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Market Study into personal banking services – response to the Preliminary Issues paper dated 10 August 2023

Thank you for the opportunity to submit on the Commerce Commission's Preliminary Issues Paper (**Paper**). This is a joint submission of The Co-operative Bank Limited, Kiwibank Limited, SBS Bank and TSB Bank Limited. Each bank also may be providing an individual response to the Paper. However, we consider it worthwhile reinforcing the common issues highlighted in response to question 16 of the Paper:

> *"Which conditions of entry or expansion in the personal banking sector most significantly affect competition?"*

The Commission has rightly noted the four Australian-owned banks (classified by the Reserve Bank of New Zealand as Domestic Systemically Important Banks (**D-SIB**)) hold a combined 88% of the assets of all registered banks in New Zealand (para 84). Smaller, New Zealand owned banks face impediments to growth, innovation and their overall competitiveness that D-SIBS do not. The following areas are acting as constraints that hinder us from competitively growing market share in relation to personal banking services:

- The Reserve Bank capital rules have historically favoured D-SIB banks;
- More generally, banking regulation imposes disproportionate costs on non-D-SIB banks;
- Smaller banks are materially constrained in their ability to compete through investment and innovation because of those regulatory obligations and non-scalable operating costs;
- Low "main bank" switching rates and less than effective switching processes reinforce the market position of D-SIBs; and
- Finally, the D-SIBs have more funding options and these generally lead to a lower cost of funding and entrench the ability of D-SIBs to compete in an enhanced manner relative to smaller banks.

1. The D-SIBs benefit from a material capital advantage due to capital requirements

The evolution of capital requirements over the past 20 years has improved the resilience of the overall financial system. However, an unintended consequence of the approach taken to implement these changes has been a material capital advantage for the D-SIBs relative to smaller competitors. This acts as a barrier to entry and expansion in retail banking and protects the incumbency of the D-SIBs.

New Zealand registered banks are obliged to hold a minimum amount of capital by the Reserve Bank. The Reserve Bank adopted an approach where the D-SIBs could implement accredited internal ratings based (**IRB**) models to calculate risk weights for each asset class they hold (**RWA**). As has been publicly traversed for some time, under IRB models the D-SIBs have been able to hold less capital against their lending exposures than under standardised models.

Smaller banks were not able to implement the IRB models as they did not have access to the large customer data sets with long time series necessary to build these models (which the D-SIBs had

due to historic presence and market share). They were also not able to leverage expertise and proprietary IP from their parent banks that had already adopted equivalent IRB models. The cost of obtaining IRB status consequently was prohibitive given the lower scale and profitability of the smaller banks. The smaller banks made submissions on this to the Reserve Bank in 2019.

As a result of the differences between standardised and IRB modelling, when a smaller bank acquires a home loan from a larger bank, the riskiness of the loan (as measured by RWA) is deemed to have increased by 45% despite there being no change in its risk profile (the only change being the change in lender). The additional capital to support that loan is a drag on competitiveness for the smaller banks. Smaller banks must retain more profit as capital to support lending growth, compared to the amount required to be retained at one of the D-SIBs. D-SIBs can also utilise that profit for reinvestment such as innovation or promotional activities, further strengthening their market position.

This advantage was further amplified over the past 15 years due to the unprecedented market growth in home lending in New Zealand. The D-SIBs have been able to keep pace with the market growth far more efficiently than smaller competitors due to the lower capital requirements, even more so through periods when the market was at its peak. Furthermore, the ease with which they have been able to grow has seen them increase scale advantages and their ability to fund additional capital requirements, widening the gap with smaller competitors over time.

The current changes to capital requirements that are being phased in through to 2028 include some measures to address this difference through the introduction of the D-SIB buffer. However, the D-SIB buffer should not be used to level the playing field on home loan lending – the D-SIB buffer was imposed to reflect the increased financial stability risk a D-SIB represents. That buffer is illusory if it only results in the D-SIBs having the same capital requirements for home lending as a smaller bank. Additionally, the increase in capital required to meet the new standards has a disproportionately larger impact on smaller banks due to their lack of scale and lower profitability.

We would welcome additional consideration to bank capital requirements in the context of the relative systemic risks and the competitive disadvantage that still exists for smaller banks.

2. More generally, the regulatory ecosystem has a disproportionate impact on smaller banks and inhibits competition

Over the past 10 years, the financial services sector has faced an unprecedented number of "once in a generation" regulatory changes. This has imposed significant costs, complexity and resource needs, with a high fixed cost/resource need component regardless of the size of the bank.

Compliance with regulation will always take precedence, particularly for the smaller banks that are having to make trade-offs due to their smaller profits and size. Even when smaller banks can afford to fund the regulatory changes, they often do not have the equivalent resource bandwidth to accommodate them in the same way as the larger banks. This is especially true given the inherent complexity of much of the recent regulation and frequently the need to make changes to a bank's infrastructure (such as its technology systems) to implement the changes. D-SIBs have access to larger internal resource pools to deliver those changes. They also often have the ability to leverage experts, and expertise, from their parent company when making some changes, effectively leapfrogging them ahead of small local banks.

In addition, as regulatory change in financial services becomes increasingly complex and moves from singular legal obligations to broad multi layered license and compliance programmes, banks are more heavily dependent on sourcing experts to help deliver it. Larger banks can draw on their

deeper budgets to outbid smaller players and secure the specialist talent and expertise needed which at times is in short supply.

The NZ Small Domestic Banks' Group has previously submitted to the Council of Financial Regulators on ways to address this, for example having staggered start dates for new legislation and taking a more proportionate approach to both regulation and enforcement. We have also asked for better coordination of the regulatory work programme and some commonality of regulatory requirements such as reporting (so small banks are not having to provide the same data to different regulators in different ways).

Having to implement that regulatory change has had a flow on effect on the amount of innovation in the market. Proportionality should be applied to the way in which regulatory change is introduced to the market to prevent the disproportionate impact on the smaller banks which for the reasons outlined above hampers competition.

Relatedly, other than the Deposit Takers 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 any obligation does not adversely impact competition. There are no purpose provisions for other empowering Acts (such as the FMCA and CCCFA) imposing a positive obligation to consider the competition impact of any regulation, focussing instead on ensuring that the market encourages confident and informed consumers. This has led to unintended consequences – for example, recent CCCFA changes made to affordability assessments may have inhibited competition and reinforced market positions because those obligations made it more difficult for customers to refinance their home lending with another bank. Information required for the new affordability assessments may not have been required by the customer's current bank.

3. Without the scale benefits enjoyed by D-SIBs, smaller banks are materially constrained in their ability to compete through investment and innovation

A large proportion of banking costs are reasonably fixed. The D-SIBs disproportionally benefit from economies of scale. As a result, they can commit more investment into change, innovation, marketing and competition than smaller banks without making trade-offs against cost and key resource allocation (including management time) toward regulatory change and maintenance activity.

We consider there are opportunities to introduce shared infrastructures that are more proportionately distributed to reduce scale disadvantages for smaller banks and that results in better outcomes for Kiwi regardless of where they bank. Some areas for consideration include a national identity service (which would remove the need for each bank to verify a customers' identity and make it easier for customers to switch banks) or shared infrastructure and co-ordination in relation to managing and preventing fraud across all banks.

There may also be benefit in reviewing the mandates, structure and conduct of industry bodies that support the banking industry.

4. Due to low main bank switching rates across the market, the D-SIBs as the largest incumbents can maintain growth with less competitive positioning

There are low levels of main bank switching in the market. Essentially, the larger and more established banks, which account for 85-90% of the market, enjoy the benefits of a large inert customer base that they have built up over many years making it harder for smaller and newer banks to attract customers.

Due to their incumbent main bank market shares, the D-SIBs benefit from a much larger share of customer choice by being the default main bank for most of the market. This enables them to compete less than challengers on price or features and still retain existing customers while also gaining a large market share of new business.

We believe there is more opportunity to support and promote easier bank switching at an industry level in addition to any focus by individual competitors by looking at international examples, such as Pay.UK and their Current Account Switch Service (CASS). In 2022, CASS switched over 900,000 accounts, with a total of 8.8 million switches made since the launch of the service in 2013. This is compared to the low level of switching in New Zealand via the current Easy Switch process.

5. The D-SIBS have a lower cost of funding due to their market position

Regulated retail banks need capital and debt funding to meet their regulatory obligations. D-SIBs have access to a wider range of both capital and debt funding options. These will also often be at a lower cost than what smaller banks can raise at. Smaller banks may also have ownership constraints (such as a co-operative or mutual membership structure) which impact their ability to raise capital.

Credit rating agencies consider an implicit government guarantee for D-SIBs in setting credit ratings. This means D-SIBs have a more favourable rating for the equivalent risk, which provides a significant cost of funding benefit either in wholesale or institutional markets. Higher relative funding costs for smaller banks act as a constraint to grow a bank's balance sheet efficiently.

The higher credit ratings of the D-SIBs also provide wider access to the wholesale and institutional markets. Institutional depositors, especially in the funds management and insurance space, often have investment mandates that limit or prohibit deposits in lower rated entities. This provides a diversification benefit to the large banks which ultimately reduces the competition for retail deposits, as large banks can meet their funding requirements in the wholesale and institutional markets when retail funding costs increase. This funding diversification is also viewed positively by regulators, rating agencies and market participants, further entrenching the funding advantage. While this is hard to solve for, it is important to understand when assessing the market dynamics.

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