DAY 1 – PERSONAL BANKING SERVICES MARKET STUDY CONFERENCE

SESSION 2 – PRUDENTIAL CAPITAL REQUIREMENTS AND OTHER REGULATORY FACTORS

13 MAY 2024

Adjournment from 10.41 am to 11.10 am

BRYAN CHAPPLE: Okey-doke, I think we might get going on the second session, which is on capital requirements, so John and I are going to lead on this one. So in our Draft Report we found a divergence between the amount of capital required to be held by banks, depending on how that capital is calculated, whether by the IRB approach or the standardised approach, and we illustrated that through some tables in our report. And just acknowledging that we have a small error in the first version published of those, but that's since been corrected on our website.

And so what we found was that the IRB banks, who are also the largest four banks, have been able to hold lower capital than the non-IRB banks for assets with similar risk profile, which had the impact of constraining the growth of smaller banks and giving them an advantage since the introduction of that approach in 2008.

Once the Reserve Bank's capital review is fully implemented in 2028 that difference decreases, but some difference still remains, putting aside the D-SIB buffer. So our draft recommendation included that the Reserve Bank should review it's prudential capital settings to ensure they are completely neutral and that smaller players are better able to compete. And we also suggested relaxing the IRB accreditation criteria and queried the basis for the 85% output floor.

We also suggested that where the risk of lending, such as some home lending, is likely to be identical, the level of capital should be standardised. And we received some good submissions on this, thank you, noting that even if the policy intent behind the 2% D-SIB buffer is to reflect the increased systemic risk of those banks, it does still have the impact of more or less eliminating the divergence in required capital holdings, that the criteria to become an IRB bank shouldn't be relaxed, and a potential alternative is to have a single standardised methodology using a more granular Basel III approach. Also that the Reserve Bank's capital settings are based on internationally developed standards and that increasing the 85% output floor wouldn't be appropriate.

So in terms of this session, what we'd like to do is first talk about the D-SIB buffer and just how to think about that, given the difference in views that have been expressed on that; then talk about the differences in capital requirements on using the IRB approach and how the different risk weightings work. And then we can, more or less after that just pick into the questions about how the risk weighting works across those different methods.

So just starting on the D-SIB buffer. So our understanding is that that is put in place for systemic risk, rather than equalising the risk weighting of different types of lending, and that's the approach we took in the report. But we've received some submissions expressing differing views on that, so we're keen to tease into that and understand where people are coming from on those questions.

So can I just start with maybe some of the larger banks who have expressed the view that the D-SIB buffer should be included when you're comparing the IRB and the standardised approaches rather than separately as we'd done. So I can see Dan nodding, would you like to kick off on that thanks?

DAN HUGGINS: We acknowledge that the 2% D-SIB buffer has been put in and is aimed at systemic risk. However, we believe the Commission should consider the impact of that as well. So the impact, whilst put in there for systemic risk, has been to, or will be to impact the flattening of capital requirements bringing the larger D-SIB banks closer to the non-D-SIB banks and resulting in an outcome which is that the capital that will be held for a like-for-like loan is effectively the same consistent with what the RBNZ New Zealand found. So that's the position as we've stated.

BRYAN CHAPPLE: I guess what we're trying to understand is if the riskiness of given lending is treated more or less the same, there's then an additional risk from the systemic risk posed. And so if you are equalised once you've taken account of that systemic risk, then actually there is a differential for the risk weighting on those assets.

DAN HUGGINS: I guess the way we were looking at it was the -- having an advanced status is a reflection of the risk of that bank, and so it would mean that actually there is lower risk there; but then you apply the D-SIB. The outcome, from a competition perspective, is that the same capital, once those D-SIB buffers are applied, is the same for capital, you know, across both.

So from a competition perspective, the impact of the D-SIB buffers, albeit that they are there for systemic risk, is still that the capital is the same and therefore there isn't an impact on the competition outcome.

JOHN SMALL: So should we just call it something else? Because it doesn't sound as if it's doing its job --

DAN HUGGINS: Perhaps.

JOHN SMALL: -- in that sense. If its purpose, if we're thinking about it as, well it does this levelling up, it performs a levelling up function, then it's not actually a buffer in any sense.

DAN HUGGINS: Our view is that there are a whole range of different components that are going to come into any given capital stack which will be specific to a given competitor. When we then put all of that together, given all of those considerations, and look at the outcomes of that total capital stack and what needs to be applied to any given loan, when we look at that total capital stack they are the same.

And so the way in which we got there may have differed because it differs across different banks given all of the different considerations that come into that. The outcome is still that the capital is the same, and therefore for the consumer the costs underlying that loan are not different across the different banks as considered by those banks for capital.

BRYAN CHAPPLE: Thanks Dan. Antonia.

ANTONIA WATSON: And I'd add that the RBNZ made that point themselves as an outcome of the capital review, is that some of that historic difference has been levelled by the capital review and we're now in the position -- with the advanced models the other thing not to forget, is that advanced model outcomes can be, and are at times, higher than standardised outcomes. What they are are far more granular and look far more specifically at the risk involved in an individual loan, for example.

BRYAN CHAPPLE: I wondered if Kiwibank wanted to comment because you had a different perspective in your submission.

MIKE HENDRIKSEN: Yeah, I think when we think about it, part of the desire for simplicity and sort of a non-contorting way to get to equivalency is shaped by the historical differences. So if you think about the decades where there was a fundamental difference between IRB and standardised banks in terms of credit risk and the consequence that's had on the scale of the industry in the market that we face into, that's why we get sort of vexed by a difference which may end up being equivalent but goes through a sort of slightly contorted way. I mean even the Reserve Bank in its response to the market study confirms that for the homogenous asset that is the largest asset class in New Zealand, it's still a 90% credit capital allowance for an IRB bank versus a standardised bank.

Now, accepting that there are other methodologies that get it to equivalency, we still think why wouldn't you just have equivalency? What's the driving factor that doesn't allow you to get to the same result for capital for a very homogenous asset?

BRYAN CHAPPLE: So is that an argument for not having a D-SIB buffer? Is that what you're suggesting?

MIKE HENDRIKSEN: No, I think the question is, if the D-SIB buffer is meant to serve a purpose, being the recognition of additional risk for a large bank, then that should be done after you've made an equivalency, yeah.

BRYAN CHAPPLE: I see, okay. All right, thank you, that's clear. Does anyone else want to come in on this issue? I think we've got the -- Kent.

KENT DUSTON: Kent Duston, Habilis New Zealand. There's no argument in all of this that the D-SIBs are real, they are domestically systemically important, they can sink the banking network and our financial system with it. So I don't think anyone's arguing that point. The thing is that the Australian banks do have the equivalence of a government underwrite. As Tex illustrated earlier, that affects their cost of capital raising.

So the effect of a D-SIB buffer, the fact that they are a D-SIB has two implications. The first is obviously the higher capital buffer from the 2% ratio, but against that has to be set the lower cost of raising capital that comes from that implicit and actual government guarantee. Because as we saw during Covid, the Reserve Bank expanded its balance sheet by around about $80 billion to the liability of the New Zealand taxpayer, largely to the benefit of the large banks.

So yes, the 2% D-SIB buffer is real, but that's because D-SIBs themselves are real, but the guarantee that is implied there lowers their cost of capital compared to the smaller competitors.

BRYAN CHAPPLE: Thanks Kent. I understand we've got an online question from I think David Harvey. Can you line him up and then I think Vittoria, yeah.

DAVID HARVEY: Hello, good morning, David Harvey coming in as an individual.

BRYAN CHAPPLE: Morning David.

DAVID HARVEY: Mine is mainly the technology side, but I will bring it up tomorrow in the open banking session. What about capital requirements when it comes to app-only offerings, what's the Reserve Bank New Zealand going to do about these type of offerings, because these app-based offerings are common in Asia, Europe, US and I was just wondering what is the RBNZ going to do about capital requirements of these online app-only banks?

BRYAN CHAPPLE: I see, okay. Alright, I think that's probably a question for the Reserve Bank, but I imagine, putting myself in their shoes, it will depend on whether or not they are deposit takers in the New Zealand market, in which case they will then be subject to the deposit taker requirements here, as other deposit takers are. So I don't think whether they're only online or not will be a factor on that. But thank you for that question, David, and look forward to hearing from you tomorrow.

DAVID HARVEY: Yeah, thank you.

BRYAN CHAPPLE: Vittoria.

VITTORIA SHORTT: Vittoria, ASB. This is probably more of a lead-in to the second section, but I want to reiterate that in aggregate there is no competitive differentiation, I think that is a very important point to make, irrespective of what is the role of the individual component parts. A lot has been made about the D-SIB buffer, but IRB is often referred to in a lot of submissions as something that means less capital. I just want to reiterate, and we've provided in our confidential version, often IRB results actually in higher risk rates not just lower and that alters over time.

So I do think we need to make sure that we're really clear about the purpose of each, why they are the way they are. It's a globally recognised framework, I think that is very important to the way that we calculate the capital that we hold. It is very important when we're raising funds around the capital that we hold, it's an important market dynamic.

So these are just sort of some general points that I think are critical when you think about the different component parts. So I just want to make sure that we can't sort of argue one way for D-SIB and then another way for IRB; it is the total stack that matters.

JOHN SMALL: Could I just -- actually I might be straying into the next topic.

BRYAN CHAPPLE: That's okay, let's move there.

JOHN SMALL: Okay, so the notion that you've both brought up and was in submissions also that sometimes an IRB approach will throw up a capital requirement that's more than the standardised approach, that won't be true in general, will it, because otherwise you wouldn't be doing the IRB approach? That must be an oddity, not the average or the norm?

ANTONIA WATSON: It's not an oddity, but what it reflects is that you are taking a very granular approach. So, for example, standardised has a cut-off over 80%, under 80% LVR. If we have a 99% LVR, we treat it from a capital perspective very differently and with much more capital than you would for an 81% LVR, for example, reflecting that very granular view of risk.

JOHN SMALL: Sure, that's right. But I mean the Reserve Bank makes the point at times that part of the reason for a difference between capital holdings, depending on whether you're using the IRB or standardised approach, is that there needs to be some incentive for banks to use the IRB approach, it's referred to us a couple of times. And you do have the choice, I think, don't you, to take the standardised approach? So you choose to spend money on the

IRB approach, it must be surely that this is overall better for you?

ANTONIA WATSON: Historically I think everyone rightly puts it out there as being a bigger difference, but that difference has been eroded with the current capital. It's still worth us investing in the models because it gives us a better view of our risk and banks are all about taking risks.

JOHN SMALL: Yeah, understand.

ANTONIA WATSON: And so we are far more comfortable that we're able to make that investment in a method that allows us to calculate that risk at a very granular level.

VITTORIA SHORTT: Vittoria from ASB. Just to add to that point, it is what is the incentive? The incentive is to understand risk and allocate capital correctly and price it correctly. That's the incentive, that's at the heart of what we need to do. If you go back in time, we were holding higher levels of capital than what regulators -- so we were very focused on economic capital that suggested higher levels than regulators. So we felt like we had a better view of the capital that we should hold.

So it changes over time, and I think that's a very important point not to forget in the decades that you think about capital. So at this point in time it might look a particular way, but it doesn't always look that way.

JOHN SMALL: So you would continue to use this approach, even if it systematically on average caused you to hold more capital than the standardised approach?

VITTORIA SHORTT: If I get a bit more detailed and practical in terms of home loans, we've again submitted in our confidential version; if you have a look at where the majority of home loans are written, that we would suggest there's a lot of home loans written in the 70 to 80% LVR, if you have a look at those home loans and you have a look at the capital that we are holding under our IRB model, that reinforces the point I'm trying to make.

BRYAN CHAPPLE: Okay. Can I just check whether there's any other smaller banks or NBDTs who want to comment on this? Dan, did you want to?

DAN HUGGINS: Dan Huggins, BNZ. We also have a prudential regulator, obviously the RB. So I think it would be inappropriate, perhaps, to suggest that a bank that is sitting on an IRB with a situation where they had a very high IRB relative to standardised would then get permission from the RB to then say actually we'll just move back to standardised, thank you very much, and hold capital. I'm pretty sure the RB would either not allow that, or they would put overlays in place to reflect the fact that that means you've got a very high risk book, that's what IRB means, and it would be reflected by the RB.

BRYAN CHAPPLE: Okay. One thing I wanted to follow-up on, particularly for some of the smaller organisations, was that in our Draft Report, in our analysis of this issue we focused on the difference in level of capital required to be held. And the Reserve Bank in its response submission on the Draft Report pointed out that the funding cost implications of that aren't necessarily that high. Which I understand; it assumes that you're not capital constrained.

So I'm just interested in hearing from some of the smaller organisations under the standardised approach whether the issue is capital constraint as opposed to the pricing difference, which as the Reserve Bank pointed out isn't that great.

MIKE HENDRIKSEN: Looks like it's me. Mike Hendriksen, Kiwibank. Yeah, I think our position would be that the cost of funds issue as assessed by the RB is probably ballpark right. The question we have always had, and again, more historically than under the current rules, is how does that leverage. So if you have less capital, then you can lend more on the same amount and then you become a larger bank, and you get operational scale and all those sort of things. So we wouldn't resist the Reserve Bank's analysis of cost of funding, we just say that's not the whole story.

BRYAN CHAPPLE: In a sense because implicitly there are capital constraints?

MIKE HENDRIKSEN: Correct.

BRYAN CHAPPLE: Any other?

LARISSA VAUGHAN: Larissa Vaughan, TSB. I'd echo what Mike said, there are capital constraints, yes, but likewise, that's not the complete story. It has got to do with the cost of funding and it's almost like getting into kind of a virtuous cycle of having sufficient capital to make lending to get the good credit rating and it's part of, I guess, an important step in that cycle which enables you to compete effectively.

BRYAN CHAPPLE: Is someone else wanting to speak on that? No? Brent.

BRENT KING: Good morning, I'm Brent King from General Finance. We're clearly a lot smaller than the persons to my left and in front of me; so from our side, when there is any further stress, pressure, Covid etc, we move quickly to higher capital adequacy. So we're in a position where we have to do that. That, of course, impacts our profits. We don't have the apparent support from governments, whether it's real or not. So we have to be sure that we can quickly move to that liquidity and be able to look after ourselves in that difficult time. As you've talked about earlier, that can include places like Christchurch earthquake, or Gabrielle, or whatever else may have happened. So there is a significant cost to the smaller parties not having that government apparent support.

KEVIN HUGHES: Yeah, hello, Kevin Hughes from Unity Credit. I think the issue for us definitely would be around the capital component, especially when you're a credit union like ourselves and your sources are capital are minimal, and effectively being a mutual in that environment makes it quite difficult.

So maybe it goes down to the bottom point around the role of competition and Reserve Bank's policy-making, but there are other jurisdictions, given some of the scale of challenges credit union has, there might be other opportunities for the Reserve Bank has to provide positive incentives for organisations like ourselves, especially around the kind of customers that we support that aren't supported necessarily by the major banks.

BRYAN CHAPPLE: Sorry, can I just check, you mean in terms of lower capital requirement for different capital requirements?

KEVIN HUGHES: Yeah, depending on the environment that you're in around how you might be able to provide -- we talked a lot about scale this morning. Scale is a big issue in this market, and the fact that there used to be 105 credit unions ten years ago and now there's three tells you about what's happening in that part of the market, even though it plays a really important role for New Zealand communities.

So I think where you've got disincentives and challenges, there is an opportunity for the Reserve Bank to provide benefits to some other organisations around providing more competition in the marketplace.

JOHN SMALL: Is there something special about mutuals in this regard that's relevant to risk and where it might fall eventually?

KEVIN HUGHES: Yeah, I mean you could definitely argue that obviously we're not for profit, we try to put profit back into our members and our communities, so there's that wider greater good that's going on. Antonia's talked a lot about the shareholder returns that the banks are looking for. Obviously we haven't got that same imperative, but we have got an imperative to be financially viable.

BRYAN CHAPPLE: Okay, thank you. Maybe might just move on and talk a bit about how the IRB system works and the way in which risk is treated, and Vittoria started us off on that talking about the differences in the kind of capital required, you know, that changes and can be more at times.

So one of our suggestions was that for a low LVR home loan, mortgage lending, that's fairly standardised and you would expect that risk to be fairly similar in terms of risk of loss, well, we had expected that to be fairly similar in terms of risk of loss and given all the institutional protections around the mortgage market as well.

So I understand that above that, and there may well be quite big differences, you could expect them to be quite stark at higher LVRs; but for lower LVR mortgages I just want to check what the differences there when you apply IRB analysis. And I appreciate some of it might be confidential so we can get into it in some of the other discussions, but I am interested in understanding just a bit more about how material that is.

VITTORIA SHORTT: Okay, so good for a confidential conversation, yes, because it goes to pricing and the like.

BRYAN CHAPPLE: Yes.

VITTORIA SHORTT: So I mean I think the points to call out there is the whole point of IRB is that we have the data to make that assessment.

BRYAN CHAPPLE: Yeah.

VITTORIA SHORTT: So these are our assessments based on our experience, based on our book, the composition of who we are, where we lend and our settings. That is the fundamental benefit of the IRB. Again, in our confidential submission we've provided all of the LVR bands, we've shown ourselves versus Basel versus New Zealand, so I think we can kind of pick up the ASB view in a confidential conversation. I think the Reserve Bank will be much better able to -- they see all of the data for the organisations, so they'll be able to provide a more holistic market view.

BRYAN CHAPPLE: Sorry, can I just follow-up, but also happy for others to comment. So I understand the benefits of using the data to analyse your risk, that's, as you say, it's the business you're in. My experience of large data models is that you get 80% of the gain for 20% of the data, and that as you add the remaining 80% of the data you get somewhat more refined but actually not that much.

And so that gets to the question really about the threshold for IRB accreditation. And I understand also that this is, you know, we're operating in a global environment and this is a sort of internationally standard approach to some extent. But I am interested in just understanding from people's experience with this modelling just how much of that data really matters, if you're able to say anything on that?

VITTORIA SHORTT: Well, enough, I guess -- what's the way of answering that from an ASB lens? You can see the range across the bands. It's a big range. And it's a big range because that's what our data tells us it should be.

BRYAN CHAPPLE: Yes.

VITTORIA SHORTT: So it's a roundabout way of answering the essence of your question. I can't elaborate further on the models and the 80/20 and the last 20% of data, but the outcome of all of our data suggests that there is a big range of risk.

BRYAN CHAPPLE: Thank you. Does anyone else want to comment on that? Yeah, thanks.

GRANT KNUCKEY: Grant Knuckey, ANZ. When we consider the risk of home loan, for example, we're considering both the probability of default as well as the loss given default. So, the LVR - I think the point, there's not homogeneity around two home loans that have the same LVR because in the end we lend to a borrower, we don't lend to a house.

BRYAN CHAPPLE: I understand, yeah.

GRANT KNUCKEY: So the circumstances of that borrower, the probability of their default is an important part of that risk consideration. So I think we just need to be clear around whether two loans in a similar LVR band, or even with the same LVR, are actually homogenous.

ANTONIA WATSON: To be a bit more specific on the types of things, it could be the savings buffer the customer has, income, do we have a concentration to a particular downtown Auckland apartment building. So there's a lot of different factors; is there a regional concentration? A home loan in Taranaki might look different to TSB than it does to ANZ because of a particular regional concentration. So there's lots of different things that could make the same home loan look very different and those are the sorts of things we take into account. Leaky building as a security [for example].

JOHN SMALL: Can I pick up on the loss given default point that you mentioned there, Grant. So that is substantially limited, isn't it, by the, well, indicated by the LVR?

GRANT KNUCKEY: Yes, that's correct, yeah. But the point I'm making there is that in considering risk, we're obviously also considering the borrower's individual circumstances.

JOHN SMALL: Yeah, that's the probability of default. But your exposure and the size of your security, is crucial to figuring out what the bank's exposure is.

GRANT KNUCKEY: Yes.

CATHERINE McGRATH: Catherine McGrath, Westpac. Just two quick comments. One is there's clearly quite a material cost to choosing to run IRB as well as potential upsides or downsides. And then secondly, I think we need to be quite forward-looking too. So whilst we, for years, have been stable on - LVRs are a good indication, Cyclone Gabrielle gave us a reasonably good indication that there will be more datasets that we will need to use in the future and the same LVR might have a very different given loss based on precisely where it is on the street and what the water may or may not do to it. So I think there's lot of complexity where some of those risk factors will be very different moving forward.

BRYAN CHAPPLE: Good point, yeah. Okay, we might have -- yeah, Kent.

KENT DUSTON: From our perspective this particular issue of IRB seems to sit between the Commerce Commission obviously wishing to achieve a neutral and level playing field for all operators so that there are good competitive outcomes. So that's on the one side. And on the other side, there's the clear desire from the Reserve Bank to end up with a stable and secure financial system, and both of those are desirable outcomes. And IRB, in that sense, from everything that's been said in this room, would appear to be a very useful tool in its assessment of risk at a granular level, and I think it would be difficult to find anybody who would say that that's a bad thing.

So when it comes to the recommendations, perhaps the Commission might turn its mind to whether there is a mechanism to achieve the good outcomes that the Reserve Bank desires with IRB at a sufficiently low regulatory cost that we do achieve the neutral and competitive market that is desired.

So in other words, this is not about the desirability of applying IRB to one group of organisations and not another, but how we could achieve all of the benefits of IRB at sufficient, you know, regulatory cost to all organisations so that all compete equally.

JOHN SMALL: Nice idea, but how do you get there? So what does that mean, does it mean that if you're a smaller bank with smaller dataset and fewer financial modelling resources, what does it mean for someone like that?

KENT DUSTON: Well, I mean obviously one of the possibilities there is that the maintenance and running of IRB across all of the smaller entities becomes a shared service rather than something that's held internally to those organisations, because obviously setting up and running these models is a non-trivial process that requires both expertise and money. And so the Reserve Bank may wish to turn its mind to how that could be achieved, because in that sense we're kind of in a world where we either have standardised models which are relatively simplistic, or IRB which is a lot more sophisticated.

In the world that we live in, where the country is open to all kinds of challenges to its financial system that don't arise from the financial system itself, and we've talked about earthquakes and cyclones and some of those things, surely it's desirable for all financial organisations to have the fine grained view that would come out of IRB, but to do that in a shared way so that the regulatory cost doesn't fall disproportionately on the smaller participants. And obviously that's not a thing that the Commerce Commission can solve, but it is a thing that perhaps the Reserve Bank could usefully turn its mind to.

BRYAN CHAPPLE: Thank you. I think we had Dan and then Mike.

DAN HUGGINS: I guess as I'm sitting here, one of the things I think we can't lose sight of is this is about customers. And we just need to be very careful in these conversations that what we don't end up with is a situation where Kiwis are paying more for access to the funding that they need to achieve their dreams of ownership, or grow their -- this isn't about businesses, but grow their businesses.

So I just think it's -- as we think about, as the Commission considers these different things, we need to just be mindful of if we suddenly end up with all of New Zealand holding a lot more capital than we currently do today for these same loans, then that's going to have the consequence of making borrowing more expensive for Kiwis, which is ultimately not what we're looking to do here, we're look to providing amazing services to Kiwis at the best possible cost.

JOHN SMALL: Is that a reaction to Kent's suggestion?

DAN HUGGINS: No, it's not, I just think that as I've been listening to all of the questions, we talk about D-SIB buffers and other components and we just need to be careful that we don't end up in a world which says, well actually, just put a whole lot more capital into the system to try and equalise things, I think we should be trying to find other ways to do that without just layering cost into the system.

BRYAN CHAPPLE: We might come back to that question of total capital after we've finished this but on this kind of risk weighting stuff. Mike.

MIKE HENDRIKSEN: Yeah, I think, you know, the sort of nature of the dynamic assessment of risk is something that all banks face into. So I definitely get the point of the IRB banks that that helps not only for capital purposes but for others.

I'm sort of still mulling over the question of whether this could ever be subject to a JV for non-D-SIB banks where you could still get enough data and it would actually be efficient to achieve that.

In our mind, if everyone is agreeable to a level playing field for capital, that's probably where we'd see the movement towards a Basel III risk assessment for standardised banks is at least getting us closer to that because it does allow for the sort of granulised nature of the LVRs for standardised banks rather than what it's currently at.

BRYAN CHAPPLE: That was where I was going to go next so that's a good lead-in. Can you pick into a little bit more what that would mean, what the differences are?

MIKE HENDRIKSEN: Essentially it grants standardised banks more discount from a capital perspective for lower LVRs, so there's more buckets to recognise and have a different risk weighting depending on the relative risk of the loan, as I understand it anyway.

BRYAN CHAPPLE: And that is something that is a regulatory choice for the Reserve Bank, or a choice for -- you can't opt into that?

MIKE HENDRIKSEN: Well, no, it reflects the Basel standard, so it would have to come via the

RB and their capital rules, I'd imagine, yeah.

BRYAN CHAPPLE: Does anyone else want to comment on that particular question about the more granular risk weights for entities using the standardised approach? No? Okay.

Maybe then we'll go to where Dan started on, which is total capital requirements. We didn't focus particularly on that in our Draft Report, but there were a few comments in submissions about the extent to which capital requirements here are high relative to other jurisdictions. So I'm just interested in whether anyone wants to talk about what that means in terms of competition and outcomes in the market, whether anyone wants to pick up on that or not. No? Okay.

TEX EDWARDS: I'll have a go.

BRYAN CHAPPLE: Okay, Tex.

TEX EDWARDS: If nobody else will have a go I'll give it a go. Look, I need to reflect on the head prefect from the BNZ talking about raising costs, because we need to look at -- this is a conference about competition and consumer benefits. It's not about dominance and preservation of incumbency. And when we talk about capital and IRB, we need to look at other industries where competition has evolved from asymmetric cost bases. And I mention that because that's the problem we've got with the smaller banks here, because there's an asymmetric cost basis. And my contribution point to the conference, Commissioners, is that if we look at other industries where we've broken dominance, asymmetric cost bases can be justified. I urge that consideration when we're talking about the central bank. Thank you.

JOHN SMALL: That's certainly the way that -- it's consistent with the way we've been thinking about the impact of regulatory capital and other regulatory overlays, is that we've been much more interested in trying to level up the playing field than worry too much about, you know, where that playing field is. So that's why we've been interested in the ability or inability of smaller banks to challenge the big four. I think that's crucial in the whole thing.

BRYAN CHAPPLE: Yeah. Just in some of the detail on this, there were some submissions around the 85% output floor and the 1.2 scalar in terms of how the IRB approach works out and concerns about sort of potential changes to those. And also that the 85% floor is fairly high or conservative by international standards. I think that was in ASB and ANZ's submissions. Is there any comments you want to make about that?

ANTONIA WATSON: I'd just probably make one, and it goes back to your question before about the actual raw levels of capital that we hold in New Zealand. I don't think they're necessarily anti-competitive, because that is a level playing field. Everyone has to hold more capital than maybe our international peers, which we can argue about but it's probably not for this forum. But I think the RBNZ's been reasonably deliberate about how they've put in those particular constraints that you've just talked about.

So they did a five-year capital review, three of the recommendations were to increase the scalar to 1.2%, so whatever comes out of our IRB models we have to add 20% to that. We also have to make sure that it's no more than 85% than the amount that the standardised approach would get, and we've had the D-SIB buffer already enacted, so that 2%. So all those things have gone in first, and I would submit that we're in a, you know, there or thereabouts level playing field now.

What comes now is all of us increasing our capital ratio by a per cent every year. That we can argue about or not, but it's probably -- that's level, so it's probably not something that I think would drive competition or not.

VITTORIA SHORTT: Vittoria, ASB. I'd reiterate the same points. The total stack is level, full stop, that's what all of the calculations in the various submissions have shown and proven. So I don't understand the question, or the residual question around the competitive nature of it, because that's what the analysis shows, is that the total stack is level today. You could argue even the way that the capital changes have occurred is that we're holding more capital because some of these additional elements have come in at the outset of the capital changes rather than at the back end. So yeah, I'm reiterating the same points.

BRYAN CHAPPLE: Thank you, understood. Yeah, BNZ.

SAM PERKINS: Sam Perkins, BNZ. I think just one last comment would be that the role of internal ratings enables more competition across varying asset classes in a way that perhaps you wouldn't get if you were standardised. So because we might have a micro market interest, or want to target some, you know, you've got different areas with different portfolio characteristics, the internal approach enables one person to have a different perspective from another person, much as you would in any other market, and that would actually increase price competitiveness across.

BRYAN CHAPPLE: Can you just explain how that works? I'm not quite sure I understand, because standardised banks can also choose to play in different niches, so how does the IRB make that?

SAM PERKINS: If you took an example of a customer from one bank who had a certain profile on that bank and then that customer could go to a different bank and the different bank would have a slightly different risk assessment. And if that happened across all those four banks, then the customer could go and target the bank that had the most attractive pricing, and pricing's variable depending on how each bank considers the risk profile of that customer. That's, of course, how it works across the entire IRB system, not just personal.

BRYAN CHAPPLE: But that could only work if the -- testing -- if the IRB system for a given loan meant that different banks had -- I guess it had different risk levels, and that's presumably because of the --

SAM PERKINS: Internal rating.

BRYAN CHAPPLE: Yeah, so that can't be because of that particular loan because that loan is the same. So presumably that's just because of the other asset mix of those banks mean that when you look at the bank as a whole you get a different answer for that loan, because a given customer should, well, you could argue it's the same risk. The idiosyncratic risk is the same for that loan.

SAM PERKINS: But each bank's -- yeah.

BRYAN CHAPPLE: But in the context of the broader pool it might be different. Okay.

JOHN SMALL: Just so I can understand that, is the idea that because your IRB model is based on your own history --

BRYAN CHAPPLE: And your broad book.

JOHN SMALL: And your broad book, so let's just take a single customer of a type that fits into everyone's models; if your history with that type of customer has been more positive than ANZ's, then you'll perceive them to be of lower risk and give them a sharper rate; is that the idea?

SAM PERKINS: That's the idea.

BRYAN CHAPPLE: Even though the actual ex-ante expectation is the same of the kind of loss from that customer.

JOHN SMALL: Because it's worked out on the history of them with that customer. Which goes to another interesting -- I mean is there a limit, like so if you're an IRB accredited bank, does that mean you use IRB for all of your loans, or are there some other systems that kick in if you've had fairly thin exposure to some loan types and so haven't got a big history in that loan type?

SAM PERKINS: You have to use IRB across the board otherwise you effectively start cherry-picking the whole portfolio and you get --

JOHN SMALL: Alright, so does that mean then that accreditation relies on you having sufficient depth of experience across all loan types?

SAM PERKINS: It does, yeah.

JOHN SMALL: Right, thanks.

BRYAN CHAPPLE: Okay, thank you. I just want to just check if -- I'm going to move on to the depositor compensation area now so I just want to check, does anyone else want to comment on risk weightings or just in general, anything on this? So Kent and then Andrew.

KENT DUSTON: Kent Duston, Habilis NZ. Just a thing about availability of capital, because obviously this varies very significantly depending on the size and type of the organisation. If I have higher capital requirements and I am a listed bank, I have access to the equity markets.

But to pick up the earlier comment about credit unions, and those organisations that are run as not-for-profits and are a lot smaller, their ability to access equity in any form is very heavily constrained. So the weighting of risk and the regulatory requirement for additional capital, obviously this is one of the factors that's led to credit unions almost ceasing to exist in this country, is because in some cases accessing additional capital for equity is a straightforward process, well-understood, well-priced. In other circumstances, the smaller the organisation becomes the more difficult it becomes, and the less liquid those capital markets become.

So some of the regulatory changes can have the effect of effectively saying that these organisations will be unable to respond to the capital requirements and will cease to exist. So it's just a factor for the Commission to consider in thinking about how the regulatory environment interacts with the competitive environment.

BRYAN CHAPPLE: Thank you. I think Andrew.

ANDREW BODY: My name's Andrew Body, I'm an investment banker but here in my personal capacity. I want to raise a couple of points that could be broadly categorised under the topic of are the risk weights correct. I think there are a couple of areas that I'm familiar with which suggest that the risk weights aren't correct. And there are a number of conclusions that come off that.

One is around the relative risk weights for housing versus business. I know business isn't under the topic here but profitability definitely is. And what you can see if you look at the ANZ, ASB, Westpac, credit experience over the last 15 years, unfortunately the BNZ doesn't publish statutory disclosures that allow a proper analysis, is that the relative credit experience of housing versus business -- sorry, I'll turn it around the other way; business versus housing is much more favourable than the risk weightings. And competition doesn't seem to be eking out that.

So to put some numbers on it, in the last 15 years those three banks combined have

190%, for business the credit experience is 190% more than for housing for home loans; whereas the risk weights are 230% more. So one of the, you know, I think there are a whole lot of productivity issues there which the Commission should be concerned about, but obviously there there's a competition conclusion there as well.

I should say how pleased I was to see Matt Comyn and Shayne Elliott talking about financial inclusion and, you know, how you basically had to be a rich person in Australia to get a home loan. But I think actually their concerns obviously with the APRA rules can be extended to business as well. So that's my example number one about risk weights.

My example number two is basically the banks are getting a return on risk that they're not taking in the area of housing co-operatives and community housing providers. Now you could say well that's business, but actually if I choose to create a housing cooperative, borrow money from a bank, you know, that's personal.

And what is happening, and this goes directly to the Reserve Bank, is that the Reserve Bank, in its wisdom, has not adopted the BIS guidelines. So if you look at CRE20 and CRE30, which are in the, I think they call it the single rule handbook for BIS framework, those rules haven't come down into the Reserve Bank rules.

And basically what's happening is the banks are using the corporate slotting rule, you know, there's a better name for it, the supervisory slotting procedure under income-producing real estate assets, corporate lending, to categorise lending in that area. Which is, you know, it doesn't stack up from a regulatory point of view, doesn't stack up from a first principles analysis of the economics, doesn't stack up from the international evidence where, in fact, borrowing as a -- for example, a housing cooperative is less risky than an individual because of the mutualisation.

So it's really interesting that the Reserve Bank -- I should also say, actually, the EBA, European Banking Authority, has adopted the BIS rules, 27 countries. But for some reason in New Zealand we know more and we haven't. So it's a small thing, but in terms of financial inclusion, in terms of productivity, in terms of actually being a progressive, liberal democracy, and Tex's point about benefitting customers, the RBNZ is way behind the 8 ball and the banks are, knowingly or unknowingly, getting the advantage of it in their profitability, because they are being paid for risks that they are not taking.

BRYAN CHAPPLE: Thanks Andrew. A comment over here, or a question or comment I should say.

MARTIN TAYLOR: Thank you, Martin Taylor from Positive Money. I have very limited banking experience, it goes back to the end of that golden era where it was easier to get a house and harder to get a loan, which of course we've flipped around, and not necessarily to our advantage.

But where that's relevant, I think, to the conversation about capital, is we need to be thinking about the composition of the capital, and the composition of the capital allows for -- we never needed overseas money to buy our own houses, right, what we needed it for was business investment. The composition of capital allowed, which definitely favours the large banks, allows funding treated as capital, you know, debt funding treated as capital, to be sourced from foreign sources.

Now that gives them an advantage in both cost and scale. It doesn't give New Zealand an advantage in the sense that, as I say, we never really needed foreign money to buy our own houses. And back in the days when it was done differently, the level of savings in communities probably largely determined the scale of lending, which is a much better way to kind of route the money system, domestically anyway, into housing.

So my request is that the Commerce Commission consider what they can do to separately regulate retail from wholesale banking. Because there's certainly a good case to ensure that we're globally connected to capital sources and funding sources for a corporate world, and in fact that was the way that deregulation was originally sold 30 years ago, we all thought that it was going to be to grow business, but unfortunately the lazy balance sheets that were identified were households. So that capital's been redeployed in the wrong places.

Now, one of the questions that you asked at the end was what was not mentioned in the report, and I, through our submission, suggested that it was consideration of separation, because retail and wholesale, they're different sorts of banking. The corporate, the big end of town is quite different banking needs from the small end of town. We have hybrid banks here.

Whether that separation is in the form of, you know, like ring-fencing, the sort of Chinese wall approach that the Bank of England's taken, whether it's more in the sense a sort of Chorus/Spark, wholesale/retail split, which was done to overcome a technology reluctance by an incumbent to move along, which has parallels here. I believe it should be seriously considered, because it opens the opportunity to separately regulate and to separately regulate in a way that is less disadvantageous to those smaller local banks and actually more advantageous to the consumers in whose lives this needs to be connected, back to whose lives this needs to be connected, right, through, for example, savings translating into a house purchase.

So you know, I'm not suggesting we return to the golden era of the 60s and 70s where these banks had single digit mortgage percentages, but I am suggesting that we should seriously consider separately regulating the retail side of banking.

BRYAN CHAPPLE: Thank you Martin. Alright, I might move us to talk about the Depositer Compensation Scheme then, but we can pick up anything else from this if we need to. So, we've received quite a lot of submissions on this. Obviously it's a live process underway at the moment in terms of the Reserve Bank's consultation on the levies and the one from the Treasury that's just come out on the overall size and timeframe to build up the fund. So appreciate that those agencies have these processes underway.

We did make some comments in our market study about the scheme, and also quite a lot of submissions we received and material we received prior to the report suggested some differing views about how this should be funded and thought about.

So one thing I just wanted to start off with is discussing how we should think about the scheme and the way in which it's funding. So there was a bit of a mix in some of the views we've received about whether, in thinking about the way in which it's funded, one should think about who benefits and the benefit they get; and people have made various suggestions about, in particular, that some of the smaller institutions will receive more benefit because at the moment they're not seen as having, what some have described, as an implicit guarantee. Whereas as I understand it, as we understand it, the basis on which the funding is being dealt with is what is the expected cost from that institution to the scheme.

So I'm just interested in any perspectives on that, what is the basis on which to think about that? Anyone want to comment?

PENNY DELL: Penny Dell, ANZ. I guess a lot of consultation to date from the Reserve Bank has been on the levy setting, and that's where the Commission has focused thus far. I just highlight that it's worthwhile thinking about in a BAU scenario some of the impacts we're likely to see from a market impact, because we're only talking about half of the equation if we talk about the levies themselves.

And I'd refer you to the Reserve Bank's consultation on the Depositor Compensation Scheme framework and them talking about some of the impacts to retail deposit rates, particularly the convergence of the gaps between the finance companies where they talk about on average they pay 120 basis points over today over the major banks. So if we see some convergence there I guess there is some offset to the risk-based levy framework. So it's not just one piece of the puzzle, there's multiple pieces.

BRYAN CHAPPLE: But should that be taken into account in thinking about the pricing of it is my question really?

PENNY DELL: I'd say it has been taken into account. And I guess the other piece to the puzzle is the risk of default. And when we think about that side of things the multiplier that's been suggested is that a lower rated, or the lowest rated, or unrated entities would pay a levy of four times someone in the higher levy. If we look at the credit ratings of an A rated bank versus a B rated bank, they're considered 10 to 12 times more likely to default by the credit rating agencies, so four times already takes it into account.

BRYAN CHAPPLE: Alright, thank you. I think ANZ you'd also mentioned that we should think about OBR in the context of the DCS. I was just interested in unpacking that a little bit. I didn't quite understand the relevance of that.

PENNY DELL: Yeah, I guess through the consultation process what's become clear is for the major banks it's not considered likely that there'll ever actually be a pay-out under the Depositor Compensation Scheme to individual customers, but more likely it will be a resolution and the funds from that will be used for a resolution event, and hence the interaction with the open bank resolution policy. So it's not likely that you'll ever get a customer payout directly under DCS, whereas for smaller entities that is being considered.

BRYAN CHAPPLE: But if a larger bank fails and goes into OBR, let's hope that won't happen, and there's a loss, right, once you go into -- I mean there will be a haircut that would come through from the scheme; are you just saying because it comes through indirectly rather than directly to customers we should think about that differently?

PENNY DELL: Yes, essentially it's used to fund the resolution of the bank rather than --

BRYAN CHAPPLE: But why should that impact, then, how you assess the levy the different organisations should pay, why does that matter for that?

PENNY DELL: It's just a different relationship, I guess, in terms of the pay-out, it's not a -- although we're getting levied on the basis of the customers that would get paid out and the proxy volume that would get paid out, the fund would be used in a different way actually for that purpose.

JOHN SMALL: But still used.

BRYAN CHAPPLE: But it would still be used in the way that would be based on the customers you had and the losses that the bank suffered, wouldn't they?

PENNY DELL: It's capped.

BRYAN CHAPPLE: How is it capped?

PENNY DELL: There's a cap under the Deposit Takers Act on how much can be used for that resolution purpose.

BRYAN CHAPPLE: You mean per person? No, for the --

PENNY DELL: For the entity.

BRYAN CHAPPLE: Okay, sorry I wasn't aware of that. Alright, we'll check on that. Thanks, that's useful.

MIKE HENDRIKSEN: I'm going somewhere else if you've finished with that line.

BRYAN CHAPPLE: Yeah.

MIKE HENDRIKSEN: So I think in Kiwibank's perspective the largest issue is sort of a follow-up from where we were talking. So if capital rates are high comparative to international norms, then the speed of the build of the fund should be reflective of those higher capital obligations, because that's your first safety net.

The issue that Kiwibank is most intrigued by is the ability to give life to proportionality and the maintenance of competition in relation to these things. Now we've submitted that all material regulatory ecosystem pieces of legislation should have those two obligations. But this is quite interesting in relation to the DCS, because it's not a situation where the financial stability overhangs the conversation about how the levy should be built. Because you're talking about, well, other than -- you could create financial instability through your pricing methodology obviously, but otherwise, it's a straight proportionality maintenance of competition issue in our mind.

So we support the risk-based approach. But what we have a particular area of interest in at the moment is the consultation that is live, and reflective of the conversation that we've all just had where the equivalency between D-SIB on 18% and standardised on 16% seems to be there or thereabouts, you know, through the cycle once those capital rules are in.

At the moment, the way in which the methodology is applied, or is proposed, for a third of the pricing methodology which gets you into the bucket that then gets you charged as a wonderful bucket, the Reserve Bank is suggesting that a 18% capital rate is zero risk and a 16% capital rate isn't. So while on the one hand there's the argument from the Reserve Bank that it is equivalent, for the DCS it's not.

So our position would be that if you're going to try and achieve both proportionality and the maintenance of competition, you ought to respect the general rule that you're putting forward as capital. So those two things should be aligned, particularly when the capital rules are a third of the methodology so can have a very significant impact on an entity that isn't getting the zero rate for capital, even though they're meeting the statutory minima of the Reserve Bank for capital. Thank you very much.

KEVIN HUGHES: Kevin Hughes from Unity. You're right, we're in the middle of this consultation so I think there's a lot to come through, I think this would be another example where we would say there's lots of difference that make it harder for smaller organisations and not-for-profits to keep doing the things they're doing. This is an opportunity for the Reserve Bank to give some signals back and some support while everything else is changing.

But I'll give you an example. So there's a theory, and even the RBNZ's own thing says we're not certain what will happen upon introducing the DCS. The example that they assume that suddenly organisations like ours are going to suddenly get a whole lot of money coming in because it's all derisked I think is going to be false. I don't think anyone's going to wake up the day after the DCS things and I've got a million dollars at ANZ is going to go and split it ten ways. One reason will be because they won't think ANZ's any riskier or less risky than it was the day before.

The other thing is if you try to go and open up ten different accounts with ten different organisations, the other things that are going on in the wider sector means you're not going to bother; AML etc, the paperwork and the process of going through it, it just will not be worth it.

So I think there's other settings, again, like was called out before, you can't look at these things in isolation, you've got to look at what's the actual behaviour going to be given everything else that's going on. So I think the Reserve Bank's been a bit naive around the assumption it's making around what will happen in the market.

The other thing is the barbecue test. You ask most people at a barbecue, they already think we've got one, they already think it exists. So I think you'll find that this will be a reasonably minor change in behaviour, but it has quite a big impact on organisations that are in the buckets at the riskier end. The levy is a material change to the financials, whereas for the big players in town it's a rounding number.

BRYAN CHAPPLE: Yeah, from General Finance and then TSB.

BRENT KING: Brent King from General Finance. I support Kevin's comments there too, it's going to be a major event for our industry, particularly in regards to what will happen when the reinvestments come along. So most of us fund for a term when a person has 300K with you, what are they going to do? So there's going to be a lot of work, effort, involvement at that point. So the increased cost at that point is going to be significant.

I do support the New Zealand system over Australia, I think it's got some significant advantages over that. But I don't think we've taken into account the impact of a failure from an NBDT. So if you think that through, the impact is virtually negligible. So we do not expect that the impact is going to be significant at any point.

And the difference between the banks and ourselves, of course, directors of NBDTs can be personally liable and some of those have gone into prison in the past, appropriately in many cases. But we have that vulnerability. So I think the directors in NBDTs now are particularly sensitive to their futures and the decisions that they are making.

We have put in representations that we do not think that the NBDT sector should be contributing to the levy in the first three years until we see that the industry settles down and we know what proportion of our depositors are at 100K or higher or lower. We know what they are now, we can work out what's happening now. Kevin's point's valid, we do not know what the market will do shortly thereafter. It may get better, it may get worse, it may get tougher. Kevin's point I reiterate; many people think that banks are currently government guaranteed. This is going to be a whole new scenario for all of us.

Our ability to predict in the future: yes, we can do that, we can't do it accurately. We know what we're doing, we know what the trends have been, we can track that through, draw dotted lines into the future. But at the moment we're simply not in a position to say two years hence we're going to be exactly this proportion and this is going to be the amount we're going to have to pay in the levy. It could be very significant or it may not. Thank you

BRYAN CHAPPLE: Thanks Brent. Larissa.

LARISSA VAUGHAN: Larissa Vaughan, TSB. I just wanted to pick up the points in terms of the Deposit Compensation Scheme levy and the live consultation on that, and the importance of competition and proportionality in that. And the particular bucket I want to focus on of the three budgets is the return on equity bucket, which is there are these three kind of evenly weighted buckets, liquidity, capital and return on equity, and we are making submissions on that.

You know, we think that really doubles down on the advantages already enjoyed by the large banks, particularly under the what is now, I guess, the legacy capital regime, we don't think return on equity appropriately reflects risk, so we'd be submitting in favour of weighted buckets as opposed to evenly weighted buckets.

We have looked at what the impact of that will be on TSB and we think it will be material in terms of 5 to 7% of our profit. We've also looked at our risks relative to others. I think effectively we think it's going to be a double impact on us versus the large banks. We've got very low loan default rates, we are A minus rated. So we don't think the evenly weighted three buckets approach is going to be proportionate, it will not maintain competition. Thank you.

BRYAN CHAPPLE: Sorry, did you -- yeah, Mike.

MIKE HENDRIKSEN: Just a short sort of practical matter which I think the Commission can take away and think about is, you know, the Commission obviously has a greater history of the discipline of assessing competition. And so maybe one thing to think about in relation to all these other regulators, or government agencies who need to take this into account, is how can you help them structure their consultations and return submission responses in a way that actually engages with that, because at the moment it could be that people are sort of searching for a methodology to actually do that.

BRYAN CHAPPLE: Thanks. Tex and then we'll stop for lunch and we can come back to this after lunch if there's anymore.

TEX EDWARDS: Thank you Commissioners. I absolutely see this as the critical point of the conference, just before lunch, the role of competition in the Reserve Bank's policy-making.

BRYAN CHAPPLE: Can we start that one after, will you be here after lunch?

TEX EDWARDS: Yeah, I'll be here after lunch.

BRYAN CHAPPLE: We're going to move off the DCS, how about we do that. Let's break now, we can come back and then start on the -- is that okay Tex?

TEX EDWARDS: Fantastic, good as gold.

BRYAN CHAPPLE: Thank you. You'll have the first go on the floor.

Lunch adjournment from 12.29 pm to 1.32 pm