BUDDLE FINDLAY

18 December 2023

To
[redacted]

From
Simon Jensen

By Email
[redacted]

Dear Jessica

NBDT Responses to Commerce Commission Topics

1. INTRODUCTION

1.1 The purpose of this paper is to provide supplementary information and context to the "NBDT Responses to Commerce Commission Topics" document, submitted on 22 November 2023.

1.2 Since then, we have received more historic information on sector trends and market share, which will help contextualise competition amongst financial services entities, including Non Bank Deposit Takers (**NBDT**s), regulated by the Reserve Bank of New Zealand (**RBNZ**) over the last 10-12 years. This data has also led to the review and collation of more information on the NBDT sector from various other RBNZ reports released recently.

1.3 The paper will background the history of NBDT regulatory change versus its competitors and then incorporate this history into a response to the three specific questions ("requested topics") from the Commerce Commission.

1.4 There will be some minor repetition of points made in the earlier paper submitted in November, but we have endeavoured to limit the duplication to Risk Weighted Asset topics omitted in the earlier paper.

2. EXECUTIVE SUMMARY

2.1 This month the Bank for International Settlements (**BIS**) published a report on the New Zealand market – authored by the RBNZ. It contains data that confirms our view that the non-bank mortgage market has become less competitive over the last decade with more and more market share going to the big banks.

2.2 We believe the key reason for this is the capital advantage afforded to the big banks as a result of their ability to develop their own internal based capital ratings as opposed to standardised ratings.

Furthermore, even the standardised ratings give the small and medium sized banks a capital advantage over NBDTs – whose standardised risk weightings are appreciably higher than even the standardised equivalents for banks. There is no credible reason for this. Lending to the same customer secured over the same asset should have the same risk weighting no matter who the lender is.

2.3 As a result of incentives created by the risk weightings (especially for the IRB banks) New Zealand's smaller banks and NBDTs no longer have access to LMI insurance, which can both offset some of the competitive advantage of the IRB banks but also facilitates innovation. We believe steps need to be taken to re-open the New Zealand market to LMI by ensuring there are capital benefits from using LMI.

2.4 A classic example of how mortgage insurance can work is Kainga Ora loans where the existence of a government guarantee that NBDTs could access to be competitive enabled them to lend more competitively than banks. This has now been removed and so this advantage has been lost. Correspondingly no benefit is currently provided to NBDTs to lend into the cyclone relief scheme (despite being particularly active in the effected regions), so their loans are risk weighted at 150% whereas the banks can risk weight at 20% (although efforts are being made to change this, progress is slow).

3. BACKGROUND

3.1 The RBNZ set the regulatory framework for NBDTs in 2013 following the introduction of the Non-bank Deposit Takers Act 2013. Prior to this there was increasing regulatory focus on capital buffers and the adoption of Risk Weighting Capital for the financial services sector. By 2013 New Zealand had seen the consolidation of many Building Societies into the big commercial banks who sought to reweight their balance sheets with mortgage lending and take advantage of new capital allocations/ risk weights in this area.

3.2 The big Australian and UK banks operating locally quickly appreciated the profitability of this lower risk lending and began to compete aggressively in this market. About this time (circa 2008) Westpac became the last major bank to withdraw the use of Lenders Mortgage Insurance (LMI) in New Zealand. This led the major international mortgage insurers to effectively grandfather their New Zealand portfolios and withdraw from retail distribution.

3.3 Prior to this many building societies and banks used LMI products to innovate and compete with the majors in the knowledge that they could lay off credit risk, parcel up mortgage portfolios into Residential Mortgage Backed Securities (**RMBS**) in need (for funding) and ultimately help protect their capital. The LMI product remains a cornerstone of the Australian Residential Mortgage market and greatly assists smaller participants that are innovating and growing while mitigating credit and funding risks.

3.4 Since 2010, in the New Zealand context, the big four offshore owned banks took advantage of their scale and historic data capabilities on residential mortgages, to take the risk premiums charged for over 80% LVR lending to profit. They now have regulatory approval to use their own "Internal Ratings

Based" models to allocate risk weighted capital. i.e. they have no need to seek third party credit enhancement or capital relief from LMI insured loans.

3.5 The RBNZ now has three frameworks that support deposit taker risk weighted policies, as they apply to residential mortgages. 1) The Internal Ratings Based framework for approved Registered Banks (the big 4), 2) the "Standardised Approach" for other registered banks, and 3) The NBDT Act Risk Weighted asset allocations.

3.6 The registered banks have been working with the RBNZ over many years to achieve the current frameworks and more recently (October 2023) some modifications to the standardised framework. Despite presentations to the RBNZ, the NBDT sector has not been able to have the 2010 Risk Weight regime reviewed or made fit for purpose. Please note the historic comparatives in the table below with a recent update included, showing the implementation of a new standardised approach for Government Insured Kainga Ora loans. [1]

	Pre 1st Oct 2023					**Post 1st Oct 2023**			
	NBDT Act 2010		Banks standardised approach			Banks standardised approach		NBDT's	
LVR	Kainga Ora	Standard mortgages	Not insured	Insured	Kainga Ora	Not insured	Insured	Kainga Ora	Standard mortgages
<=70%	20%	35%	35%	35%	35%	35%	35%	20%	35%
>70% to <=80%	20%	50%	35%	35%	35%	35%	35%	20%	50%
>80% to <=90%	20%	100%	50%	35%	35%	50%	35%	20%	100%
>90% to <=100%	20%	125%	75%	50%	50%	75%	50%	20%	125%
>100%	20%	150%	100%	100%	100%	100%	100%	20%	150%

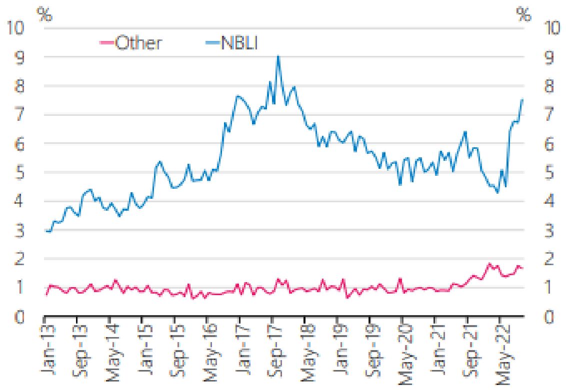
3.7 The key point to note is that the NBDT sector over the last 10-12 years has not been able to secure any risk weighting benefit from using a mortgage insurer/ LMI product and has effectively been penalised on a like for like basis for risk weights since 2010.

3.8 For context, Kainga Ora lending has been the only true opportunity for NBDTs to have some Capital allocation and pricing advantage since 2010. However, for various government policy reasons the product and volumes of business have been very small until 2021 when the limit for new loans was extended to 1600 p.a. (Kainga Ora annual report 2020/2021). Subsequent government policy reviews have lifted that number to an additional 2300 p.a. in 2022. As at June 2021 Kainga Ora had $1,787m insured.

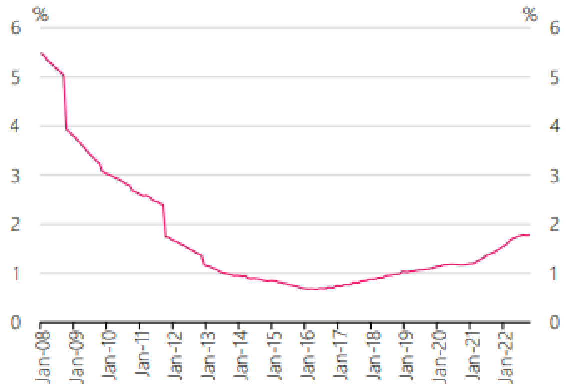
3.9 Referencing the RBNZ December release of CGFS Paper No 69 Macroprudential policies to mitigate housing market risks New Zealand, the RBNZ published long term trends of market share of mortgage lending by non-banks. This may be a slightly broader measure than just regulated NBDTs but does give a picture on how small market participants have competed since 2010. See graphs 10 & 11 below.

[1] To qualify for insured loans the insurer must have an 'A' rating as defined in BPR131 table C3.9 and insure over 40% of the value of the loan. The risk weights for qualifying insured loans are sourced from BPR131 C3.10 (as at January 2023).

Graph 10: Share of housing purchase transactions financed by non-banks



Graph 11: Share of mortgage lending held by non-banks



3.10 In recent Financial Stability Reports, the RBNZ has documented the demise of the NBDT sector from **24 participants i**n 2018 to **14** in 2023. It suggests further consolidation is imminent. While acknowledging the importance of the NBDT sector to many customers and market challenges they face, the bank does not reflect on any regulatory impacts that might be affecting performance and ultimately competition.

3.11 It is well known and accepted, that the RBNZ policies around the allocation of risk weights drive capital allocation and pricing of the risks of the underlying assets. The New Zealand market is immature by international standards in the innovation and development of third party credit risk products. These support individual residential mortgages, portfolios of mortgages and the credit enhancement opportunities to assist marketing mortgage-backed securities (RMBS). This current state suits the large incumbents with "Internal Ratings Based" models. Until this dynamic changes it will be very difficult for NBDTs and small banks to compete and grow share in the New Zealand market. This challenge is exacerbated even more by the mutual structures and capital raising challenges of many of the smaller entities.

3.12 The long term RBNZ focus on stability and resilience of the majors, at the expense of innovation and competition, has driven perverse outcomes for small competing entities. It is the contention of the NBDT sector that the historic inequitable allocation of risk weights on mortgage assets has adversely affected performance and ultimately competition of the NBDTs. The market share data provides a lead indicator to this hypothesis.

3.13 The paper will now address the specific questions as they relate to the Commerce Commission request.

What are the specific regulatory requirements that most affect your ability to compete to provide personal banking services. How and why?

The historic and inequitable Risk Weighting framework for NBDTs.

The risk weight allocations of insured mortgages sends a clear market signal to international credit risk insurers that the regulatory environment either supports participation or not. To date insurers have not seen RBNZ support encouraging them to re-enter the market. The problem is exacerbated by the fact that the major 4 banks with Internal risk based models have no reason to use them. i.e. the small competitors need regulatory support and scale before they can attract LMI providers.

By signalling there is no benefit to using LMI or other credit risk related products the entity is unable lay off credit risk and enhance capital buffers which is very important for mutuals.

Mortgage lending with LMI products with an appropriate risk weight would drive better informed innovation in the NBDT sector and allow smaller participants to compete with the majors. This is important in terms of market data, credit risk knowledge and key risks.

The cost of capital to fund the residential assets is a key driver of pricing in the market. As a result NBDTs face higher product costs as soon as the mortgage is underwritten.

On a like for like basis, NBDTs have had to allocate more capital for a comparable mortgage impacting its prudential capital ratio's.

The October 2023 the RBNZ published new revised risk weights for Kainga Ora loans (to 20%) for "Standardised Banks". This has already driven increased competition in a niche that the NBDTs had been actively working on. As you would expect, after the regulator has signalled that Government insured loans require less capital, there is intense competition for these customers. An opportunity traditionally held by building societies and credit unions.

Describe the impact of each requirement identified to provide personal banking services.

To the points made earlier, by not having large scale mortgage insurers in the New Zealand market, the incumbent 4 majors have significant competitive advantage when managing credit risk. They have huge data histories with approved regulatory internal models. These models combined with monthly market property and sales data allows them to apply credit "risk on" and "risk off" strategies with pricing nuanced to the customer and region.

The RBNZ rewards these internal models with improved capital allocations, creating a virtuous economic benefit that is very difficult to compete with. It could be argued that the RBNZ has driven stability over competition by rewarding scale in the way it has.

NDBTs on the other hand are treated as high risk and have been given inequitable risk weights. This has encouraged perverse risk behaviours, as many sought out higher yielding higher risk / revenue opportunities. Many credit unions and smaller NBDTs facing intense home loan competition from brokers and banks, have pursued more riskier products. Over time this "increased risk appetite" has led to poor financial performance and outcomes. The wider regulatory regime has effectively created more competition in the traditional "bread and butter" NBDT 1st Home buyer market, at the expense of new participants and niche entities.

As a result, over time (refer to the earlier RBNZ charts) the NBDT sector has lost a majority of what little market share it had, to the majors in residential lending.

The recent update to standardised risk weights to Kianga Ora loans, will invariably create intense competition on a small niche / sub set of the market that NBDTs have benefited from. The fact that the consultation document had only one brief acknowledgement of a “closing of a gap with NBDTs” highlighted how little the sector is understood, when making impact assessments.

The NBDT sector would suggest that the ongoing trends of poor financial performance, lower numbers and little innovation has been driven by poor regulatory oversight and a lack of understanding of regulatory impacts when making changes to the capital regimes of regulated institutions.

What specifically could be done in relation to each requirement identified in your response to question 1 to better achieve the purposes of the Act/Regulation/Policy with least negative impact on competition?

In the earlier paper (6.23c) the point was made that adjusting the credit risk weightings for NBDTs to the same as banks on standardised capital regime. This suggestion will be expanded on.

Please refer to the appendix which contains extracts from the 22/23 RBNZ Annual report. The RBNZ has a core value of innovation. The appendix extracts highlight that the Minister of Finance has provided a financial policy remit (FPR), which provides outputs and measurable activity that should underpin any impact assessment of policy going forward. These measures and outputs should also become a performance measure reported in SOI’s and the Annual report.

The contention is, that RBNZ policy teams have in the past focused heavily on stability over other priorities. i.e. “risk off” over innovation and competition –“considered risk”. Their impact assessments have tended to not apply equally, if any, weighting to the Ministers remit. These priorities are not mutually exclusive and should take a more holistic “NZ inc.” view, particularly as it relates to home grown local/ domestic competition. Considered risk should be accepted within the Ministers remit.

We would suggest that competition be given an equal ranking on an impact assessment. This would hopefully drive improved consultation and understanding of the NBDT sector and a more nuanced approach to policy development and risk settings.

As a matter of urgency we would support a review of the credit risk weights framework for NBDTs on the basis that this would be a template used under the wider Deposit Takers regulations. i.e. a third level framework for NBDTs or their equivalent in the new regulatory regime.

The RBNZ has been collating the balance sheet data of regulated entities for many years. i.e. it holds all the market share data at an aggregate and sector level and has published risk weighted insights periodically in the Financial Stability Report.

We are not aware of any reports that break down long term market share trends for mortgage and consumer lending by: 1) Internal ratings model banks, 2) Standardised banks and 3) NBDTs. This information would be a key indicator of success or otherwise of competition, innovation and the adoption of the Ministers remits. The publishing of non-bank data only is less helpful when making an assessment on all regulated deposit takers.

It is our recommendation that the above market share information is published by the RBNZ using long term historical data sets for the three risk frameworks described above. This could form a baseline on relative success or otherwise of participants to gain share and be competitive. No doubt the Commerce Commission would also want to understand the data and make its own interpretations on competition.

Under urgency again. Using the above market share data and supporting NBDT risk weight changes, encourage engagement with RBNZ and international insurers and NBDTs. All parties need to better understand what policy settings will bring back international industry experience in credit risk management of mortgage and consumer lending (retail banking) to New Zealand. The stated objective here is a more critical assessment of new loans underwritten by NBDTs and smaller banks and the ability to lay off credit risk with significant capital benefits.

Finally international insurers can support new innovative wholesale products in the capital markets. Their experience regarding credit enhancement products for mortgage portfolios etc can be transferred to smaller NBDT competitors and give some parity on funding options for them. i.e. the ability to develop / support well proven wholesale funding structures.

In the December 2023 GCFS papers, using the Australia case study, a similar comparative was made of non-banks and market share to New Zealand. What is of particular interest to NZ NBDTs is the following quotes, “Non-bank lenders have not been subject to APRA’s macroprudential policies.” “Currently, non-bank lending comprises around 4% of mortgage lending and is not considered to be presenting material risks to financial stability”. Australia appears to be applying proportionality to the smaller participants in a measured way. NBDTs would encourage a similar approach on risk weights from the RBNZ demonstrating proportionality and the unique capital structures of many entities. i.e. mutuals.

Thank you for the opportunity to make a late submission. If you have any further queries or require any further information, please do not hesitate to contact me.

Yours sincerely

Simon Jensen
Consultant

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APPENDIX A - '22/'23 RBNZ ANNUAL REPORT EXTRACTS

The Minister of Finance issued the first Financial Policy Remit (FPR) on 1 July 2022.

It states that:

- It is desirable to have a financial system that is strong, efficient and inclusive, with a low incidence of failure of entities regulated by the Reserve Bank;
- Within the appetite for a low incidence of failure, **a competitive financial system should be encouraged** so as to best ensure ongoing financial efficiency and inclusion. In this respect, the Reserve Bank should have regard to the benefits of:
    - imposing regulatory and supervisory costs that are **proportionate to the expected risks and benefits to the financial system and society;**
    - **encouraging new investment and financial innovation that raise the productive potential of the economy; and**
    - **encouraging the allocation of financial resources in a way that maximises the sustainable long-term growth of the New Zealand economy**; and
- if a regulated entity does fail, the Reserve Bank is expected to manage the failure in a manner that minimises the costs of the failure and the disruption to the broader economy, and prioritises protections for vulnerable consumers, depositors and public funds.
- The FPR also considers it desirable for the Reserve Bank to have regard to Government priorities regarding:
    - sustainable house prices;
    - building resilience and facilitating adaptation of New Zealand's economy, society and environment and to climate change;
    - **improving financial inclusion and maintaining financial sector diversity;** and
    - improving New Zealand's cyber resilience.