HABILIS

Draft Report submission

Market study into personal banking | 22 April 2024

HABILIS

Introduction

He tina ki runga, he tāmore ki raro.

In order to flourish above, one must be firmly rooted below.

This submission is made in response to the Draft Report into personal banking services by the Commerce Commission.

Our submission notes that:

1. The Commission has done an excellent job of describing and evidencing the degree of market failure in the banking sector, over and above the work completed in the Preliminary Issues paper, and the market studies team is to be commended for their work.
2. The Commission has also done useful work in characterising the source of the market failures, particularly around the entrenched regulatory issues and the resulting market distortions.
3. The Commission's proposed rectifications for these failures are, however, too timid and likely to be ineffectual, particularly when assessed against the strategic objectives for Aotearoa.
4. We therefore propose a structural reform of the sector, made up of three pillars – regulation, reform and redress – which will increase the competitiveness of the banks whilst increasing the resilience of our financial system.
5. We note the desirability and achievability of these reforms and advocate for their inclusion in the final report, whilst noting the role the Reserve Bank is playing in blocking systemic improvements.

We address each of these components in turn.

About us

Habilis New Zealand Ltd provides consultancy and advisory services to regional Aotearoa, including strategy development, economic and social impact modelling, business case and investment proposal development, stakeholder engagement and communications, and benefit and impact analysis. Our client base includes iwi, NGOs, local government and the private sector.

Habilis NZ Ltd is based in Tāmaki Makaurau.

Evidencing market failure

The Commission has done an excellent job of characterising the type and extent of market failure in personal banking.

While we disagree with the Commission's guidance to the then-Minister to restrict the scope of the study to personal banking only – thus ignoring the implications of market failure and excessive bank profitability on the productive economy – many of the findings are directly applicable outside the immediate scope of the study.

There will undoubtedly be submitters who wish to debate the points and merits of the Commission's conclusions about the sector; we see little value in taking this route. Instead, we concur with the Commission that the Australian banks are bloated, lazy and inefficient, and are engaged in a process of systematically looting the New Zealand economy for the almost-exclusive benefit of overseas shareholders.

This is clearly not in our national interest.

Having concluded this most obvious of points, attention should therefore turn to the root cause analysis and the prescriptions for remeditation, which is the focus of this submission.

Root causes and drivers

Root causes and drivers

We think the Commission has made some valid points in its analysis of why our banking sector is so dysfunctional and expensive. However, we think the Commission has been overly timid in sheeting home responsibilities to the primary drivers.

In our view there are two root causes of the issues described in the Draft Report:

1. The Reserve Bank's systemic regulatory failures that have over-weighted financial system stability and resulted in an inefficient banking system, at the expense of the rest of the economy
2. The vertical integration of the banking sector, which has allowed the Australian banks to obtain super-profits whilst excluding competitors.

We will address each of these areas in turn.

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Financial system stability

As the Commission notes in Chapter 7, the regulatory burden imposed on banks and NBDTs is a major determinant of viability and profitability, and the Commission has done a thorough job of exploring these issues. However, there are a number of areas where the logic has not been explored to its natural conclusion.

The role of the Reserve Bank

The Draft Report notes that "Personal banking services and providers (especially banks) are highly regulated in the interests of financial system stability, consumer protection and other policy objectives."

Developing and applying these policy objectives and regulations is the responsibility of the Reserve Bank – and it is clear that RBNZ's policy objectives are heavily over-weighted in favour of financial stability, to the detriment of every other sector of the economy. This is the underlying root cause that leads to a lack of competition and the excessive profitability of the Australian banks.

The RBNZ's stated goal is "promoting the maintenance of a sound and efficient financial system". While it may arguably have achieved the first goal – soundness – the Commission's market study confirms the "efficient" goal has been an abject failure; there is no metric from the study of the documents that surround it that shows the New Zealand banking system is efficient in any believable way.

Basel III and the financial system

The desirability of a stable and sound global financial system was underlined by the Global Financial Crisis, which resulted from commercial banks mis-pricing risk. The major concern at the time was contagion; the threat that failures in one bank could spread to other nationally-significant banks, and that the contagion could spread internationally.

Much has been written about the causes and consequences of the GFC, and it will serve no purpose to reiterate any of it here; further research is left as an exercise for the reader. However, one of the important outcomes of the crisis from the perspective of the banking study has been the implementation of the Basel III international regulatory framework for banks, administered and supervised by the Bank of International Settlements:

> Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks.
>
> Like all Basel Committee standards, Basel III standards are minimum requirements which apply to internationally active banks. Members are committed to implementing and applying standards in their jurisdictions within the time frame established by the Committee.

Aotearoa is a signatory to these accords.

The purpose of Basel III is to require that banks have adequate capital that reflects their true risk profile. While much of the technical approach to capital adequacy and risk assessment are best left to the detail of the standards, there are very significant implications for how the RBNZ prudentially manages our national financial system. This has led to an emphasis on the stability of the commercial banks, and a clear focus from RBNZ to ensure that there is not contagion that can spread across the banking system in Aotearoa, or onwards to the global banking settlement system. This focus has come at very considerable cost to our national economy.

Stability but not efficiency

As RBNZ notes in its most recent Financial Stability Report:

> Our prudential objective is to protect and promote the stability of New Zealand's financial system. Financial stability means having a resilient financial system that can withstand severe but plausible shocks and provide the financial services that we all rely on.

The effective test for stability of the financial system appears to be the expectation that all commercial banks will be able to withstand a 1-in-200 year adverse event, without failure; in other words, a 0.5% risk of failure of a major component of the financial system is the desired policy goal. And as noted above, one of the objectives of the goal is to ensure any bank failure in Aotearoa won't spread to the international banking settlement systems, endangering other jurisdictions.

As far as we can ascertain, the specific rationale for why the financial system stability threshold is set at this level is not described by RBNZ. While RBNZ adheres to the Basel Framework, the specific threshold does not appear to be enshrined in the Framework itself; rather, it appears to be indigenously developed.

The effect of this goal is pernicious – not because financial stability is a bad thing, but because its implementation has entrenched the dominance of the Australian banks and reinforced their high profitability, due to the resulting structure of our banking sector and the vertical integration that has been allowed to develop. In effect, RBNZ has provided direct policy support for the very situation described in the market study, apparently driven by Basel III obligations.

For instance, under RBNZ rules derived from the Basel Framework, all banks must demonstrate the sufficiency and quality of the assets they hold, such as mortgages and loans. Yet these rules also specify the Australian banks can mark their own homework by setting their capital requirements according to their own internal models. While all larger banks have greater capital requirements, the internal models can produce results that require less capital than is the case for smaller banks, which must follow RBNZ's modelling to the letter; this provides a distinct financial advantage to the four Australian banks, which is not passed onto its customers but accrued as profit. The draft report notes this.

And the RBNZ's policies are littered with exactly these additional incentives and easing of controls for the big banks. In isolation, none of the specific requirements are particularly noteworthy and all have entirely rational justifications; but in totality, the effect is a very significant tilting of the playing field, to the point where the market control and profitability of the Australian banks is effectively unassailable due to RBNZ rules.

It is our view that RBNZ has entirely lost sight of its obligations to engender an efficient financial system, because it has mistakenly equated profitability with stability. The RBNZ rationale seems to be, having excessively profitable Australian banks is a good thing because it indicates the financial system is robust and stable – as if this was the only economic policy goal that matters in the entire country.

While the goal of financial system stability is a worthwhile one, and the Basel Framework provides useful guidance and mechanisms for how this can be achieved, Aotearoa's policy prescriptions are entirely the construct of RBNZ; it therefore bears primary responsibility for the distortions and problems that have arisen.

This is best illustrated by the RBNZ's policy failures during the COVID-19 pandemic.

COVID-19 and financial largesse

RBNZ instituted a number of programmes designed to improve liquidity in the financial system and to support confidence in the banks as the pandemic developed; through these programmes, RBNZ expanded its balance sheet from $24.60 billion to $104.38 billion at peak. Further, RBNZ reached agreement with the Crown that taxpayers would indemnify RBNZ for trading losses as some of the programmes were unwound – so the entire nation appears to be on the hook for any adverse outcomes.

In any event, the financial system did not get anywhere close to collapse during the pandemic, but RBNZ's policy supports did supercharge the profits of the four Australian banks, as they were the primary beneficiaries of the programmes.

In areas such as the Funding for Lending programme, there were negligible controls on how the banks could use the cheap funding from RBNZ, and there appears to have been very little assessment of how effective or efficient the programme has been when it came to providing support for everyday New Zealanders. And while correlation is not causation, the primary effect of the cheap funding appears to be a very significant uplift in bank profits over the time period.

With the benefit of hindsight, the various financial system supports provided by RBNZ through the pandemic look awfully like industrial-scale corporate welfare for a small number of highly profitable banks, at the expense and risk of the New Zealand taxpayer.

Now, there is an argument that the COVID-19 pandemic was an exceptional global event, with a return period on the order of a century, and that exceptional events require exceptional measures. However, as noted above, Aotearoa is already paying the higher costs associated with insulating our financial system from a 1-in-200 year calamity. When looked at through that lens, the pandemic appears to be exactly the sort of event the RBNZ claims our financial system is already robust enough to withstand.

The RBNZ can't have it both ways: it can't inflict the higher costs associated with excessive bank profitability on the entire economy, then proceed to fling vast amounts of taxpayer-underwritten cash at those self-same banks at the slightest sign of trouble. This is clearly not what New Zealanders expect.

There are a number of clear lessons from this particular debacle:

- For all its posturing about the necessity for the banking sector to be robust and be able to weather the financial ups and downs of a global economy, RBNZ will unhesitatingly step in to support the commercial banks in the event of a major challenge, moral hazard be damned.

- RBNZ will simply shrug and move on if the event and its associated moral hazard result in excess profitability for the banks, and there appears to be little expectation of accountability from the banks for the public funding they receive – for instance, we can find nothing that indicates RBNZ has conducted a cost-benefit assessment of its COVID-19 response.

In effect, the RBNZ policy responses during the COVID-19 pandemic amounted to a taxpayer-funded underwrite of profits for the Australian banks. As a nation, we are sending an entirely clear message to international bank shareholders: we will make sure your profit expectations are realised, come hell or high water. This is obviously not in our national interest.

Vertical integration

The structural issues in the banking sector

A large part of the problem created by RBNZ's regulatory approach stems from the vertical integration of the banking sector. In Aotearoa, all four Australian banks are retail banks interacting with customers, wholesale and clearing banks interacting with the domestic and international banking network and RBNZ, and owners of the national payments system. There are very clear systemic risks in this configuration.

The key challenge lies in the lack of any compartmentalisation or firewalling between functions, which means that any bank stability problems are very difficult to contain. The nature of the vertical integration means that a major issue at any one of the Australian banks will likely spread to other local banks because of their interconnectedness, and risk contagion of the international settlement system. From our perspective, this seems an unacceptably high risk profile.

Containing a potential failure also becomes harder as the size of the bank grows – with ANZ representing the largest systemic risk due to its 40% market share. In that sense, ANZ is well past the threshold of being "too big to fail", with all the moral hazard this implies.

The RBNZ response to these issues has been entirely counterproductive, in our view. The policy direction is to allow banks to continue to be vertically integrated and too large, but then to enforce increased capital requirements, risk transparency and prudential oversight in an effort to make them more resilient. Should this RBNZ-mandated resilience be insufficient, systemic failure of our financial system is a genuine risk.

To use an analogy, the financial system in Aotearoa is like a ship that has no watertight compartments at all; any major breach of the hull will cause the vessel to sink. The regulatory response to this danger has been to increase the thickness of the hull, install more pumps, and have plenty of people walking around the ship with flashlights looking for leaks. All of these things are useful, but are essentially misguided – the obvious and effective solution is to install watertight compartments.

And in this context, simply making the existing banks smaller and increasing their number won't really help; if they are all interconnected vertically and horizontally, a major event still has the capacity to overwhelm the entire system without truly heroic efforts.

We will come back to recommendations about changes to the structure of the banking industry later in the document – but suffice it to say, the current structure of the banking sector in Aotearoa is inherently and dangerously fragile, and no amount of profiteering by the Australian banks or increased oversight by RBNZ will change that fact. However, the unwillingness of regulators to address the structural issues arising from vertical integration of the sector has directly led us to the anti-competitive outcomes detailed in the market study.

The public sector's policy failures

As the study notes – although not in these words – the Australian banks are fat, lazy, inefficient, and excessively profitable. Our financial systems is therefore expensive for consumers, lacks innovation and product choice, and is riddled with systemic problems such as rampant fraud. The country is not being served well by the Australian banks.

As noted above, a very large contributor to these issues are the current policy settings of the RBNZ. However, as the market study also notes, there are additional regulatory controls that are also engendering rigidity in the sector, and costing the country dearly. The new Deposit Takers Act 2023 is a major contributor, as is the Credit Contracts and Consumer Finance Act 2003 and its subsequent amendments.

All these legislative frameworks suffer from the same problem: they try and apply a one-size-fits-all approach to the entire financial sector, scaled as if every institution carries the same risks and requires the same level of oversight and can absorb the same level of compliance costs. The effect is to set the current industry structures in stone, create barriers to entry and growth, and yet fail to produce the outcomes required.

The study characterises some of these problems – such as the issues with the CCFA Act and associated regulations – as "unintended consequences":

> We have also been told that CCCF Act requires lenders to take a "one size fits all" approach, regardless of the size of the loan or whether the lender has an existing relationship with the customer.
>
> We consider that the regime overall has had unintended negative consequences for competition.

These should not be unintended consequences – the downstream effects of the regulatory changes should have been entirely predictable. Given how much time MBIE has spent fiddling with these regulations, the implications for financial institutions, consumers and the wider economy should have been properly researched and well characterised. The fact they have not been correctly identified and explored is an indictment on the public sector's policy development processes, which suffers from poor performance and over-much conceptual rigidity.

The same issues arise in far too many areas of public policy in Aotearoa, always resulting in entirely predictable "unintended consequences". As a random collection of examples:

- Following Cyclone Bola in 1988, the Crown instituted a planting programme to stabilise land in Tairāwhiti – but did so with a single species, *pinus radiata*. The effect has been the widespread and subsidised planting of the wrong tree in the wrong place in much of the unstable land, which in turn led directly to the regional devastation of Cyclones Hale and Gabriel in 2023.

- The systemic rigidity of the Building Act and the BRANZ product approval process following the leaky homes debacle led directly to the decline in construction and product innovation across the country, which in turn gave rise to the "gib board crisis" following the COVID-19 pandemic, and the Commission's resulting market study into building products.
- The one-size-fits all approach to earthquake prone buildings where a low rating in one part of the building is applied to the entire structure has resulted in excessive costs for residential apartment owners, the loss of billions of dollars of property value, personal bankruptcies and buildings sitting empty during a housing crisis because they are uneconomic to bring up to standard.

All these examples arise from the same underlying cultural issues in the public sector: that there are simple solutions to complex problems, which in turn results in a sort of bureaucratic magical thinking and an apparent belief that miracles are certain to fall from the sky. To state the obvious, simplistic solutions do not result in high quality and nuanced outcomes: they result in entirely predictable "unforeseen consequences" that have to later be addressed, typically at very considerable cost to the country.

This is very much the case with the regulatory frameworks that are currently constraining innovation in the financial services sector, driving additional cost for consumers, creating barriers for new entrants – and in the process, handing the Australian banks an enormous profit windfall.

The need for reform

As noted above, the Commission has extensively documented the sorry state of competition in the banking sector, and has gone a reasonable way to identifying at least some of the causes. However, the draft report proposes interventions that simply won't have the desired effect. In fact, some of the recommendations – such as Kiwibank becoming a disruptive competitor – reflect the same magical thinking as has beset the policy development process.

This is not to say that the recommendations in the draft report are poor or even wrong – they are merely insufficient. Every single one of the Commission's draft recommendations could be adopted and implemented tomorrow without the slightest impact on the profitability or market shares of the Australian banks, and with no discernible increase in competition.

The market disbelieves the Commission

This is reflected in the market response to the draft report when it was released in March; as ANZ's Australian share price on the day shows, the price briefly dipped once news of the report reached the market, but recovered in a matter of hours. In other words, investors do not think the Commission's recommendations will have the slightest effect on the simply stellar dividend flows they have grown accustomed to – and we concur with their sentiments.

The share prices of the other Australian banks show similar trends; there is no indication that any of the shareholders of any of the banks are even slightly concerned by the draft recommendations in the report.

The reason for the scepticism is obvious: the proposed interventions are merely fiddling with the existing market structures and making incremental changes to the existing dysfunctional arrangements. Even if implemented in full and with alacrity, the existing oligopoly will not be ended and no brave new age of vibrant banking competition will be ushered in. Even with every single one of the recommendations in place, Aotearoa will continue to be looted by the Australian banking oligopoly – as the Australian share market predicts.

Being clear about the problems we're addressing

In our view, this ineffective incrementalism in the draft recommendations is caused by a lack of clarity about the problems in the banking sector that the country is attempting to solve.

Thankfully, Habilis has considerable professional skill in this area, and we lean heavily on some proven international methodologies including Investment Logic Mapping to identify the underlying issues that need to be addressed. We've applied these techniques to the issue of banking dysfunction, and our analysis shows we are grappling with three interlinked problems:

1. Our banking sector is vertically integrated, which results in a fragile and vulnerable system that can threaten Aotearoa's financial integrity.
2. The regulatory attempts at protecting the sector entrenches the market power of the incumbents and excludes new competitors.
3. The resulting banking oligopoly lacks competitive pressure and can extract rents that produce unjust enrichment, in the absence of firm regulatory constraints.

Cumulatively, these problems present a strategic challenge to our national interests: our current reality is that the excessive profits of the Australian banks and their wholesale export to overseas shareholders are creating a very significant dead-weight drag in our economy. This is a highly adverse outcome that impoverishes New Zealanders to the benefit of offshore bank shareholders.

The case for reform of the sector

It is obvious that the causes of the market dysfunction are structural in nature; that is, the constraints under which the banking sector operates are locking the banking market into its dysfunctional state. These constraints are in turn being exploited by the Australian banks to generate super-profits.

The primary constraining factor is Basel III; our international obligations require the banking sector to be sufficiently robust that it cannot spread contagion to the international settlement system. This in itself should not distort the market, but does – because of the structure of our banking system, largely inherited from the 1980s.

As noted above, vertical integration is the defining feature of the New Zealand banking sector; all the major banks are retailers, wholesale and clearing banks, and beneficial owners of the payments infrastructure. In the context of Basel III prescribing the quality of assets banks can hold and the RBNZ interpreting this as requiring banks to be able to survive a 1-in-200 year adverse event, this provides an unassailable obstacle to any new entrant.

Achieving better outcomes for whānau and businesses in Aotearoa therefore requires the entrance of new competitors, offering new products and services at competitive price points. This is nearly impossible given the vertical integration of the sector, for the following reasons:

- There is a strong regulatory bias towards the Australian banks that provides them with lower costs than any new entrant, as extensively documented in the draft report
- The Australian banks are not required to provide wholesale or clearing services to new entrants, and based on material in the draft report, have seemingly used AML requirements at times to deprive fintechs of access to the banking system
- The bank owners of Payments NZ are not obligated to provide any new entrant with access to the payments network, thus excluding them from the very services that are required to interoperate with the incumbent banks.

These are virtually insurmountable hurdles for any new entrant. In fact, in the face of these structural obstacles, even the exceptional profitability of the banking sector in Aotearoa cannot justify investment in a new challenger bank; there is no viable business case to be made, because there is no viable pathway to the level of vertical integration already achieved by the Australian banks.

In order for a new challenger bank to complete on a level footing with the incumbents, the following will have to be true:

1. The challenger will need to convince the RBNZ it has the same level of financial soundness as the Australian banks, so that it has access to same funding at the same cost
2. It will also need to convince the RBNZ that it is deserving of access to the ESAS clearing system on an equivalent basis to the incumbents
3. It will need to convince the existing banks to sell it a shareholding in Payments NZ, or at least gain access to the Payments NZ system at an equivalently low price as the shareholding banks, so that customers can transact.

Under the current regulatory, policy and market settings, there is simply no prospect of these basic operating conditions being met. The hurdles for a new challenger bank are insurmountable, and it is safe to say that no new entrant will arise.

Which leads us to the question of Kiwibank.

Kiwibank is not our saviour

Assuming that the current vertically-integrated structure of the banking sector remains unchanged, it is not clear what benefit a larger and better-capitalised Kiwibank would bring to consumers.

If Kiwibank was simply larger, then it's reasonable to expect its growth in market share would come at the expense of some or all of the Australian banks. But there is little evidence that Kiwibank has more or even different products to its Australian competitors, or that it is more efficient in any substantive way, or that it is seeking lower profits. This is largely because RBNZ's regulatory framework fits Kiwibank into the same asset and funding straightjacket as the Australian incumbents, albeit at a somewhat higher cost to Kiwibank.

In effect, the dictates of the current market structure and its constraints would simply move customers from the Australian banks to a bigger and better capitalised Kiwibank, with a different logo on their Internet banking screen, but a fundamentally similar product and service experience. This does have some benefits at a national level, as the 30% dead-weight drag being exerted by the Australian banks as they export their profits offshore would decline – but this is very much a theoretical benefit to everyday bank customers.

As the supplementary report from Dimitris Margaritis and Maryam Hasannasab notes, our banking sector is inefficient and lazy, and many of its actions and inactions are readily explained under a "quiet life" hypothesis:

> Market power may result in higher costs (rather than higher profits) due to inefficiencies arising from the reduction of competitive pressures, as the management is under less pressure to minimise costs - the so-called "quiet life effect" (Hicks, 1935; Berger and Hannan, 1998)

Without structural reform of the sector, simply making Kiwibank bigger and better capitalised is highly likely to simply rearrange customers between five banks that are all enjoying a quiet life, rather than the four we currently have. This is borne out by the fact that ASB was seen as an aggressive disruptor a decade ago, but is now content to simply extract ever-higher profits from a largely static customer base today.

It's reasonable to assume that a larger and better capitalised Kiwibank would fall prey to the same temptations in the medium term. In effect, the cold, dead hand of the RBNZ's regulatory compliance obligations will squeeze any new challenger into the same set of narrow products, indifferent service, archaic IT systems and high profits. And in our view, this will be the ultimate fate of a better-capitalised Kiwibank.

Reform is the precursor to better outcomes

The source of the dysfunction in our banking sector is the RBNZ's one-size-fits-all regulatory approach, which it seems to think is justified as an acceptable cost for a putatively stable banking system. As we have noted, the fundamental problem with this approach – the idea that an inefficient and extractive set of incumbents will somehow insulate our financial system from shocks – is that it will fail.

And when it does fail, the RBNZ will immediately back-stop the Australian banks at very considerable risk to the taxpayer. So Aotearoa has the worst of all possible worlds; a ridiculously expensive and inflexible banking system, with an implicit taxpayer guarantee for the operations and profits of overseas banks. It is harder to conceive a more intellectually flawed approach, or one that has higher moral hazard.

Plainly, these issues cannot be addressed by fiddling in the margins, as the draft recommendations do. While improved open banking and more informed consumers are useful, they will not address any of the structural issues in the sector, provide a workable platform for a new market challenger, or address the excessive profitability of the incumbents. This can only be achieved by root-and-branch reform.

So having defined the problems and identified the importance of solving them, we are left with the question: what then should we do?

Developing the options for reform

Working from the earlier problem statements, the strategic objectives we wish to achieve as a nation are as follows:

1. Our banking system must be **resilient, robust and secure**, and able to absorb internal and external shocks without causing financial peril to the nation.
2. Our banking system must be **efficient and competitive**, with the ability for new competitors and innovative products to develop, and for those companies and products to succeed or fail on their own merits.
3. Our banking system must provide an environment where banks generate a **fair rate of return** to investors for the risks they are taking, but no more.

In our view, there are three elements necessary for the strategic objectives to be achieved, resulting in the fair and efficient functioning of our banking sector – these are the triad. All must be implemented in parallel for reform to be effective. They are:

1. **Regulation** – Regulatory reform to provide the level playing field required of an efficient banking sector, and to remove the distortions and moral hazards created by RBNZ's current policies.
2. **Restructure** – Structural separation of the banks, to provide risk partitioning, prevent contagion, and provide a neutral platform for competition and innovation in the sector.
3. **Redress** – Legislative and court action to claw back the excessive profits of the Australian banks, to remove any incentives for profiteering while the reforms are being emplaced, and to ensure that competition law is fully enforced on the bad actors in the sector.

We will address each leg of the triad in turn.

Leg 1 – the Regulation requirement

As the draft report demonstrates, there is an urgent and pressing need for the RBNZ to pursue policies that are in the best interests of the country, rather than being in the best interests of international bank shareholders.

We concur with all the regulatory reforms put forward in the draft recommendations; however, we think it's long past time for the Commission to state these as directives rather than couching them in the very tentative bureaucratic language in the draft report.

Further, we would extend the recommendations, by requiring that the RBNZ act on its stated policy objective of an efficient banking sector. In practice, this will require a re-stating of its key strategic documents, agreeing efficiency metrics, targets and KPIs with the Minister of Finance, and implementing the programmes required to deliver efficiency as an outcome.

There are other key regulatory reforms required across the sector, such as changes to the CCFA and addressing the systemic failures of the AMLA, as identified in the draft report.

For instance, it is a major indictment of AMLA that our entire banking system has become a major conduit for financial fraud via mule accounts, despite this highly intrusive and operationally expensive legislation; yet the machinery of government has

been utterly silent on why the banks responsible for these failures are not being held to account. Thanks to AMLA, it's almost impossible to buy a packet of winegums in this country without proof of ID, yet the banks provide a willing and very efficient conduit for fraudsters to launder hundreds of millions of dollars at an industrial scale, seemingly without consequence.

In terms of implementation, there is already a public sector body tasked with coordinating policy and legislative responses in the financial sector: the Council of Financial Regulators (CoFR) – Kaunihera Kaiwhakarite Ahumoni. This grouping of key regulatory agencies undoubtedly has both the regulatory purview and the mandate to address the systemic issues that cross the boundaries of multiple pieces of legislation, and could champion and drive the necessary regulatory reform.

However, it is notable that the Council does not include having a competitive and efficient financial system as one of its priority areas. This seems a stunning oversight. If the Council is going to perform a useful policy function within the machinery of government, then it needs to become a bit less of a talking shop and focus on the matters that are clearly causing billions of dollars of damage to Aotearoa's economy and whānau.

Leg 2 – the Restructure requirement

In the previous sections we noted the fundamental problem with Aotearoa's banking system: the vertical integration that is allowing a small number of over-sized banks to exert oligopoly power and achieve ongoing unjust enrichment of their shareholders. We also note that there is a very large implicit underwrite of the profits of the Australian banks by the New Zealand taxpayer, as all four are arguably too big to fail (TBTF) with all the moral hazard this implies.

So there are two areas that need to be addressed in the Restructure leg of the triad:

1. The cessation of the vertical integration currently defining the sector
2. The reduction in scale of the existing banks, in order to eliminate the danger that a TBTF bank poses and remove the implied taxpayer underwrite.

We will discuss each in turn.

Step 1: The ending of vertical integration

The banking industry would have us believe that implementing a fairer and more efficient banking system can only be done extremely slowly, if at all. But overseas experience shows it can be achieved rapidly and at low cost, with a few decisive and straightforward actions, producing quick results.

Our plan is based on earlier lessons from the telecommunications industry: the most effective way of reforming an entire sector is structural separation. In the case of the banking industry, that means:

1. Banks can choose to be retail banks serving customers, or they can be wholesale banks serving the industry – but not both.
2. All existing banks must decide to be retail banks or wholesale banks, but there can be no common ownership of the two types.

3. Where a bank remains a Systemically Important Domestic Bank (SIDB) as assessed by the Reserve Bank after structural separation has occurred, it must be broken up to ensure no single bank can pose a systemic risk to the New Zealand economy if it fails (see Step 2: Downsizing).
4. The payments platform for New Zealand – currently Payments NZ – must be divested by its current bank owners and placed in independent ownership, with independent governance and a requirement to deliver open banking services on a neutral basis, at pace.
5. Payments NZ or its replacement can make a profit, but this return to shareholders is regulated by legislation, in the same way as Chorus for telecommunications and lines companies for electricity supply.

These simple and easily implemented changes will establish a level playing field for all current and emerging banks, and allow competition and innovation to flourish. The diagram below shows how it will work:

Retail banks deal directly with customers, and can take deposits and make loans, including mortgages. They conduct inter-bank transactions via the Clearing banks.

Clearing banks provide wholesale transaction and lending services to Retail banks. They do not deal directly with retail customers.

The Processing entity maintains the processing network and processes the electronic transactions for all Retail and Clearing banks, in a neutral way.

As structural separation in the telecommunications industry has shown – and which has been demonstrated over nearly 15 years – these measures are highly effective at reforming uncompetitive markets, creating a platform for innovation, and producing a stream of new entrants at different points in the market.

And as the telecommunications market also demonstrated, vertical integration is not necessary for technology or efficiency or operational or financial reasons – despite what the current incumbents might say. Markets are more vibrant and effective when there are a larger number of participants operating at a range of scales in different segments, with a clear set of rules, and none of this occurs with strong vertical integration.

The same is true of the banking sector. There are no operational imperatives that require vertical integration; money is inherently weightless, the entire global industry has long experience in operating financial markets at scale in real time, and there are known risks in allowing individual entities to achieve a dominant position.

Which brings us to the toxic effects of TBTF and the steps necessary to resolve it.

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Step 2: Structural downsizing

As is apparent from reading any history of the GFC, the damage done to global economies was entirely the bastard step-child of TBTF banks. Regulators had allowed individual entities to grow to the point where they could and did pose systemic risks to national economies and global economic stability – which in turn resulted in central bank-funded bailouts, which promptly spread the economic damage to the real economy and blighted the lives of many hundreds of millions of people.

Achieving TBTF status must absolutely delight the shareholders of the banks. The old saw – that they have privatised their gains and socialised their losses – was proven to be completely true during the GFC, and it is undoubtedly true of the Australian banks in Aotearoa today. Paradoxically, in the event of a major global challenge to our financial system, it is highly likely the RBNZ would sacrifice New Zealand-owned Kiwibank in order to save the Australian-owned banks – and their shareholders will be laughing all the way to, well, the bank. The RBNZ response to the COVID-19 pandemic – and the lack of any apparent cost-benefit analysis – is offered as evidence

As discussed above, the regulatory response to the GFC – primarily Basel III – takes reform in exactly the wrong direction. The solutions to TBTF have tried to insulate the global financial system from the "Fail" element whilst doing nothing about the "Big" element.

Intuitively, this makes less than no sense; central bankers are smart people, and as well capable as any common or garden consultant at drawing the linkage between the size of a bank and its propensity to do significant structural damage to the economy that hosts it. Yet the regulatory response has been to allow banks to continue to grow, despite the danger.

The cause of this conundrum seems obvious: central banks and financial regulators have been extensively captured; their way of thinking about the banking sector seems infused with a particular banking-centric dogma – that size somehow equates with efficiency.

As we all know to our cost, this particular neoliberal catechism emanated from the Chicago School, and it has well and truly suffused Western thinking about the inherent desirability of large corporations. But as we all collectively skid down the slope from service delivery by many companies to rent extraction by a small group of behemoth companies, it's apparent that efficiency through size is a myth.

In response, the banks point to our willing use of their services as proof that people don't really care about oligopoly behaviours; but this is rather like arguing that inmates are happy to be in jail because they use the prison library. Confronted with the reality of a near-Feudal banking system where rents are extracted rather than profits earned, people make the rational decision to make the best of it. That is not consent, and it is not good governance at the national level.

This is the unfortunate path that Aotearoa has walked down in the last 20 years, since the merger of the National Bank with ANZ was approved in 2004. Reading the analysis and merger approval documents for that transaction is a truly Alice in Wonderland moment: despite every indication that consolidation was unhealthy for competition, the Commission decided that new and entirely fictional entities – Superbank, anyone? – would magically spring to life and lead us to a nirvana of innovative and competitive banking services.

The reality – as 327 pages of the draft report illustrates – has been somewhat different.

Thankfully, there's an easy fix, detailed above: in addition to structural separation and an end to vertical integration, where a bank remains a Systemically Important Domestic Bank (SIDB) as assessed by the Reserve Bank after structural separation has occurred, it must be broken up to ensure no single bank can pose a systemic risk to the New Zealand economy if it fails.

To state the obvious, the Restructure leg of the triad will require both political will and the passing of legislation, and the second part of the step will take a little bit of time. Which brings us to the question, what happens in the meantime?

Leg 3 – the Redress requirement

It is notable that the market study into personal banking comes after many years of exceptional profits, under-investment and lack of innovation from the Australian banks. Depending on how the trend is read, it seems apparent that the Australian banks began diverging from the median profitability in the OECD around 2010 – about 14 years ago.

As every aspiring economist knows, the totality of the excess profits extracted by the Australian banks is merely the area under the graph, defined by the level of profits actually achieved versus the fair return on capital. And to make the obvious point: there's a lot of area under *that* graph.

These profits have been enabled by regulatory failure, and arguably the Australian banks have merely reacted rationally to the distorted incentives they've been given. However, a harm is a harm, and redress is required; the profits are not the result of competitive capitalist endeavour, so the excessive returns on capital have been un-earned.

There appear to be two routes to addressing the unjust enrichment of the Australian banks: the levying of a windfall tax, and a prosecution for abuse of market power under the Commerce Act. We heartily recommend both courses of action conducted simultaneously, for the following reasons:

- It will be some time before the full weight of legislative and regulatory reform can be brought to bear on the behaviours of the Australian banks – although, as the saying goes, time is of the essence – and in the interim, it is unlikely that the profiteering culture that suffuses all four organisations will change markedly. As a nation we therefore need to ensure the bankers in question change their behaviour quickly and radically, to limit the further damage they can do to our economy and whānau. Reclaiming un-earned profits via a windfall tax benefits the Crown directly, but also removes the morally hazardous incentive to continue the behaviour; there is no point in profiteering if the profits are simply taken off the table by the umpire.
- It is apparent from the plethora of data in the draft report that very considerable excess profits have been removed from the nation by the actions of the Australian banks – and this seems like a *prima facie* case of achieving unjust enrichment by the abuse of market power, in direct contravention of the Commerce Act. There are a number of different ways of calculating both the excess and the fair rate of return on capital, and it is in the interests of natural justice that these different methodologies are tested in court, and a judgement rendered. This allows both the banks and the Crown to make their case, and the judiciary to dispense justice accordingly, including assessing the applicability of any punitive penalties contemplated in the legislation.

These courses of action will undoubtedly cause dismay amongst the banking fraternity and their shareholders, and there may well be claims of a lack of fairness; however, these steps accord with philosopher John Rawls's basic principle of justice: the interests of the weakest and poorest groups must have first call on the protective power of the state. Say what you like about them, bankers are a long way away from being the weakest and poorest group in Aotearoa.

Achievability of the reforms

Working from the problem statements earlier in the document, the strategic objectives we wish to achieve as a nation are as follows:

1. Our banking system must be **resilient, robust and secure**, and able to absorb internal and external shocks without causing financial peril to the nation.

2. Our banking system must be **efficient and competitive**, with the ability for new competitors and innovative products to develop, and for those companies and products to succeed or fail on their own merits.

3. Our banking system must provide an environment where banks generate a **fair rate of return** to investors for the risks they are taking, but no more.

It is apparent that the little-by-little draft recommendations in the market study report will not achieve these objectives, and that a root-and-branch reform of the banking sector is required. The triad does, however, achieve all the strategic objectives.

The next question becomes: is this a practical plan? For assessment of that issue, we need to identify the critical success factors that must be achieved if the reforms are to be successful. Looking at the nature of the problem statements and Aotearoa's national and international environment, the relevant critical success factors are:

- **Regulatory compliance** – the option must be compliant with Aotearoa's international treaty obligations, such as Basel III, although there is a working assumption that changes to our internal legislation is both required and feasible to give effect to the chosen option(s).

- **Achievability** – the option must be able to be implemented in a relatively short period of time without requiring an onerous burden on legislators, regulators or the sector.

And as noted, there is an assumption that the political will exists to reform Aotearoa's banking sector to make it fit for purpose and to ensure it operates for the benefit of the nation, rather than the benefit of overseas shareholders. We are of the view that this political will exists, and that legislation can therefore be enacted to give effect to the reforms.

On the subject of achievability, it may be the case that both regulators and the Australian banks throw up their hands in horror at the scale and extent of change, particularly driven by the Restructure leg. Again, harking back to structural separation in the telecommunications industry, this was achieved by legislating around 230 binding undertakings, which were duly achieved in around four years in an industry that is vastly more complex and has many orders of magnitude more infrastructure than banking.

And as noted above, some of the incentive for rapid change will come from the Redress leg of the triad, particularly the levying of a windfall tax; this will undoubtedly focus the attention of the Australian banks on the fact that attempting to kick the can down the road and lobby for delays will not result in the continuation of their super-profits.

The question of appetite

There is always a complex interplay between regulators and legislators, and it is a truism of politics that there needs to be a reasonable alignment between politicians and officials in order for any major reform to be effective.

As noted earlier in the document, the two-decade-long tolerance for adverse outcomes in the banking sector appears to have stemmed from regulatory capture, which equates size with efficiency. There is every sign that this *de facto* consensus is breaking down, as the damage to Aotearoa's economy – in electricity, fuel, supermarkets, building products and banking – becomes more and more apparent.

However, there is no getting away from the fact that regulators – particularly the Commerce Commission and the Reserve Bank – will have to play more assertive roles when it comes to achieving a reformed, efficient and competitive banking sector. And there are both encouraging and discouraging indications on that front.

As we have noted elsewhere and as will undoubtedly be stated by other submitters, the quality and depth of the Commerce Commission's work on the draft report is superb. It is a *tour de force* through the dysfunction of the banking sector, and leads to the inevitable conclusion that the market is broken and in urgent need of change.

Further, it is also apparent that the quality and depth of analysis has improved significantly from the market study into the grocery sector, and the Commission's market study team deserves to take a bow for this.

We've noted, however, that the policy prescriptions in the draft recommendations are insufficient to address the issues that the Commission has so clearly articulated. The next step is, of course, working out what should occur from here; our proposed reform of the banking sector is described in depth above. The obvious question then remains: is the machinery of government be prepared to take the actions necessary to enact the required structural changes?

On the encouraging front, there is clearly an increasing global recognition of the negative and pernicious aspects of monopolies and oligopolies. Regulators in the US, the UK and Australia are all taking a much more clear-eyed view of the role of large corporations in stifling competition and engendering poor outcomes for consumers, and there is a much more assertive line being taken by the FTC, the ACCC and others.

In that sense, Aotearoa is simply late to the party – but it's likely that our regulators will also see the societal benefits that come from breaking up natural and engineered oligopolies. This bodes well for achieving better outcomes through reform of the banking sector.

On the discouraging side of the ledger, the RBNZ's intransigence at seeing or addressing the role is playing in enabling the oligopoly behaviours and supercharging the profits of the Australian banks is deeply concerning. Rather than acknowledging the issues and proposing a pathway to a competitive and efficient banking market, RBNZ's submission on the draft report reads more like a technical apologetics for the banking industry.

For instance, the RBNZ pays no attention to the sources of excess profitability in the New Zealand banking sector, seemingly assuming that these bloated profits are somehow an Act of God. The RBNZ's position on profitability seems to be perfectly aligned with that of the Australian banks – which seems to be a textbook example of regulatory capture. This does not bode well for reform.

We will cover these issues in more depth in a cross-submission.

Summing up

In conclusion, then:

1. The draft report is a *tour de force* in identifying and describing the systemic market failures in our banking sector, and the Commission's market studies team deserves accolades for their excellent work.
2. The draft recommendations are insufficient to address the problems the draft report identifies, and even if implemented immediately and in full, there is little evidence that greater competition would result.
3. In that context, a better-capitalised Kiwibank is a useful thing, but will not in itself become the catalyst for more competition or better outcomes, because the barriers preventing a vibrant market in banking services are structural in nature.
4. The only way to achieve the strategic objectives – of a banking system that is resilient, robust and secure, via a market that is efficient and competitive, and which produces a fair rate of return (but no more) for investors – is by the structural reform of the sector.
5. The necessary reform needs to incorporate three interdependent pillars, of regulation, restructure and redress to ensure the strategic objectives are met. These reforms are practical and implementable.
6. The reforms need to be enacted decisively and at pace, to limit and prevent the damage that is being done to Aotearoa's economy and whānau by the extraction and export of excessive profits to offshore shareholders, and we believe there is the political appetite for the required changes.
7. The primary obstacle to this process is the RBNZ, whose apologetics for the banking sector is highly indicative of regulatory capture, and whose intransigence is imposing a very large cost on the country.

We are supportive of the continuation of the market study process, and we encourage the Commission to take a much more decisive line in recommending interventions that will result in structural reform of the sector in the final report. To that end, the copy-and-paste functionality that will enable the triad of reforms – regulation, restructure, and redress – to be transferred to the final recommendations awaits.

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