Reserve Bank
of New Zealand
Te Pūtea Matua

Submission on Finance and Expenditure Select Committee Inquiry into banking competition

25 September 2024

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1 Executive Summary

Competition and financial stability

- We support efforts to improve competition in banking services. Competition is a fundamental contributor to financial system efficiency, which ultimately supports broader economic prosperity and well-being.
- As a prudential regulator our mandate and primary focus is promoting the stability of the financial system. This was confirmed through the Reserve Bank Act review and passage of the Reserve Bank of New Zealand Act 2021 and Deposit Takers Act (DTA) 2023.
- The DTA requires us to take into account competition, and this principle is already influencing our prudential policy development, including through a proportionality framework for how we regulate and supervise different entities. The prudential framework and banking industry are dynamic, and we keep our rules and standards under review to ensure they can best deliver on our mandate. This includes achieving the right balance between stability and competition, as a prudential regulator.
- Competition is also relevant to our other roles as a central bank, including our stewardship of the money and cash system. We are currently reviewing the access policy for our settlement account system, including competition considerations. We also continue to investigate the potential role of a central bank digital currency and how it could contribute to innovation.

Prudential regulation

- The capital requirements we apply to banks are an essential tool to promote their financial resilience. Capital is the funding of a bank from its owners, and acts as the buffer protecting creditors such as depositors from losses. Our framework for setting these is risk-based (riskier lending requires more capital) and proportionate (larger banks need larger capital buffers). This is consistent with global practice.
- Capital requirements for different types of lending, e.g. residential mortgages, business or agricultural lending, are based on the underlying credit risks associated with that lending. In doing so, they aim to have a neutral effect on the lending and business strategies banks pursue. Many other factors influence banks' lending decisions such as a sector's economic prospects, perceptions of riskiness, demand for credit, and competition among lenders. Even if they were not regulated, banks would maintain some level of capital to cover unexpected losses and would undertake a risk assessment and capital allocation as part of this.
- We work with banks to build industry capability and understanding of climate-related risks. Our approach is similar to other risks banks face and focuses on identifying, quantifying and managing any risks. Banks are working with their customers to identify climate-related risks and develop transition plans.
- Industry and regulators are working together to improve Māori access to capital and lending on whenua Māori. We have identified and addressed where our prudential regulations may have historically been an inhibiting factor. Progress is continuing on developing expertise and processes in banks, supported by a practice note from Te Kooti Whenua Māori.

- We work closely with the Financial Markets Authority (FMA) and other regulatory counterparts through the Council of Financial Regulators (CoFR) to identify and manage regulatory overlap, and coordinate our activities to the extent possible.

Agricultural and business lending

- The agricultural and business banking markets have different risk factors and operating models to personal banking. Business banking is an individualised customer relationship and banks lend to a wide range of industries with varying risk profiles.
- Agricultural and business lending are higher risk, on average, than residential mortgage lending. For agriculture and business lending, borrowers' financial positions, e.g. income streams and asset values, are more closely tied to conditions in individual economic sectors such as commodity prices. For households, underlying risks are more diversified across the economy. These differences in risk profiles are reflected in higher capital requirements.
- The agricultural and business banking markets have shown significant change in recent years, and market shares have been less stable than in personal banking. The four Australian-owned major banks have become less dominant than in the past. Other overseas-owned banks have grown their market shares in the agricultural and large corporate sectors, while domestic-owned banks account for a growing share of small and medium-sized business banking.

Barriers to competition

- The Commerce Commission's market study highlighted the significant advantages that major banks derive from their scale. Major banks achieve economies of scope (i.e. efficiencies from operating in multiple complementary business lines) and scale (i.e. efficiencies due to increased size, such as spreading of fixed costs including IT systems). Both of these factors support their elevated profitability, relative to smaller peers. Prudential regulatory settings can influence the structure of the banking market but in comparison with these structural factors are not the most significant barrier to competition in our view.
- In the presence of these economies of scale and scope, it is common for banking industries to concentrate among a small number of large firms. New Zealand is not unique in this respect. Scope and scale economies can lead to more efficient outcomes for consumers if they are also accompanied by strong competitive rivalry between firms.
- The Commerce Commission's market study has highlighted that high levels of customer inertia are a barrier to the competitive process. Inertia occurs both in lending and deposit-taking. This gives incumbent banks advantages in both revenue generation and through access to low-cost funding through deposits. Efforts to reduce real and perceived barriers to switching banks and progress on open banking will assist in creating disruptive competition both among incumbent banks and from outside entrants.
- We are currently considering the recommendations for the Reserve Bank from the Commerce Commission's market study into personal banking services. Our initial view is that we can progress these recommendations through our current statutory framework and existing workplans.

2 Banking competition and the Reserve Bank

2.1 The role of competition in supporting economic well-being and prosperity

An efficient financial system facilitates economic prosperity

The financial system supports economic activity by allowing households and businesses to make payments, save, access credit and manage risk. An 'efficient' financial system is one where the level of this financial intermediation is optimised, thereby supporting broader economic prosperity and well-being.

Competition makes a fundamental contribution to efficiency and therefore welfare, by helping to allocate society's scarce resources to their best use (*allocative efficiency*); providing financial products and services at least cost (*technical efficiency*); while supporting improvements in the way the various functions are performed over time (*dynamic efficiency*).

Competition is desirable, but can come with trade-offs

It should be recognised that competition in some circumstances may not always positively contribute to economic welfare:

- Market prices arising from 'competitive' markets could under-price risk and therefore distort the allocation of savings and investment.
- Competition may result in unsustainably low profit margins for financial institutions, reducing their financial buffers to withstand negative shocks.
- Cost savings that arise from competition may not always be fully passed on to consumers, or could compromise the quality of financial services and products provided by financial institutions.
- Innovation that is motivated by short-term profit-seeking behaviour may not always support sustainable economic growth (e.g. the repackaging of subprime housing mortgages into tradeable financial products in the US prior to the Global Financial Crisis).

That said, on balance, we agree with the Commerce Commission's problem definition that a more competitive banking market is desirable.

2.2 Competition and the Reserve Bank's role as New Zealand's prudential regulator

We focus on financial stability to promote well-being and prosperity

The purposes of the Reserve Bank of New Zealand Act (RBNZ Act) 2021 are to promote the prosperity and well-being of New Zealanders and to contribute to a sustainable and productive economy. Our prudential function supports this outcome through the objective of protecting and promoting the stability of New Zealand's financial system.[1]

[1] Section 3 and Section 9 of the RBNZ Act 2021

A stable financial system helps ensure that New Zealanders can have confidence in making payments, saving and having access to credit.

Financial stability means avoiding the significant and costly economic, fiscal and societal impacts of financial institution failure. International evidence indicates that banking crises can have significant and long-lasting impacts, both in terms of lost economic output and fiscal cost.[1] Our prudential regulations including capital, liquidity, and operational resilience aim to address the market failures that would result in excessive risk-taking. Our focus on financial stability is the best contribution we can make, as a prudential regulator, to well-being and prosperity.

This is consistent with global norms. The international standards for banking regulation and supervision – the Basel Core Principles – state that the primary objective for the regulator should be to promote the safety and soundness of banks and the banking system. If broader responsibilities are assigned, these should be subordinate to the primary objective and not in conflict.[2]

A focus on financial stability was confirmed in the recent Reserve Bank Act review, and the new legislative architecture requires us to take into account competition and inclusion

The prudential-related objectives for the Reserve Bank were thoroughly examined through the recent review of the 1989 RBNZ Act and passage of the RBNZ Act 2021 and Deposit Takers Act (DTA) 2023. Most stakeholders supported replacing the 1989 Act's 'soundness and efficiency' objective with a singular and clearer focus on financial stability, one that is more in line with the international consensus.

Parliament agreed to reframing and unpacking of the "efficiency" concept within the legislative architecture. The need to maintain competition within the sector is one of the decision-making principles we must take into account under the DTA. The DTA also features principles relating to the desirability of taking a proportionate approach to regulation and supervision, and the need to avoid unnecessary compliance costs. A subordinate purpose of supporting reasonable access to financial products and services was also included. These act as a constraint on the way the Reserve Bank will go about achieving the statutory purposes and are designed to prevent 'stability at all costs' - that is, a financial system that is too stable and less efficient than it would otherwise be.[3]

The competition principle in the DTA is already influencing our prudential policy work

Our recent public consultations on the DTA standards are good examples of how the Reserve Bank is considering the desirability of maintaining competition within the deposit-taking sector.[4] The standards constitute the new rulebook for banks and other deposit takers, and will come into effect in 2028. Where relevant, the proposals for individual standards (e.g. capital, liquidity, risk management etc.) include an assessment of how the competition principle has been taken into account in the standard's calibration.

The proposals include different calibrations across three groupings of deposit takers to reflect differences in the size, systemic importance and business models of the sector. Proportionate requirements will support competition by preventing a one-size-fits-all approach, thereby ensuring

[2] See BCP 1 here: Core principles for effective banking supervision (bis.org)
[3] Most submissions received on the first consultation held in late 2018 opposed including 'competition' as a high-level objective sitting alongside financial stability, while a majority were in favour of including this at a lower tier.
[4] See: Deposit Takers Core Standards - Reserve Bank of New Zealand - Citizen Space (rbnz.govt.nz) and Deposit Takers Non-Core Standards - Reserve Bank of New Zealand - Citizen Space (rbnz.govt.nz)

a diverse deposit-taking ecosystem. We are currently considering the feedback received on our proposals.

We continuously seek to achieve the right balance between stability and competition, as prudential regulator and central bank

In summary, we believe the new legislative architecture strikes a balance for the Reserve Bank as prudential regulator, between a primary focus on financial stability, and other considerations such as maintaining competition between deposit takers. Any barriers to entry – for example in the licensing process – are deliberately calibrated to ensure this balance is struck.

Competition is also a key consideration across our role as a central bank. Notable examples include:

Exchange Settlement Account System Access Review (ESAS) – The Reserve Bank operates ESAS which enables transactions between financial institutions to be settled electronically. A key driver of our review of ESAS access was the recognition that broader access could enable and encourage competition and innovation in the financial system. Our analysis will include competition considerations. We expect to consult further in the fourth quarter of this year and make decisions soon after that.

Digital Cash – We are currently investigating the potential for implementing digital cash, an electronic version of cash to supplement physical cash. This work is in part driven by the potential innovation and competition benefits to ensure our cash system continues to meet the needs of New Zealanders.

CoFR Payments Vision[5] – We are working alongside the Commerce Commission and Ministry of Business, Innovation and Employment (MBIE) to support progress on key initiatives, such as open banking, digital identity and next generation payments.

Financial inclusion work - The Commerce Commission report made several recommendations in relation to financial inclusion. We are leading work through CoFR[6] and with industry on Basic Bank Accounts and will continue with our Māori Access to capital work programme.[7]

We are currently considering the recommendations directed at the Reserve Bank from the Commerce Commission's Market study into personal banking services. Our initial view is that we can progress these recommendations through our current statutory framework and existing workplans.

[5] Financial regulators set vision for New Zealand payments landscape | Kaunihera Kaiwhakarite Ahumoni - Council of Financial Regulators (cofr.govt.nz)
[6] Financial Inclusion | Kaunihera Kaiwhakarite Ahumoni - Council of Financial Regulators (cofr.govt.nz)
[7] Improving Māori Access to Capital - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz)

3 Detailed comments on Terms of Reference

3.1 The state of competition in banking

The Commerce Commission's market study provides a thorough assessment of competition for personal banking and overall bank profitability

The Commerce Commission's recently concluded market study provides a comprehensive assessment of the current state of competition in banking, with a particular focus on the personal banking services market.

The final report provides a detailed analysis of New Zealand banks' profitability, finding that over recent history the sector has on average performed in the upper quartile of peer countries on three key metrics: return on equity, return on assets, and net interest margin.

The final report found that the personal banking services market is dominated by the four largest banks, who have experienced stable market shares for a long time. In the Commission's view, the market does not exhibit consistent competitive rivalry between the four large banks or from smaller players.

Moreover, the four major Australian-owned banks (ANZ NZ, ASB, BNZ, Westpac NZ) have several structural advantages over smaller peers, including economies of scope and scale, and advantageous funding costs in part due to their large deposit bases. These factors are common in other jurisdictions, and the concentration of banking industries into a small number of large players is not unique to New Zealand.[8]

Lending to businesses differs from personal banking and is not a homogenous market

The personal and business banking services markets have some notable differences, including the types of products offered, the nature of the customer relationship, and the level of risk that the lender is exposed to. Business banking also spans a wide range of customer types – from sole traders borrowing against their house to fund their business, to large corporates needing a complex range of financial services. We provide a brief comparison of residential mortgage lending and business lending in Annex A.

Within each of the business subsectors (dairy, sheep & beef, horticulture, commercial property, SME etc.) banks choose to compete more or less aggressively based on a range of factors, including:

- Their views on the long-term economic prospects and demand for credit in that sector.
- How their exposure/concentration in that sector aligns to their risk appetite and comparative advantages.
- Credit demand and supply dynamics and impacts they have on relative lending margins, including the impact of competing sources of business finance such as equity investment and non-bank credit.

[8] Banking system concentration by country, around the world | TheGlobalEconomy.com

Australian-owned banks have become less dominant in recent years

In contrast to the stable residential mortgage lending market (figure 1), the agricultural and business lending markets have shown material shifts in market shares in recent years. Market shares are not necessarily indicative of the intensity of competition, but such changes are consistent with banks successfully pursuing different business strategies to their competitors.

In both agricultural and business lending the dominance of the major Australian-owned banks has declined over time, with increased market shares for domestic and other overseas-owned banks:

- In the agricultural lending market, ANZ's market share has declined over the past six years, although it remains the largest lender (figure 2). Rabobank has steadily grown its market share from 16 to 22 percent, becoming the second largest agricultural lender in June 2024. Across all banks, lending to the dairy sector has declined as farmers in that sector have paid down debt, while the horticultural sector has seen strong lending growth, for instance in kiwifruit. Changing sectoral trends such as these are an opportunity for banks to compete for market share.
- In the business lending market (including commercial property lending), domestic-owned and other overseas-owned (non-Australian) banks have grown their combined market share to 22 percent (figure 3). Other overseas-owned banks have been particularly active in lending to large corporates, and now command a 30 percent market share for this segment (figure 4). Domestic-owned banks have focussed on small and medium-sized business lending, growing from 4 to 9 percent market share over the past six years.

Figure 1: Residential mortgage market shares

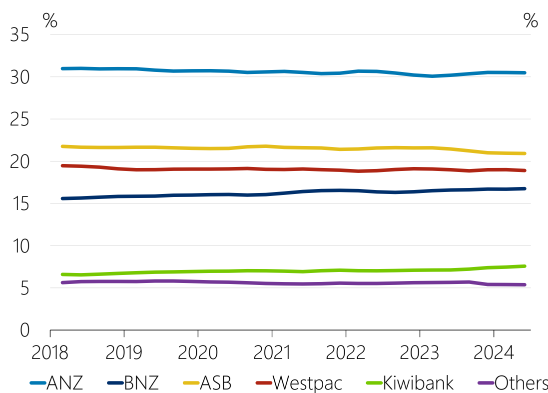


Figure 2: Agricultural lending market shares

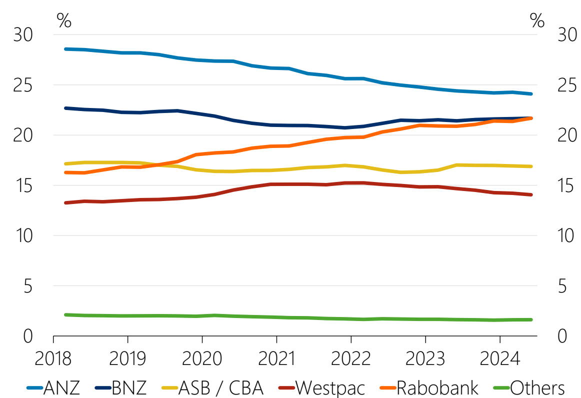


Figure 3: Business lending market shares

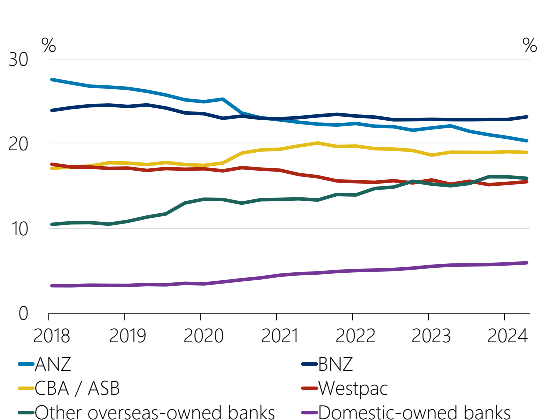
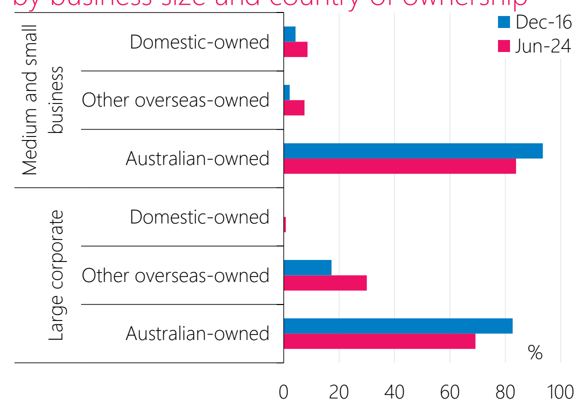


Figure 4: Market share in business lending, by business size and country of ownership



Source: RBNZ Dashboard

Source: RBNZ *Bank Balance Sheet survey*

Banks have proprietary approaches to measuring the profitability of different products and sectors

We monitor and collect data that enables us to analyse the overall profitability of banks, as part of our financial stability monitoring. Banks also have systems that allow them to assess the contribution that individual business units and products have to their profitability. This includes both lending and deposits products which are assessed against internal 'transfer pricing' benchmarks. These metrics are not standardised across entities.

We recommend that the Committee invite banks to explain their internal metrics of profitability across the different business lines and how these influence their strategies for agricultural and business lending.

3.2 Barriers preventing competition in banking

Regulatory settings are not the primary barrier to competition, in our view

Our submission to the Commerce Commission's draft report noted that concentration of banking services in a small number of large banks was a trend in many overseas markets as well as New Zealand.[9] We think this reflects increasing benefits to scale and scope rather than being primarily related to regulatory settings. Major banks achieve economies of scope (i.e. efficiencies from operating in multiple complementary business lines) and scale (i.e. efficiencies due to increased size, such as spreading of fixed costs). Both of these factors support their elevated profitability, relative to smaller banks and non-bank deposit takers (NBDTs).

Nevertheless, in our market study submission we set out a number of policies we are implementing that should help level the playing field. One of the most important is the introduction of the Depositor Compensation Scheme. This allows small deposit-takers (who might have struggled to convince depositors they were a safe place to put funds) to compete for funding without credit risk being of concern to insured depositors.

Open banking and unbundling of services could disrupt the structural advantages of incumbents

One aspect of competition for banking services that we suggest deserves more consideration is the possibility of unbundling the key roles of 'transactional services', 'lending products' and 'investments', which may be enabled by progress towards open banking. A classic banking model is for deposits (both transactional and term deposits) to fund lending. As noted in the Commerce Commission's final report, high levels of customer inertia are a barrier to the competitive process, particularly in giving incumbent banks a low-cost source of funding through deposits.

In some other countries much lending is securitised (sold to investors who may hold those interests instead of holding term deposits). It is also possible for providers of 'securities accounts' to offer limited transactional services linked to the securities account (e.g. a debit card that can be funded when needed by selling securities, potentially offered by a new technology or 'fintech' firm that makes managing this easy). Similarly, deposit broking services can help to improve returns and competition by seeking out the best deal for customers.

Growth in these channels, enabled by progress on open banking, would allow increased competition in the loan origination market (since it is not necessary to build a deposit base to

[9] See Submission on Personal banking services market study: Draft report (rbnz.govt.nz).

lend). The loan originators do not require a deposit-taking license. The provider of the transactional account would need to deposit transactional funds into a client money account run by a deposit-taker, but the provider does not need a deposit-taking license itself. Even while they are reliant on a deposit-taker, they may be able to negotiate more effectively on behalf of their clients than the clients could individually. 'Unbundling' could have the potential to increase competition across all key deposit-taking activities.

3.3 Impact of the regulatory environment on competition and efficient access to lending

How and why we set capital requirements for banks

Prudential capital requirements are an essential part of supporting banks' financial resilience

Our capital framework requires banks to maintain a level of capital that ensures their probability of failing (becoming insolvent) is kept to a very low level. The capital framework underwent a multi-year, comprehensive review that finished in 2019. A key outcome is a progressive increase in banks' capital ratios to levels that will lower the likelihood of a banking crisis to one in 200 years. The decisions in the capital review were supported by a cost-benefit analysis that found the additional resilience benefits of higher capital (avoidance of costly economic and financial crises) outweighed the potential costs (higher credit costs). Ongoing monitoring indicates that the costs are tracking in line with our 2019 estimates and there has been no evidence of disruptive effects on financial markets.[10] Other regulators, such as APRA in Australia, have also reviewed their capital frameworks in recent years and are similarly increasing their regulatory requirements.[11]

We have a risk-based approach to setting capital requirements for banks

Banks' capital requirements are set in proportion to the riskiness of their lending activities, which is achieved through applying risk weights to the different categories of lending – for example, residential mortgage, rural, commercial property, and general business. As described in our recent *Bulletin*,[12] the primary purpose of risk weights is to reflect the underlying credit risk that a bank faces – both the probability that a borrower will default on their loan, and the likely losses the bank would face following a default.

The two methodologies for setting risk weights are derived from global standards

Two methodologies are used to determine risk weights – the Internal Ratings-Based (IRB) approach used by the four major banks, and the Standardised approach used by all other banks. The IRB approach uses banks' internal data and modelling to create more granular risk weightings which can reflect the assessment of credit risk at an individual loan level. The Standardised approach allocates loans to broad categories determined by the Reserve Bank for risk weighting, and is therefore simpler to implement for a wide range of institutions. The Reserve Bank's IRB and Standardised approaches are based on the Basel Committee on Banking Supervision's Basel Capital Framework,[13] which is used by bank regulators in a wide range of jurisdictions. Under both approaches we regularly review the appropriateness of our risk weight calibrations, and IRB banks'

[10] See *Bulletin* article Biennial Assessment 2023 - Monitoring Capital Review Implementation - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz).
[11] See An Unquestionably Strong Framework for Bank Capital | Prudential Handbook (apra.gov.au).
[12] See Reserve Bank *Bulletin*: How risk weights affect bank lending, https://www.rbnz.govt.nz/hub/publications/bulletin/2024/how-risk-weights-affect-bank-lending.
[13] See Basel Framework (bis.org).

model outcomes, and amend these where we believe they are out of line with the underlying credit risks.

The purpose of risk weights is to accurately measure credit risk, and they are only one part of how banks decide their lending strategies

In both approaches the aim of risk weights is to ensure that capital requirements are proportionate to underlying risk. In doing so, risk weights aim to be neutral and limit distortion of banks' lending and business strategies – since risk weights aim to reflect the credit risk of the lending irrespective of borrower type/sector. In our view risk weights have little impact on whether a bank decides to target growth, or a reduction in lending, to a particular sector.

Even in the absence of regulatory capital requirements, banks would choose to operate with some level of capital to remain a going concern and attract creditor confidence over economic cycles. They would similarly need to assess the relative riskiness of their lending and assign capital to it. Regulatory capital requirements seek to replicate this risk assessment in a way that minimises distortions.

Other factors, such as the respective economic prospects, perceptions of riskiness, demand for credit, competition among lenders, and how it fits with the bank's overall business strategy, are likely to be more influential in banks' decisions to grow lending to particular sectors.

How capital requirements affect lending rates

Capital requirements are only one component of how banks set lending rates

Our recent *Bulletin*[14] article assesses the role of risk weights in our capital requirements, including estimates of the influence of risk weights and regulatory capital requirements on banks' loan pricing. A wide range of factors contribute to the lending rate a customer pays.

Loan pricing needs to cover bank' operating costs, the risks they are taking on, and provide a return to shareholders

Lending rates charged to customers are typically calculated as a spread above an internal 'transfer pricing' rate. The transfer price represents the cost of funding for the loan that the bank faces, taking into account factors such as relevant wholesale interest rates (variable or fixed rate), and the liquidity benefits/costs of holding the loan on the bank's balance sheet.

Banks add the following costs to their internal funding rate when determining a customer loan rate:

- Operating costs – This includes all costs associated with processing and managing the loan, such as staff costs and costs for IT systems. Business lending typically has higher operating costs than residential mortgage lending due to the individualised credit relationship the bank maintains with a business customer.
- Expected losses – An allowance to cover losses the bank would expect to make on average on lending of this type in any given year. Expected losses are typically low for most portfolios, but

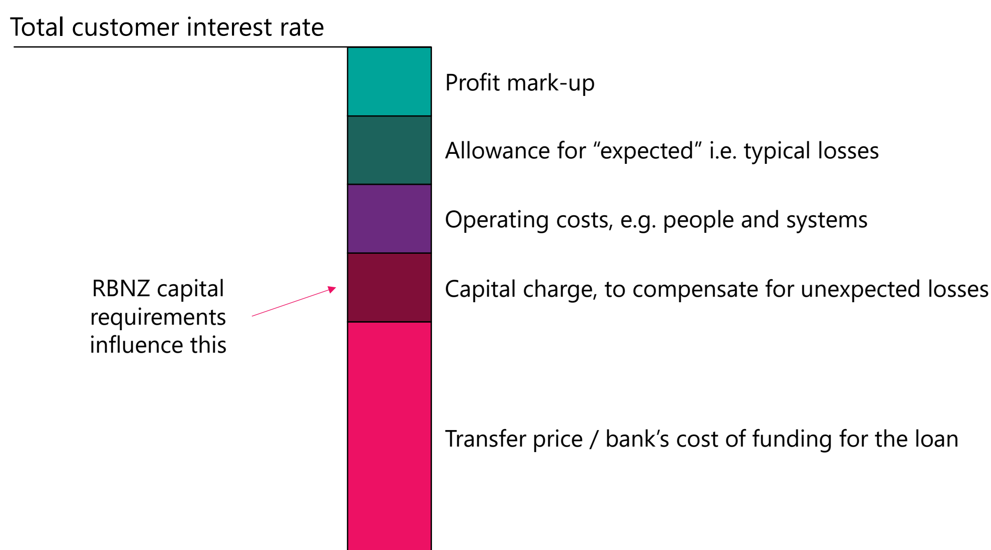
[14] See Reserve Bank *Bulletin*: How risk weights affect bank lending, https://www.rbnz.govt.nz/hub/publications/bulletin/2024/how-risk-weights-affect-bank-lending.

can be high for products such as credit cards, personal loans, and other unsecured types of lending.

- Unexpected losses / capital charge – An allowance to cover losses the bank would only make during a particularly severe economic downturn or unanticipated problem with the lending. A bank's capital is in place to cover unexpected losses, and so this contribution to loan pricing can be seen as equivalent to the cost of capital. This component is most directly influenced by the Reserve Bank's regulatory requirements, as we set how much capital banks need for each type of loan. However, as discussed above even in the absence of regulatory requirements, banks would still assign more capital to loans subject to higher unexpected losses. The capital charge is therefore not purely driven by regulatory settings, and partly reflects what banks would otherwise do without regulatory requirements.
- Profit mark-up – banks additionally seek to make profits beyond what is necessary to meet their cost of capital. This component can vary over time, depending on a bank's strategic goals – it may for instance seek lower returns in a sector (and offer more competitive loan pricing) in order to grow its market share.

These components are dynamic and vary across the different lending sectors and over time.

Figure 5: Components of loan pricing (stylised)



Source: Reserve Bank

We observe wide differences in lending rates between sectors that can't be explained by capital requirement differences

Our analysis concludes the contribution of regulatory capital requirements to differences in overall loan pricing is small – in the order of 50bps between residential mortgages and rural lending, for example. We observe wide differences in loan pricing between categories with similar risk weights applied to them – for example, in June 2024 large corporate loans and loans to SMEs had similar average risk weights in the IRB approach (57% and 55% respectively), but average contracted interest rates were 6.5% and 12.2%. These illustrate that loan pricing reflects a far wider range factors than regulatory capital requirements alone.

Lending to one sector does not come at the expense of lending to another

Moreover, we would emphasise that banks' balance sheets are not static, and their lending allocations are not a zero-sum game. Banks can build their capital resources over time to support new lending where they see it as profitable to do so. Growth in residential mortgage lending does not come at the expense of lending to the rural sector.

Prudential regulation and the diversity of lending institutions

Prudential regulation creates a regulatory perimeter around firms

By definition, the role of prudential regulation is to ensure 'prudent' risk-taking across the set of financial institutions within any given regulatory perimeter. As explained earlier, this is to mitigate the significant costs of firm failure. Creation of the Depositor Compensation Scheme will reinforce the boundary of firms that are within our prudential regulatory net.

The four major banks enjoy a significant advantage relative to smaller banks and NBDTs as a result of scale, scope, risk diversification and funding cost advantages. The four major banks account for around 85 percent of the roughly $706bn deposit-taking sector, while NBDTs account for around 0.4 percent of the sector (as at June 2024). While the Reserve Bank shares the concern of the Commerce Commission that an oligopolistic structure may not be desirable from an economic efficiency standpoint, it is not the role of prudential regulation to actively determine this market structure.

We design our prudential rules so that they are proportionate to entities' risk profiles

However, the prudential framework can influence this market structure at the margin. For example, a 'one-size-fits-all' approach to regulation could contribute to the exit of smaller deposit takers, thereby contributing to further concentration, and accentuating the advantages that larger players currently enjoy. By contrast, a proportionate approach to regulation and supervision is more likely to allow smaller entities to compete on a more equal footing. As noted above, we have developed a proportionality framework based on grouping deposit takers into three size bands, which will influence how we design the standards that apply under the DTA.[15]

Specific proposals we are currently or plan to consult on that we expect to have positive competition benefits include:

- **Graduated capital requirements** across groups of the proportionality framework, meaning smaller firms have lower requirements.
- Reduction of the **minimum capital requirement** from $30m to between $5-10m, reducing the initial entry hurdle for a deposit taker.
- Considering broadening the criteria for **use of the term "bank"**.
- Introduction of the **Deposit Takers Compensation Scheme (DCS)** – as noted above the protection provided by the DCS is likely to make smaller deposit takers more attractive by reducing risks depositors face, and incentivising depositors to spread deposits across a number of institutions.

[15] See A proportionality framework allows for diversity while promoting financial stability - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz)

- Review of elements of **standardised risk weights** to ensure they reflect risk (e.g. across mortgage loan-to-value ratios, community housing providers and lending on whenua Māori).
- Recovery and resolution planning, to enable managed failures of institutions, supporting the exit of uncompetitive entities while reducing contagion risk across the system.

Coordination of New Zealand's financial regulators

The Council of Financial Regulators coordinate workstreams to reduce regulatory impost

New Zealand has a 'twin peaks' approach to financial sector regulation, with the Reserve Bank responsible for the prudential peak, and the FMA and MBIE responsible for the more customer and investor facing market conduct peak. Deposit taking financial institutions are faced with complying with the requirements of both regimes, as well as those administered by other agencies.

For smaller entities, we recognise that compliance with these multiple regulatory regimes could be costly, particularly where the remit of the regulators overlaps in certain areas. In the context of deposit takers, this includes licensing, fit and proper requirements, supervision and monitoring, as well as enforcement strategy and activities.

The Reserve Bank cooperates and coordinates with the FMA bilaterally on these issues, and with the FMA, MBIE, the Treasury and the Commerce Commission through CoFR. CoFR currently has five priority workstreams, one of which includes Regulatory Effectiveness. This workstream is designed to help ensure that regulators work together to deliver effective and proportionate regulation and supervision, reducing unnecessary costs. This focus includes licensing and fit and proper requirements for example and coordinating regulatory activity through the Regulatory Initiatives Calendar.[16]

3.4 Rural banking issues

Climate-related risks and emissions pricing

Our approach to climate-related risks is the same as our approach to the management of any risk that may impact financial stability. That is, firms need to identify, and in some cases quantify the risk and identify and implement actions and strategies so they can be effectively managed.

Identifying and analysing climate-related risks is part of prudent risk management

We have published guidance on managing climate-related risks for our prudentially regulated entities and undertaken emissions-related sensitivity analysis and stress testing activities for the largest banks. We have not released any prudential standards or capital requirements related to greenhouse gas emissions risk.

Banks are taking climate-related risks into account for their business strategies

We do not believe our approach to greenhouse gas emissions risks has influenced lending rates. Consistent with our financial stability objectives, our approach has been to support entities to identify, and in some cases quantify, climate-related risks that banks and insurers face (now and in future) and understand how they may better prepare to manage those risks.

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[16] Kaunihera Kaiwhakarite Ahumoni | Council of Financial Regulators (cofr.govt.nz)

Within our guidance document we do not provide explicit instructions in relation to what entities should do with their exposures to greenhouse gas emissions risk. Some of the management actions entities identified to-date include pricing for climate and emissions risks, but that is a commercial decision for banks and insurers.

Through stress testing we aim to support the building of industry risk management capability

Our stress testing work with banks is designed to support building capability to identify and assess climate-related risks, better understand the significant data and modelling challenges they face in doing so, and apply any lessons learned to the management of these risks. Our 2022/23 Climate Risk Stress Test, helped participating banks to identify the actions they might consider taking to reduce their risk from emissions pricing, including:

- Customer engagement, outreach, and education to build customer knowledge;
- Finance products (e.g. 'green loans') for customers in high-emitting sectors to incentivise and finance emissions reduction efforts;
- Reviewing risk appetites and revising underwriting standards/lending criteria; and
- Restricting new lending to companies that are emissions-intensive and in some cases, as a last report, reducing lending to existing customers who after continued engagement do not plan for mitigation and adaptation.

Banks want to help customers transition to lower-emission operations

It should be noted that participating banks primarily identified changes to lending behaviours which would reduce the costs of borrowing to agricultural and horticultural operations with higher emissions profiles to help them transition toward low-emissions operations. Participating banks envisaged restrictions and reduced lending to the sector only in circumstances where borrowers opted against emissions reductions or failed to implement the solutions identified.

Lending rates for rural customers

Capital requirements are only one part of the variation in interest rates borrowers face

As described above and in our recent *Bulletin*,[17] multiple factors influence the interest rates paid by borrowers. This includes prudential capital requirements and risk weights, the primary purpose of which is to accurately measure banks' credit risk.

On average, agricultural lending receives risk weights that are higher than residential mortgage lending, consistent with a higher credit risk profile. Table 1 (reproduced from the *Bulletin*) highlights the range of risk weights and interest rate outcomes we observe over different categories of lending. The table also shows an estimate of the component of the lending rate which can be accounted for by the capital charge, which is influenced by regulatory capital requirements.

For example, on average, farm lending interest rates in June 2024 were around 1.7 percent higher than residential mortgage interest rates, but only around 0.6 percent of this can be explained by the difference in regulatory capital requirements for these two categories. Comparing farm lending to commercial property lending, while the average interest rates were similar (8.6% and 8.7%

[17] See Reserve Bank *Bulletin*: How risk weights affect bank lending, https://www.rbnz.govt.nz/hub/publications/bulletin/2024/how-risk-weights-affect-bank-lending.

respectively), average risk weights were significantly different (104% and 71%). These examples show that capital requirements are only one part of the variation in lending rates, alongside operating costs, provisioning, and other factors.

Table 1: Contracted interest rates by type of loan, and impact of risk weights

Category	Average IRB risk weight (June 2024, %)	Weighted average contracted interest rate (June 2024, %)	Estimated contribution to interest rate from capital charge (%)
Residential mortgage	30	6.93	0.38 - 0.49
Large Corporate	57	6.50	0.73 - 0.94
Commercial property	104	8.59	1.34 - 1.71
Farm lending	71	8.71	0.91 - 1.17
SME	55	12.19	0.70 - 0.90

Source: RBNZ *New Credit Flows survey*, *Capital Satellite Survey*, RBNZ analysis.

Note: 1-year fixed rate for residential mortgage, variable rate for other categories.

3.5 Lending to Māori asset-holders, organisations, businesses, and individuals

Understanding the experiences of Iwi, hapū and Māori in accessing banking products and services should primarily be achieved through direct engagement; the views of the Reserve Bank and other organisations should only supplement those direct engagements.

Gaps in understanding and capability within the financial sector are constraining Māori access to capital

The insights we have stem from the development of our Māori Access to Capital Issues Paper that was developed in 2022,[18] which included engagement with 42 Māori groups seeking capital. Engagement with these groups highlighted four key themes:

- *There is a limited understanding of Māori business values within the financial sector*: Many felt that the financial sector lacked an understanding of an intergenerational focus and investment horizon, with a high weight on long-term sustainability. Importantly, Māori business values do not mean that capital seekers were presenting lower return opportunities to the financial system. Instead, several seekers made the point that they felt investment in Māori businesses offered attractive investment options to investors with a longer-term investment horizon, willing to grow alongside the broader community. Relatedly, several businesses highlighted their geographical isolation hampered the ability to build strong partnerships with capital providers.

[18] See Māori Access to Capital Issues Paper.

- *There is a financial capability gap within the Māori community*: Several groups seeking capital suggested New Zealand's education system was failing to deliver when it came to upskilling young Māori in financial capability. Broadly, many groups that were engaged felt that improving understanding of the financial sector, effective company governance, and leadership practices could lower the barriers to accessing capital.
- *There are difficulties in lending on Māori land*: Several entities highlighted the difficulties in using Māori land as collateral to access capital within the New Zealand financial system. Compounding this, some groups seeking capital suggested that Māori entities had limited options in raising early-stage capital for new businesses. This partly reflects the low rate of home ownership amongst Māori – which limited the ability to leverage equity in the family home as a source of early-stage capital.
- *There is a lack of leadership in coordinating the issues faced by capital seekers, by the financial sector and Government*: The ecosystem of government advice and support was fragmented and hard to navigate. Further, forums where Māori, the financial industry and government work together on issues of capital access, have had limited effectiveness.

Access to lending on whenua Māori is improving

Historically banks have been reluctant accepting whenua Māori as collateral for borrowing, which we outlined in our Māori Access to Capital Issues Paper. However, in recent years, all the major banks have taken steps to reduce barriers to accepting whenua Māori as collateral.

We don't consider our capital requirements to be a major barrier to access to capital

Two of the major banks have adjusted their credit risk models so that whenua Māori (applying valuation methodologies consistent with LINZ guidance[19]) is on the same footing as other types of collateral when assessing a borrowers' level of security coverage, and therefore the risk weighting. The other two major banks' credit policies already allowed for whenua Māori to be recognised as collateral, subject to appropriate valuation.

For the other banks using the Standardised approach to credit risk, we have adjusted the treatment of Kāinga Whenua Loans[20] due to their lenders mortgage insurance from Kainga Ora. This decreased the risk weight to 20% (from 35-50%, depending on other factors).

Based on the progress and future work noted above, we consider the potential barrier that risk weights were creating for using whenua Māori as collateral is now largely resolved from a prudential regulation perspective. That said, following the recommendation from the Commerce Commission's market study final report, we will also review the concept of a separate category for lending secured by whenua Māori in the Standardised approach.[21]

Remaining barriers include bank practices, processes, and experience

It is important to note that credit policies to allow whenua Māori as collateral and risk weightings are not the only barriers to accessing capital for whenua Māori. There are other more practical barriers, which are less understood, such as expertise of frontline bank staff and internal strategic focus on whenua Māori lending. Engagement with Tāwhia Māori Bankers Rōpū and some public lending examples suggest that there has been some improvement to these areas, however limited

[19] See The rating valuation of Māori Freehold Land guidance review (the Mangatu adjustments) | Property valuation Guidance (linz.govt.nz).
[20] See Kāinga Whenua | Home loans (kiwibank.co.nz).
[21] At present, the Standardised approach does not distinguish between lending secured by whenua Māori and ordinary freehold land.

communication and presence on websites suggests public accessibility issues. Māori groups seeking capital may still have difficulty realising improvements in accepting whenua Māori as collateral given the currently opaque communication and implementation by banks.

The Reserve Bank, alongside Te Kooti Whenua Māori, is taking some steps to supplement the risk weight changes and improve banks' understanding of taking whenua Māori as collateral through the release of a Practice Note for Lending on Whenua Māori,[22] which outlines the mortgage processes for whenua Māori. The Practice Note will be supported through direct engagement with the banks in the coming months.

These barriers also contribute to lower home ownership rates among Māori

Our Māori Access to Capital Issues Paper focused on Māori business entities access to capital, not individuals. However, the insights on whenua Māori would mostly still apply, as access to capital on whenua Māori is often for the purpose of housing. A historic, and possibly present, system of unreasonably resisting whenua Māori as collateral could have contributed to lower Māori home ownership.

We are currently working on a related project, which is an expansion of our analytical note on Ethnic Variations in Firm Financing,[23] to understand how home ownership impacts the variations in interest rates.

To satisfactorily answer the question whether banks' processes and procedures contribute to a disproportionate rate of Māori home ownership (and the above question) would likely require banks to capture data on Māori individuals and entities. To date, no bank has a robust system to capture Māori individuals or entities within their customer databases - they rely on manual identification and tagging (only of Māori entities). Improved data on Māori customers would enable satisfactory answers, and insight into wider issues surrounding Māori access to capital.

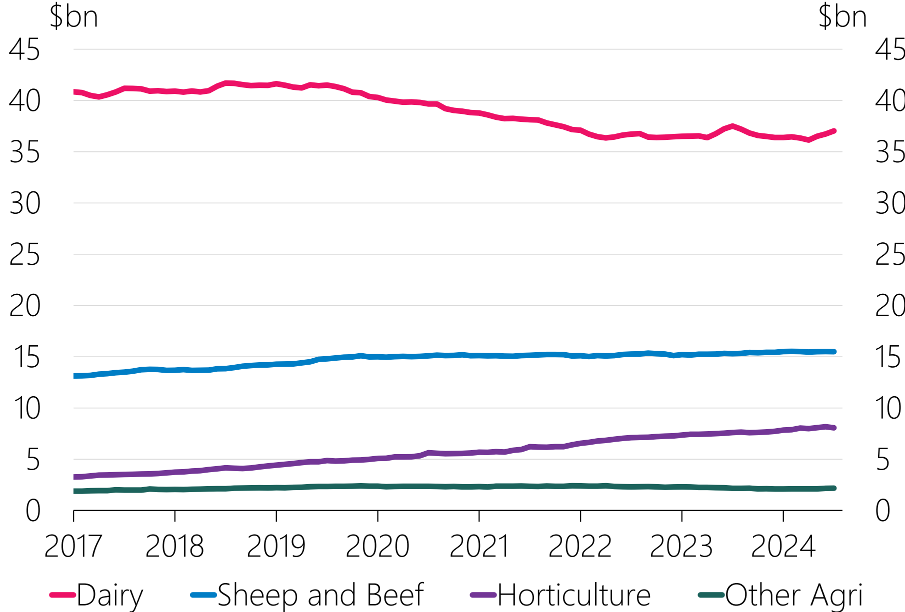
[22] See Practice Note for Lending on Whenua Māori - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz).
[23] See Ethnic variations in firm financing (rbnz.govt.nz).

Annex A: Differences between residential mortgage and business lending

	Residential mortgage lending	Agri and Business lending
Nature of credit assessment	Standardised assessment using net income service calculation, and a risk scorecard or similar No ongoing assessment except for credit events (e.g. top-ups, purchase of new house)	Bespoke assessment using a combination of models, review of financial statements, expert judgement, and sector credit policies Ongoing (annual) customer credit reviews, and assessments of new lending applications
Product offering	Generally a small number of standardised products (table loan and flexi/revolving accounts) Interest rates typically on a published rate card, with a small amount of room for negotiation between lender and borrower, and a premium for low deposit loans	More flexible and customised for business needs – e.g. term loans, overdraft facilities, business credit cards, asset finance, foreign exchange and trade facilities For larger borrowers, bespoke facilities including syndications across several lenders, interest rate hedging etc. Interest rates are individualised, depending on loan structure, level of security provided, and the bank's customer risk assessment
Source of income for debt servicing	Home loan portfolios are typically diversified over a large number of individually small borrowers, employed across a range of industries and located in different regions The underlying risk the lender is exposed to is therefore the performance of the labour market, and the state of the macroeconomy more generally (e.g. level of interest rates)	Agri and business debt servicing depends on business conditions in the specific sector the lender focusses on, e.g. dairy vs. kiwifruit vs. retail trade vs. property development, and may therefore be less diversified Borrowers' financial performance is dependent on production and trading conditions, management capability, commodity prices, policy settings etc. in their sector, which may not generalise to conditions across the wider economy
Security for lending	Residential property, typically overcollateralised (loan-to-value ratio <80%) and high liquidity (60,000+ transactions per year)	Property (farms or buildings) whose realisable value can fluctuate widely depending on conditions in that sector, and with potentially low liquidity More bespoke options for security, e.g. physical assets, shareholder guarantee, general security agreement May be unsecured, particularly for established and/or larger businesses

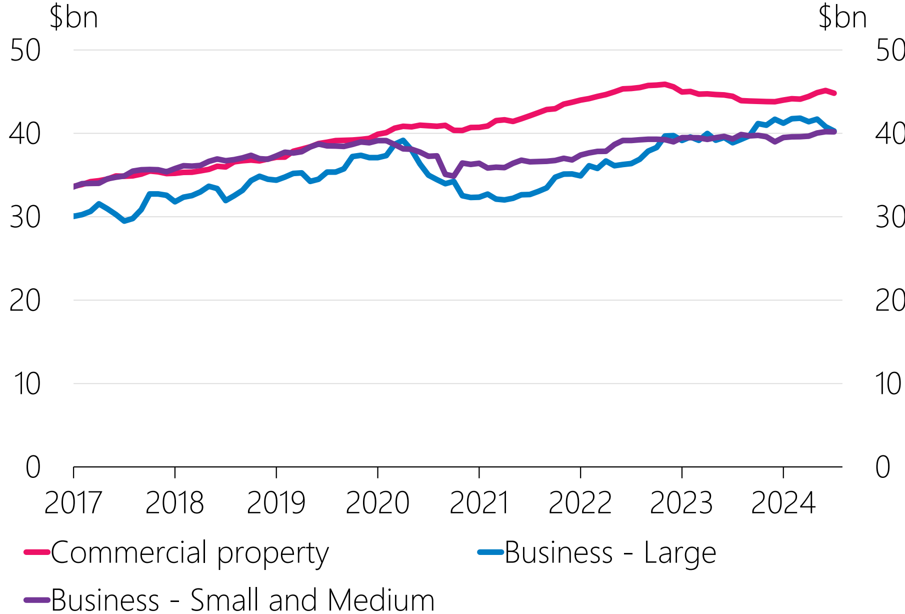
Annex B: Bank agricultural and business lending

Figure B.1: Value of agricultural lending by sector



Source: RBNZ Bank Balance Sheet survey

Figure B.2: Value of business lending by sector



Source: RBNZ Bank Balance Sheet survey