happens to those who are self-employed at present? No premises. No demand. No income.
- From a business's nationwide perspective, what is your appetite for locating in Christchurch?
- We will, over time, see stricter earthquake standards being imposed in Canterbury and possibly some other parts of the country. This is likely to be a condition for future insurance coverage. What will this do to the commercial property market?

This list is far from all-encompassing. We've merely listed a few issues to highlight just how complex the situation is.

The list of uncertainties is not meant to belittle Christchurch. Christchurch and Canterbury are a critical part of NZ.Inc. It is a manufacturing centre of excellence, gateway to the south and stands to benefit uniquely as a service hub from the positive long-term story for agriculture (particularly once we work out how to leverage more off our water resources). **Christchurch will re-emerge. New Zealand and the South Island require it. But this process faces enormous challenges and requires decisions that will create some angst.**

FISCAL POLICY

WHO PAYS

Exactly who shoulders the burden of the earthquake depends on what is damaged, and whether it is insured, as we demonstrate in the diagram below. The EQC covers all insured residential properties, and its liability (including GST) is limited

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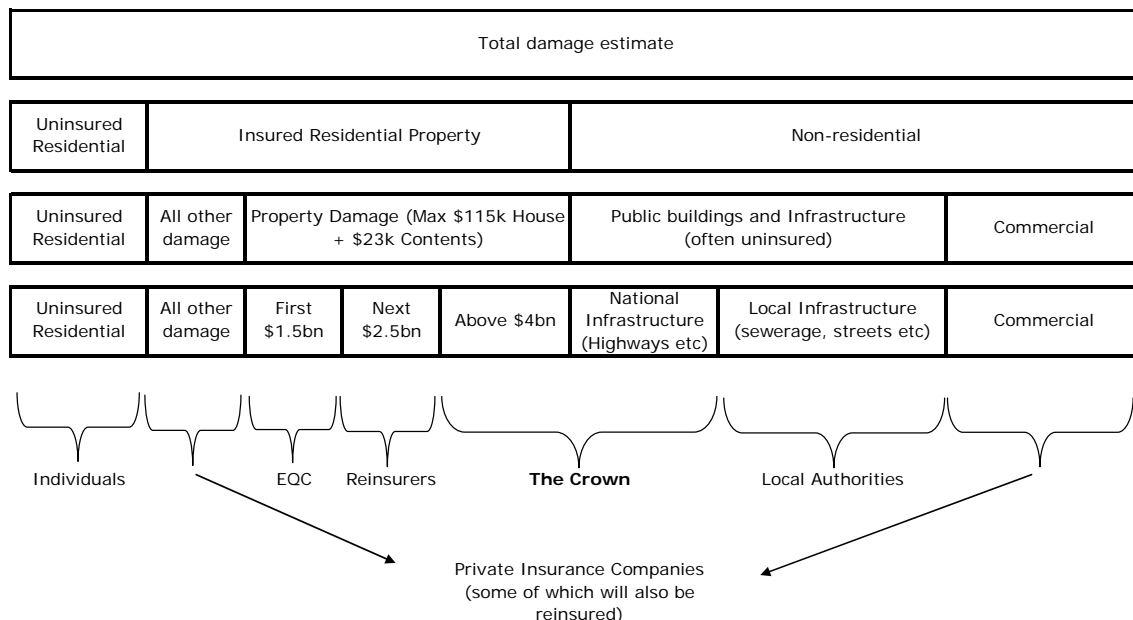
to \$115,000 per dwelling, plus \$23,000 for contents, plus the value of affected land (within limits). Claims above this amount become the liability of a homeowner's private insurance cover. The EQC does not cover damage to commercial buildings, which are privately insured. Similarly, the Crown does not typically insure its assets.

That being the case, the composition of what has been damaged matters. The more public buildings, houses and infrastructure that are damaged, the larger the burden on the Crown. By contrast, the more commercial buildings are damaged, the more the impact will fall on private insurers. In that regard, it is very difficult to know which insurance companies are affected; both locally owned and offshore companies operate in NZ. All will have some degree of reinsurance, lessening the blow.

The EQC is liable for the first \$1.5 billion of claims arising from the earthquake, with the next \$2.5 billion covered by reinsurance. At the moment, the EQC has \$5.4 billion of assets in its Natural Disaster Fund (on top of reinsurance monies received from the

September quake). So far, the EQC has made \$0.8 billion of claims relating to the September quake, leaving at least \$4.6 billion of assets, giving it ample capacity to absorb the claims that will arise from Tuesday's quake. The real issue for the Crown is if the damage to insured residential property exceeds \$4 billion (i.e. the EQC's \$1.5 billion plus the \$2.5 billion from reinsurance). Anything above this figure, as well as damage to national infrastructure and public buildings, is the Crown's liability.

To the extent that the EQC owns \$3.5 billion of Government bonds and bills, it may be forced to liquidate some of these in order to fund the \$1.5 billion liability. However, we believe the EQC owns around \$0.8 billion of November 2011 bonds, which could be liquidated with very little market impact or simply left to mature if the claims process takes some time. We also note that the EQC is sitting on previously paid reinsurance monies which may take time to be distributed, reducing near term market impacts. **In other words, we do not expect a fire sale of EQC assets.**



As we indicated above, early estimates of the cost of the earthquake range between \$5 and \$12 billion. This figure is likely to be revised over time. We should also note that, to the extent that private insurance companies shoulder a large portion of the burden, this will have a significant impact on insurance premiums going forward.

Unfortunately, the earthquake has come at a time when the Crown was looking at ways to consolidate fiscal policy. Indeed, *Budget 2011* was intended to be all about savings and investment. Tuesday's earthquake has effectively put paid to this. Not only is the Crown going to be liable for damage over and above what the EQC and reinsurance covers, but the reduction in tax

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revenue from weaker economic activity **will make it difficult for the Crown to return to surplus earlier than planned.**

The *December 2010 Half Year Economic and Fiscal Update* show that the Government expected to balance the budget by 2014/15. Even if we assume that the earthquake only has a one-off impact on the Crown's fiscal position with no other effects (i.e. a step change in the deficit and no change to the trajectory), **the impact will be significant.** For example, if the Crown has to absorb an additional \$1 billion, that would see the OBEGAL remaining in deficit until 2015/16. Similarly, a \$2 billion hit would see deficits until 2016/17. Obviously the reality is that the trajectory will change, and for the worse. Indeed, the Crown estimates that for every 1 percentage fall in GDP, tax revenue falls by around \$0.5 billion. Nonetheless, ignoring these for now, as a rule of thumb, every \$1 billion of additional cost means deficits for an additional year, or thereabouts. It certainly leaves the Crown's accounts looking very different to the planned return to surplus one year earlier than expected (i.e. by 2013/14) as outlined by the Prime Minister in his State of the Nation speech last month.

We should also add that we don't believe the imperative for fiscal restraint has all of a sudden evaporated as a result of the earthquake. The quake just makes it more difficult, and probably makes maintaining the AA+ (foreign currency) credit rating of secondary importance to bolstering the economy. But to the extent that the Government remains mindful of retaining a decent credit rating, and does not wish to be in deficit forever, we need to appreciate that **the earthquake will almost certainly mean further belt-tightening elsewhere.** We should also be ready for Australian-style special levies – perhaps on property owners or high income families, though we're not a fan of the concept. EQC is already providing such a levy-based system.

Whatever the shortfall is, it has to be funded. It's difficult to say when the cash impact of the quake will be felt by the Crown, but it is probably safe to assume it will be spread over a number of years. Bond issuance is running well ahead of schedule for the fiscal year to date, having issued \$10 billion of NZGS in the 7 months to January, against a June Fiscal year target of \$13.5 billion. In that regard, presuming market appetite for NZGS remains strong, we believe the market can easily

absorb any additional issuance. The problem is, we doubt the market will be so eager to snap up bonds given the deterioration in the Crown's fiscal position, and the possibility of a credit rating downgrade (remember, New Zealand's sovereign credit rating is already on negative outlook). This is clearly price negative for the bond market, and the lack of flexibility the DMO is likely to have going forward means that it may no longer have the luxury of altering the size of its weekly bond tenders to suit demand, as it has been doing recently.

As a general principle fiscal policy should do the lion's share of heavy lifting in response to a natural disaster. This will come via welfare support and infrastructure-related demands. It is imperative that we see a sizeable fiscal package in coming weeks. Balance sheet (debt) considerations are a secondary priority. We've taken some encouragement from the imposition of a national state of emergency: it suggests a strong and direct policy response, as the scale of events requires.

The fiscal policy response needs to be more than a direct cash and balance sheet response. **There are going to be strategic challenges related to the rebuild that will require some outside the square thinking.** One immediate challenge is going to be resourcing (labour-wise) the rebuild. Challenges here will include competition with the Queensland flood effort. While construction-related demand will be abundant in Christchurch for years, mobilising resources involves uprooting families, and quite often there is a second income in the family to think about as well. Shifting the family to Christchurch will be a huge call for many. In such instances we encourage the Government to think about other forms of assistance including the use of the air force to effectively ferry labour in for a work week (i.e. fly in Monday and back home to families on Friday).

While the initial focus is at the macroeconomic level, attention needs to turn immediately to microeconomic issues. Front and centre here is pending resourcing issues that will likely manifest over a number of years if not addressed from the supply side. We favour greater incentives to encourage people into skills based training such as core trades. There is certainly a large pool of idle labour – typically of younger age cohorts – that should be mobilised into meeting rebuild demands via apprenticeships and the like.

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MONETARY POLICY

THE ROLE OF MONETARY POLICY

The immediate priority for the RBNZ has been the availability of critical financial services and liquidity provision. The RBNZ has already responded, coordinating with the Government's National Crisis Management Centre, and stands ready to act further via its cash reserves and cash issuance.

In terms of monetary policy, a strong fiscal policy response takes some pressure off the RBNZ (and calls for emergency rate cuts). We are particularly encouraged here by the imposition of a national state of emergency. Though sounding extreme, this gives policymakers greater flexibility to respond in a targeted and timely fashion. Fiscal policy – via infrastructure and welfare assistance – represents a more direct and efficient mechanism to deliver support than the blunt tool of monetary policy. While there are calls for an immediate OCR cut, we believe it is more prudent to wait, assess the situation, and make a more informed decision. We note the RBNZ did not deliver emergency rate cuts immediately following 9/11 (it took 8 days) or the collapse of Lehman Brothers (it took over a month – but they were already in rate cut mode).

However, the RBNZ still has every justification it needs to cut the OCR, and we believe they should cut at the March Monetary Policy Statement. There is the usual array of arguments for and against such steps. The sheer scale of the event and pending impact on confidence warrants an immediate response. One of the risks the Governor noted in his January scene-setting speech for the year was a more cautious household, such that the RBNZ has to reconsider some monetary policy stimulus. Tuesday's events will hit consumers' perceptions and attitudes hard. To think otherwise makes no sense. House prices are easing nationwide and are likely to fare worse in Christchurch, meaning household balance sheets remain relatively weak, and the unemployment rate looks set to head up in Q1 following a jump in late 2010.

There are of course counter-arguments:

- Financial conditions have already responded. Thankfully the arguments in favour of a fixed currency over the years have fallen on deaf ears. Tuesday's events are a classic example of

why a floating and flexible regime is a superior, if far from perfect, model.

- The economy has momentum in the pipeline: Tuesday's increase in the Fonterra payout is a case in point.
- Rising food and oil prices look set to push the headline inflation rate through 5 percent. The starting position for inflation is somewhat prickly in terms of taking bold action, though core inflation is contained.
- The earthquake rebuilding work is likely to add to cost-push inflation pressures. However, under clause 3(a) of the *Policy Targets Agreement*, the RBNZ have scope to accommodate temporarily higher prices associated with the natural disasters.
- Some are citing a US academic paper¹ that argues that following Hurricane Katrina, the correct policy response was to raise rates. But there is no common theme across the literature about the right or wrong policy response.

Such arguments merely muddy and complicate the picture. One useful way to think about it, in our eyes, is how history could be written. To believe in ten years time that the monetary policy response to the largest natural disaster in New Zealand's history was limited to ensuring that markets are functioning and the provision of liquidity simply doesn't wash. Tuesday's events are a national disaster of epic proportions. **The appropriate response to seismic events requires coordinated policy action across fiscal and monetary policy.** As the Governor noted in December 2008, *"Everyone needs to play their part"*. The RBNZ has taken a lot of comfort from the shape of the yield curve and the falling average duration of fixed rate mortgages, with more and more people on floating rates. Cutting appears a low-risk strategy that, if required, could be reversed quickly.

FINANCIAL MARKET IMPACTS

Financial markets have responded quickly and appropriately, with the exchange rate and interest rates down sharply. We expect this to continue over

¹ Keen, B and Pakko, M (2007), "Monetary policy and natural disasters in a DSGE model: how should the Fed have responded to Hurricane Katrina?" *Federal Reserve Bank of St. Louis Working Paper 2007-025C*.

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coming days, with larger moves in short term rates relative to long term rates.

DOING THEIR PART

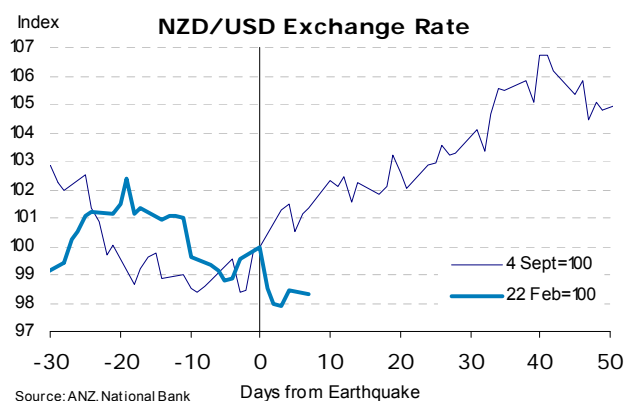
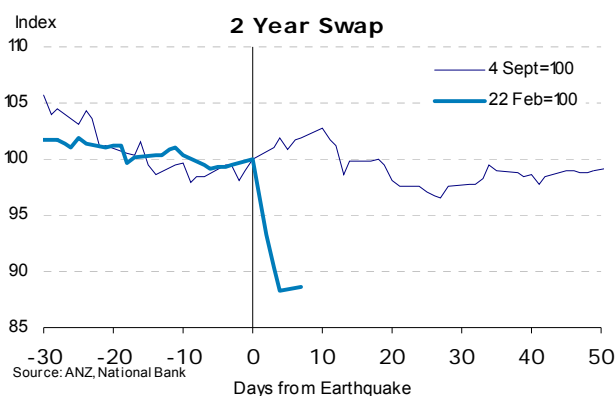
Financial markets have responded quickly and far more vigorously than to the September quake (see charts below). The New Zealand dollar is down against all major currencies. Prior to the quake, the market was expecting rate hikes later in the year – but this has all changed. Indeed, the market is now pricing in a 25 basis point cut in March. The RBNZ noted earlier this week, they were focusing on ensuring markets remain stable. Delivering on market expectations with a 25bp cut and leaving the door open to more (but contingent on confidence and inflation) may well be the path of least resistance.

With the OCR potentially heading lower at the March Monetary Policy Statement (if not before), short-end interest rates have scope to continue to move lower. At the moment the 2 year wholesale rate has fallen around 0.4 percent since the quake. But when we look more closely at what's priced in to the market, it quickly becomes clear that the market is only placing a low probability on a follow up cut in April (as we are forecasting), or a 50 basis point cut in March (which we wouldn't rule out).

Indeed, our analysis shows that the market expects the OCR to fall to a low point of 2.68 percent by June, but to be gradually inching back up to 2.83 percent by December. Of course, we know the RBNZ will only move in multiples of 25bp, whereas the market has to trade in continuous probabilities.

But we do find it rather odd that the market is pricing in June as the low point, with a rising rate profile thereafter. Regardless of whether the RBNZ cuts by 25 or 50 basis points, and in March, April, or both; if they do cut the OCR, we'd expect it to be left on hold until at least Q1 2012.

If we are right, then wholesale rates have scope to move lower yet. For example, if we assume 25bp cuts in March and April, with policy on hold until Q1 2012, even if we factor in a 50bp "normalisation" hike in March 2012, with follow up hikes in April and June, then a pause, with hikes again in September, October and December 2012, the 2 year wholesale rate can move another 0.2 percent lower. Even though that's what our forecasts imply, we are mindful of the potential for the market to overshoot. We should also stress that our forecasts have monetary policy normalising (i.e. rates heading higher) reasonably sharply in 2012. We believe this is what will happen, particularly given the inflation picture – but in the immediate aftermath of rate cuts, the market may be more inclined to flat-line the profile, allowing swap rates to move lower. And to be fair, **we must concede that there are downside risks to our 2012 OCR track – primarily because despite the inflation outlook, the risk of the earthquake becoming more of a drag on growth is significant.** It probably goes without saying that if the market takes the view that the OCR will fall back to 2.50 percent and stay there for much longer than our forecasts imply, 2 year wholesale rates could move by as much as 0.4 percent more than they have already. If that were to occur, 2 year mortgage rates could potentially move back below 6 percent.



KEY FORECASTS

Weekly mortgage repayments table (based on 25-year term)

	Mortgage Rate (%)													
	5.75	6.00	6.25	6.50	6.75	7.00	7.25	7.50	7.75	8.00	8.25	8.50	8.75	9.00
200	290	297	304	311	319	326	333	341	348	356	364	371	379	387
250	363	371	380	389	398	407	417	426	435	445	455	464	474	484
300	435	446	456	467	478	489	500	511	522	534	545	557	569	581
350	508	520	532	545	558	570	583	596	610	623	636	650	664	677
400	580	594	608	623	637	652	667	682	697	712	727	743	758	774
450	653	669	684	701	717	733	750	767	784	801	818	836	853	871
500	725	743	761	778	797	815	833	852	871	890	909	928	948	968
550	798	817	837	856	876	896	917	937	958	979	1000	1021	1043	1064
600	870	891	913	934	956	978	1000	1022	1045	1068	1091	1114	1137	1161
650	943	966	989	1012	1036	1059	1083	1108	1132	1157	1182	1207	1232	1258
700	1015	1040	1065	1090	1115	1141	1167	1193	1219	1246	1273	1300	1327	1355
750	1088	1114	1141	1168	1195	1222	1250	1278	1306	1335	1364	1393	1422	1451
800	1160	1188	1217	1246	1274	1304	1333	1363	1393	1424	1454	1485	1517	1548
850	1233	1263	1293	1323	1354	1385	1417	1448	1480	1513	1545	1578	1611	1645
900	1306	1337	1369	1401	1434	1467	1500	1534	1567	1602	1636	1671	1706	1742
950	1378	1411	1445	1479	1513	1548	1583	1619	1655	1691	1727	1764	1801	1838
1000	1451	1486	1521	1557	1593	1630	1667	1704	1742	1780	1818	1857	1896	1935

Housing market indicators for January 2011 (based on REINZ data)

	House prices (Ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a.)	Comment
Northland	2.3	-4.0	94	(-8%)	87	Positive house price growth is an exception
Auckland	-0.2	0.9	1,513	(-9%)	35	The quickest time to sell for the third month
Waikato/BOP/Gisborne	-1.5	1.9	607	(-5%)	57	Recorded the second slowest time to sell
Hawke's Bay	-2.3	-2.2	148	(-12%)	48	Number of sales heading back down
Taranaki	-1.2	0.6	182	(-10%)	48	Time to sell is at a 10 month low, below 50
Manawatu-Whanganui	-9.2	-3.5	131	(+7%)	48	Largest monthly percentage change
Wellington	-1.1	-1.9	521	(-16%)	44	Median selling price dropped to an 18mth low
Nelson-Marlborough	-6.7	-0.5	167	(+2%)	46	Third weakest annual percent change in prices
Canterbury/Westland	-6.1	-2.7	600	(-9%)	42	Annual percentage change is worsening
Central Otago Lakes	-1.5	-1.5	53	(-13%)	51	Last selling price is 30 percent off recent peak
Otago	-16.8	-4.8	172	(-23%)	43	Median selling price hits a 5-year low
Southland	-0.8	3.3	110	(-17%)	48	A recent pick up in average selling prices
NEW ZEALAND	-2.8	0.1	4,440	(-7%)	43	Market remains weak

Key forecasts

Economic indicators	Actual			Forecast						
	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12
GDP (Ann Avg % Chg)	0.6	1.4	1.4(f)	0.9	0.4	0.4	0.9	2.0	3.3	4.1
CPI Inflation (%)	1.7	1.5	4.0	4.6	5.5	5.1	3.4	3.0	2.8	2.7
Unemployment Rate (%)	6.9	6.4	6.8	6.5	6.7	6.6	6.4	6.3	6.2	6.1
Interest rates	Actual			Forecast (end month)						
	Dec 10	Jan 11	Latest	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12
Official Cash Rate	3.00	3.00	3.00	2.75	2.50	2.50	2.50	3.00	3.50	3.75
90-Day Bank Bill Rate	3.2	3.2	2.9	2.8	2.7	2.7	2.7	3.4	3.8	4.2
Floating Mortgage Rate	6.4	6.4	6.4	6.3	6.0	6.0	6.0	6.5	6.8	6.9
1-Yr Fixed Mortgage Rate	6.4	6.4	6.4	6.5	6.4	6.4	6.4	6.8	7.0	7.2
2-Yr Fixed Mortgage Rate	6.6	6.6	6.6	6.5	6.6	6.8	6.9	7.3	7.5	7.7
5-Yr Fixed Mortgage Rate	7.7	7.7	7.7	7.7	7.9	8.1	8.3	8.5	8.4	8.5

IMPORTANT NOTICE

NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

Qualifications, experience and professional standing Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- OnePath (NZ) Limited, as a wholly owned subsidiary of the Bank, is an associated person of the Bank. OnePath and its related companies may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- Direct Broking Limited (DBL), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. DBL may receive remuneration from a third party relating to a security sold by the Investment Adviser.

Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:



IMPORTANT NOTICE

- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

Use of Money and Property

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