25 September 2024

Committee Secretariat
Finance and Expenditure Committee
Parliament Buildings, Wellington

By email: fe@parliament.govt.nz

Select Committee Inquiry into Banking Competition

Thank you for the opportunity to submit on the Select Committee Inquiry **(Inquiry)** into banking competition. This is a joint submission on behalf of The Co-operative Bank Limited, Heartland Bank Limited, Kiwibank Limited, SBS Bank and TSB Bank Limited. Each bank may also provide an additional individual response to certain aspects of the terms of reference for the Inquiry, however, we consider it worthwhile reinforcing our joint view, that was supported by the findings of the Commerce Commission's Market Study final report, that the current regulatory ecosystem adversely shapes the competitive environment.

As a competitive collective, we believe that small domestic banks play a vital role in the New Zealand banking market. We offer a viable alternative to larger overseas owned banks, including through the distribution of products not provided by these banks and the provision of banking services to otherwise underserved sectors - in turn, keeping the market competitive for consumers. We also take our role in contributing to our respective communities seriously, and are committed to the overall success of New Zealand Inc.

We consider the Inquiry timely from a competition perspective, given: (i) the recent release of the Commerce Commission's **(Commission)** Final Report regarding the market study into competition in the personal banking sector, and (ii) the recent closure of the Deposit Takers Act **(DT Act)** Core Standards consultation. We have responded to those separate consultations (sometimes in a joint capacity) and maintain some shared concerns.

In our view, despite the work and recommendations of the Commission on the Market Study, the following factors will continue to contribute to the constraint of growth for smaller banking providers – likely maintaining the current two-tier oligopoly as identified by the Commission:

- The capital advantages of the four Australian-owned banks (classified by the Reserve Bank of New Zealand **(RBNZ)** as Domestic Systemically Important Banks **(D-SIB)**).
- The disproportionate costs of banking regulation imposed on non-D-SIB banks, which materially constrains their ability to compete through investment and innovation.
- The ability for the D-SIBs to access more funding options which generally leads to a lower cost of funding, further entrenching the ability of D-SIBs to compete in an enhanced manner relative to smaller banks.

We address each factor in turn in our appendix below.

While the terms of reference relating to the Inquiry obviously differ to both the Commission's market study and the DT Act consultation, we consider that the themes of an uncompetitive and uneven playing field, barriers to entry, and an inconsistent and disproportionate regulatory environment remain prevalent – regardless of the area of banking (whether that be personal, business, commercial or rural, for instance). Unless changes are made, we consider that the current regulatory landscape (alongside upcoming proposals) will continue to negatively impact the future prosperity of small banks and future competition in the New Zealand banking market – which, in turn, will unfavourably affect long-term customer outcomes and choice.

We are happy to discuss this further.

- Mark Wilkshire, Chief Executive Officer The Co-operative Bank Limited

- Leanne Lazarus, Chief Executive Officer Heartland Bank Limited

- Steve Jurkovich, Chief Executive Kiwibank Limited

- Mark McLean, Group Chief Executive Officer SBS Bank

- Kerry Boielle, Chief Executive Officer TSB Bank Limited

Appendix:

1. Capital advantages of the D-SIBs

The regulatory approach taken over the past 20 years has had the unintended consequence of creating a material capital advantage for the D-SIBs relative to smaller providers. This advantage has been further amplified over the past 15 years, as D-SIBs have been able to keep pace with the unprecedented market growth in home lending far more efficiently than smaller providers due to materially lower capital requirements. This has in turn increased scale advantages and ability to fund additional capital requirements, which widens the gap with smaller providers over time.

We acknowledge the changes to the RBNZ capital requirements that are being phased in through to 2028 include some measures to address this widening gap through the introduction of an 85% output floor for internal ratings-based (**IRB**) banks and the D-SIB buffer. However, using the D-SIB buffer to equalise the capital requirements between standardised and IRB banks creates a new inequity. As noted by the Commerce Commission, the Basel committee's intended purpose for the D-SIB buffer was to address the specific risk to an economy of a D-SIB bank failure. Using the D-SIB buffer to equalise capital requirements fails to "charge" the cost of this risk to the D-SIBs that give rise to it.

We therefore welcome additional consideration by the Committee of bank regulatory capital requirements in the context of the relative system risks and the competitive disadvantage that still exists for smaller providers, to open the door for a more even playing field. We set out below two key issues that we believe deserve specific attention by the Select Committee.

i) Allowing the application of different methodologies to quantify credit risk.

We note weaknesses around the IRB capital methodology which provides a substantial capital advantage for the D-SIBs (who in turn apply the methodology inconsistently themselves). An illustration of this is the inconsistencies in personal banking Risk-Weighted Assets **(RWAs)** as identified by the Commission in their market studies – where IRB models range from 23 – 31% for the same risk profiles.[1] This varied range and inconsistency between IRB outcomes highlights an uneven playing field, by illustrating how open to "optimisation" IRB modelling is.

This leads to an unjustified lack of alignment of capital risk weight requirements across all banks, noting that smaller domestic banks subject to standardised risk weightings have no discretion. The Government has committed to implementing the findings of the Market Study, including the RBNZ using upcoming opportunities to support competition. This includes the RBNZ reconsidering standardised RWAs through applying the more granular Basel III risk weights for lending exposures with similar characteristics, including retail and commercial exposures. This would align with the RBNZ's approach taken for operational risk and, more generally, the RBNZ's approach of moving away from internal models. Furthermore, alignment with the Basel III standardised approach would be consistent with the approach of the Australian Prudential Regulatory Authority **(APRA).**

We consider that this lack of alignment from the RBNZ to a primary global standard has resulted in overly conservative capital requirements comparative to offshore jurisdictions. Under the RBNZ's standardised approach, for instance, all applicable commercial loans have a risk weighting of 100%, whereas the same loans can have risk weights as low as 60% applied under the APRA rules. This perceived over-conservatism disproportionately impacts the smaller banks in New Zealand, as we have less access to the additional capital required (through retained earnings) due to our smaller scale, as well as less access to either offshore capital markets or parent banks (covered further by point 3 below). Additionally, there is no evidence that IRB capital modelling results in

[1] See Table 7.1 of the Commission's Preliminary Report - which demonstrated that the standardised risk weighting is 37%, however the risk weightings for IRB models range from 23 – 31% for what is the same risk profile.

better credit risk management outcomes. The D-SIBs persistently report higher troubled loan balances as a percentage of their portfolios.

For these reasons, we believe the value and use of IRB modelling for prudential purposes should be revisited by the RBNZ: both for its contribution to financial system stability, as well as a basis for competitive neutrality. The application of the 85% floor on modelled outcomes may act to reduce the range of outcomes but it does not address the validity of retaining a framework that entrenches a material competitive advantage for entities whose scale means they in no way require it and which continues to act as a barrier for smaller providers to meaningfully compete. As discussed above, we also believe that the RBNZ should reconsider its standardised risk weightings as part of the DT Act core standards consultation.

ii) Application of a single risk appetite for bank failure

The RBNZ's stated risk appetite underlying its 2019 Capital Review decisions regarding levels of required capital, was that banks should hold capital sufficient to withstand a 1:200-year stress event. This threshold has been applied to all banks regardless of their size - from Bank of Baroda (total assets $126 million) to ANZ (total assets $195 billion (i.e. ~1,500 times larger)). This is despite the vastly different consequences for New Zealand of the respective failures of these banks. This requirement has disproportionate impacts on smaller banks, thus impeding their ability to compete.

Unlike the current RBNZ requirements, the capital standards to be made under the DT Act are secondary legislation, and as such they require explicit Ministerial approval. This provides the opportunity for the Government to consider and confirm its risk appetite for bank failure in New Zealand.

Specifically, we believe that the capital requirements ought to be sufficiently tiered so that as banks increase in size, they should be required to carry a genuinely higher proportionate level of capital to reflect the increasing societal impacts that their failure would cause. This would act to:

- Curtail the current market dominance by the largest banks who can use their economies of scale to achieve market superiority over smaller competitors. This would encourage market competition by removing barriers for smaller banks to compete on price.
- Encourage increased competition by lowering the barriers to entry and growth created by the current requirement that all banks hold capital to withstand a 1:200-year stress event.
- Level the playing field. The cost of capital is a significant consideration for any bank, but as outlined above, the 100% risk weight required to be applied by standardised banks further impedes the smaller domestic banks' ability to compete and price in line with our larger competitors.

2. Disproportionate costs of banking regulation imposed on non-D-SIB banks

We agree with the Commission's recent finding that the overall regulatory burden in personal banking services is high, and that smaller providers are disproportionately affected by this, constraining their ability to expand, innovate, grow, and ultimately compete harder against the major banks. While the Commission's market study focused on personal banking services, we believe the above finding is similarly true in respect of lending to other important sectors of the New Zealand economy, for example SME and rural lending, in respect of which the smaller domestic banks play an important role.

That is, the one-size-fits all regulatory impost is disproportionate beyond personal banking and impacts wider areas of banking which will be investigated by the Inquiry.

The D-SIBs have significant economies of scale advantages over the smaller providers, which enables them to spread their fixed costs across more customers and products. As a result, they can commit more investment into change, innovation, marketing and competition than smaller providers without making trade-offs against cost and key resource allocation (including management time) toward regulatory change and maintenance activity.

We support the need for multi-faceted solutions to improve competition. However, we highlight the need for caution when considering the rollout (how) and timeframe (when) of recommendations, so as not to have the unintended consequence of further adding to the compliance change burden for smaller providers.

A number of the recommendations from the Commission's recent report, would require IT solution investment, amendment to systems and processes, and / or the production and maintenance of additional documentation. Whilst the degree of change will be variable between banks, broadly some examples include the acceleration of open banking, creation of an enhanced switching service, lending affordability safe harbour benchmark for expenses, standardised presentation of lending offers, and a process for pro-rating clawback amounts on a linear basis.

Other than the DT Act, no other legislative regime imposes an obligation on a regulator to have an explicit purpose of ensuring that the regime either improves competition or ensures that an obligation does not adversely impact competition. We are supportive of the DT Act intention to 'promote' competition, however, the distinction between "promoting competition", "maintaining competition" and "not undermining competition" is critical. "Maintaining competition" preserves the status quo, which, as has been recognised by the Commission, is not a desirable outcome – particularly with regard to the RBNZ's capital settings. However, we question if it would be appropriate for the RBNZ's mandate to fully extend to the promotion of competition, meaning to encourage, further, or advance. Requiring the RBNZ to actively promote competition in the deposit taking sector when exercising its powers, functions and duties under the Act could contribute to a confused regulatory model. It could create overlaps with the Commission's core competition mandate and would therefore be inconsistent with the twin peaks supervisory model. The coalition Government has recently announced changes to the regulation of conduct in the financial services sector which are intended to move the sector towards a purer twin peaks model, so we believe the adoption of the recommendation in its current form could work against those changes.

In our view, the requirement not to "undermine competition" might strike a better, and more appropriate, balance. It would enable the RBNZ to take competition into account in a more holistic way. The RBNZ would not be limited to maintaining the status quo when exercising its powers, functions and duties, but its mandate would not be broadened to such an extent that it duplicates the Commission's role and responsibilities.

We note that the RBNZ has introduced a separate Proportionality Framework,[2] which we support. However, to date we have seen very little evidence of application of this across the proposed DT Act standards policy consultation. It seems that any potential differentiation of outcomes is continually overridden (and unnecessarily so at times in our view) by financial stability considerations. We believe there is further opportunity in identifying / developing areas where the DT Act requirements can be simplified, especially for Group 2 Deposit Takers, without undermining the soundness of the prudential requirements. The NZ Small Domestic Banks' Group has previously submitted to the Council of Financial Regulators on ways to address disproportionate compliance burden, for example having staggered start dates for new legislation and taking a more proportionate approach to both regulation and enforcement. We consider it critical at this juncture that these views are given additional consideration.

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[2] Reserve Bank of New Zealand (2024, 14 March) *Proportionality Framework for Developing Standards Under the Deposit Takers Act.* https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/regulation-and-supervision/dta-and-dcs/the-proportionality-framework-under-the-dta.pdf

In the Commission's final report, it recommended that the Government should consider a flat-rate levy in the first years of the Depositor Compensation Scheme (**DCS**) until there is more information on the costs and benefits of the DCS, to relieve the regulatory compliance cost burden on smaller deposit takers. We are strongly opposed to a flat-rate approach to calculating all levies because:

- It could incentivise risk-taking behaviours, as deposit takers will incur the same levy irrespective of the risks they incur;
- It does not reflect the likelihood of a compensation event for a particular deposit taker occurring, and
- Its implementation would lead to unfair outcomes for deposit takers and potentially customers as well.

Alternatively, the Commission has suggested removing or reducing the weight on profitability as an indicator of risk for the composite-risk based approach if it is maintained. We are supportive of this suggestion along with the composite-risk based approach being maintained.

Beyond the DT Act, we would also welcome consideration of proportionality in relation to the proposed review of existing regulation, particularly to other empowering Acts (such as the Financial Markets Conduct Act **(FMCA)** and Credit Contracts and Consumer Finance Act **(CCCFA)**).

As noted above, we consider there are several areas where simpler, more proportionate requirements could be applied to smaller banks, reducing the overall cost of compliance, while still maintaining the soundness of the prudential requirements. Reducing unnecessary and overly burdensome requirements reduces the cost of compliance for all deposit takers, which is especially important for smaller banks and other deposit takers given a much smaller revenue base to absorb these costs. This also reduces barriers to entry for new deposit takers, supporting increased competition.

3. D-SIB's can access more funding options which generally lead to a lower cost of funding

Finally, we would like to address the advantages that D-SIBs have through their ability to access a variety of funding sources that may not be available to smaller providers due to their scale and/or credit ratings, such as international markets and wholesale funding.

We reiterate that credit rating agencies consider an implicit government guarantee for D-SIBs in setting credit ratings, which means D-SIBs have a more favourable rating for the equivalent risk. This is further exacerbated by the current regulatory capital environment which, as noted above, means D-SIBs can essentially report higher capital ratios for assets with the same underlying risk, again supporting more favourable credit ratings. This provides a number of advantages including a significant cost of funding benefit either in wholesale or institutional markets, or a diversification benefit through wider investor access. We acknowledge that this is difficult to solve but highlight it as an important factor to understand when assessing the market dynamics.

A live issue at the moment is the market for Additional Tier 1 **(AT1)** capital instruments:

- The issue being that the market for redeemable perpetual preference shares is too thin, where the requirement for AT1 instruments to be legal form equity is effectively restricting their distribution to only the New Zealand retail market; and
- The consequences that this will have on any New Zealand bank needing AT1 capital in the future as their balance sheet grows and / or they are required to issue hybrid capital to comply with the step-up requirements to achieve the RBNZ capital requirements by 2028. This is particularly an issue for smaller domestic banks whose AT1 instruments will have a lower credit rating than their D-SIB counterparts for the reasons discussed above, and none of which (other than Kiwibank) have yet issued an AT1 instrument in accordance with the new RBNZ requirements.

In Australia, APRA has recently come out proposing that banks phase out the use of AT1 capital instruments and replace them with cheaper and more reliable forms of capital that would absorb losses more effectively in times of stress. Under the proposal, larger banks would need an additional 0.25% CET1 and 1.25% Tier 2 and smaller banks would need an additional 1.5% Tier 2 (which is obviously cheaper to fund and has a much broader market, allowing smaller banks easier access to the market and enhancing competition). APRA noted the total amount of regulatory capital that it requires banks to hold would remain unchanged and banks would remain "unquestionably strong."

Removing the requirement that AT1 is legal form equity or, preferably, mirroring the proposed APRA changes will support domestic banks access to additional capital – allowing banks to meet capital requirements, support balance sheet growth and in turn enhance our ability to provide competition to the D-SIBs.