Populism at the expense of financial stability

Comments on the Commerce Commission
Personal banking services market study

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Consulting: My research serves as an input for **consulting** and international policy making. Feel free to reach out.
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1 Introduction

On 21 March, the New Zealand Commerce Commission published a study of the domestic personal banking services market.[1] The study finds that the New Zealand retail banking market is not as competitive as many of us would like it to be. The Commerce Commission attributes the lack of competition to a two-tier system, where the four Big Australian banks (ANZ, ASB, BNZ, Westpac) do not face strong competition and the smaller banks hardy pose a threat. The study (or draft report) documents that the Big 4 are highly profitable compared to other New Zealand banks and foreign banks.

The proposals included in the draft report are set to shake up New Zealand's banking landscape. At their core, the recommendations aim to level the playing field for smaller banks and Kiwibank, making capital more accessible and turning them into formidable competitors. They are pushing for a rapid rollout of open banking, cutting through red tape to spark innovation and ease fintech's entry into the market. On the regulatory front, there is a call for a more competitive approach, ensuring that decisions support rather than hinder market dynamics. Lastly, the study is championing consumer empowerment, making it easier for Kiwis to switch banks and access essential banking services. It is a bold step toward a more competitive, inclusive, and innovative banking sector.

The Commerce Commission should be commended for this study. It is comprehensive and thought-provoking, even. It should lead to changes that improve the experience of retail banking customers. And rightly so, New Zealand's banks do not treat their customers very well. A simple example: Ours is one of the two OECD countries without real-time payments.

2 Main comments

2.1 In banking, size matters

A key reason for limited competition is the large size gap between the "big four" banks (ANZ, ASB, BNZ, Westpac), with combined assets of NZ$580 billion, and the smaller banks (Co-operative Bank, Heartland Bank, SBS, TSB), whose combined assets are $25 billion. This is a 24-fold difference. Let that sink in.

[1] This submission is partially based on posts to my Capital Issues blog and an article I wrote for The Conversation.

This vast size difference offers the big four banks important advantages, such as wholesale financing at a lower cost. Moreover, fixed costs in banking are significant. They include the cost of ever-increasing regulation, systems, cybersecurity, and the policing of money laundering. Against the backdrop of these high fixed costs, size provides significant economies of scale.

Large banks can also diversify more easily. If risks in the New Zealand banking system increase, large banks can spread their risks across the world. This measure is more onerous for banks with a domestic focus.

Another problem is that small banks with a domestic focus are, in practice, beholden to politicians, who may interfere with these banks for electoral reasons. In the aftermath of the commission's report, New Zealand's minister of finance Nicola Willis indicated a willingness to look into how the government could better capitalise Kiwibank.

Unfortunately, the benefits of size are difficult to undo: size matters in banking. A country like Spain has shown how small banks can pose a significant risk to financial stability.

The Commission appears to recognise the benefits of size. Its draft report does not propose to break up the big banks. Instead, it recommends helping smaller banks, such as Kiwibank, by softening the burden of regulation (through the Proportionality Framework, for example), improving access to capital and lowering risk weights.

But the proposals to help smaller banks, no matter how well-intended, are concerning. These initiatives are reminiscent of the pre-global financial crisis (GFC) era when lower capital ratios were used to boost competition and extend excessive credit to aspiring home-owners.

Regulators in the years leading up to the GFC trusted principles-based regulation, only to discover in 2008 such regulations were gamed at the expense of the most vulnerable of our society. And yet the term "principles-based" appears on page 180 of the commission's report. Almost as if little has been learnt since the GFC.

2.2 Not the type of disruption we need

In terms of bank capital, the study offers some concerning recommendations. For example, the proposal to recapitalise a midsized Kiwibank so that it can compete more fiercely. Kiwibank is a state-owned bank that was only recently bailed out by the government because the owners were dissatisfied with the performance of their holding. Instead of depositors running, we witnessed the owners wanting to run.

At the time, the finance minister expected Kiwibank to become a disrupter. However, since the bailout, the bank has underperformed and relied on an accounting trick to prevent its CET1 ratio from becoming the lowest of all New Zealand's banks. It is now the second lowest, after having lost capital since 2018, while other banks managed to increase their capital ratios due to the new capital regime of the RBNZ. This means the bank is vulnerable to shocks and may struggle to meet the increasing capital requirements going forward.

Adding billions of bank capital will likely create moral-hazard problems. Kiwibank's management, pressured by expectations of turning the bank into a genuine disrupter, could engage in excessive risk taking, thus gambling with the bank, knowing that the government will support the bank.

Likewise, the idea aired by some to float 49% of Kiwibank's shares is concerning, as it creates moral hazard problems and uncertainty among the new shareholders: at some time a government may regret the float and nationalise the bank, . . . again.

Infusing billions of dollars in the hope and expectation of turning the bank into a disrupter is playing with fire. Disruption implies an elevated risk that ultimately can affect the stability of the banking system.

2.3 Bank capital has one job only: loss absorption

Another concern is the lack of knowledge of bank capital requirements. The study makes some sweeping statements on that topic: «Bank prudential capital requirements in particular have limited competition by constraining entry and expansion.», «Capital requirements reduce the level of retained earnings available to banks to fund growth and have had the unintended effect of constraining the growth of smaller banks relative to the major banks during a period of strong demand for lending.» and «Capital requirements are a key constraint on competition, particularly for smaller banks.»

Statements like these are generally made by bankers, whereas there is overwhelming empirical evidence to the contrary. See this well-cited study by top banking academics Allen Berger and Christa Bouwman, which documents that «capital helps small banks to increase their probability of survival and market share at all times (during banking crises, market crises, and normal times).»

Another invaluable source is the renewed edition of Professor Anat Admati's work on flawed claims about bank capital: The Parade of the Bankers' New Clothes Continues: 44 Flawed Claims Debunked.

From a financial stability point of view, the purpose of capital is loss absorption, which the Commerce Commission mentions. But then again, the primacy of loss absorption seems to be poorly understood. The theme of the study's chapter on capital is that it is a hindrance more than a help, especially for smaller banks. This is straight from the songbook of bank lobbyists, despite reams of empirical studies demonstrating the virtues of capital and a year after the fall of nonsystemically important, mid-sized, Silicon Valley Bank.

2.4 The lure of proportionality

It is tempting to empathise with smaller banks and apply regulation more proportional: stringent rules for big bank and looser rules for smaller banks. However, prudential regulators do not fully embrace proportionality; see, for example, this speech from Ignazio Angeloni, Member of the Supervisory Board of the ECB:

«Smaller banks transmit little or no risk to the system, but this does not imply that they are individually less risky. Evidence for the euro area after the establishment of the SSM seems to suggest the opposite: for most of the period, the number of bank failures has been much higher in less significant than in significant banks, both in absolute terms (total number of cases) and in relative terms (in relation to the number of existing banks).»

Moreover:

«There also seems to be little ground to favour small banking on grounds of innovation. Innovation in banking and finance comes mainly from large banks (which have broader customer base and investment capacity) or from outside the banking sector (e.g. non-banking groups or specialised Fintech firms).»

Fernando Restoy, Chairman of the Financial Stability Institute, offers additional comments on proportionality in this speech: «the political argument is based on the assumption that large institutions are less able or willing than smaller banks to offer credit and other services to retail customers or small businesses in local communities. However, to my knowledge, there is no compelling evidence that access to credit in concentrated banking systems (like those of France, Canada or the Netherlands) is generally more cumbersome than in countries with a more diversified banking industry (such as that of Germany).»

Fernando Restoy, who previously served as the Chair of the FROB, the Spanish Resolution Authority, before assuming the role of Deputy Governor of the Bank of Spain in 2012, knows something about banks big and small. With first-hand experience of Spain's banking overhaul post-2008, Restoy sheds light on the country's move to consolidate its fractured banking sector in response to the GFC. Spain's decision to streamline its banking landscape resulted in a more concentrated industry. Despite initial concerns, this transformation has proven effective, highlighting the potential benefits of such reforms.

Regarding competition, Restoy expresses concerns that small banks hinder innovation and competition, a viewpoint starkly contrasting with the Commerce Commission: «Yet, there is always a risk that the principle of proportionality could be misused to give a significant regulatory advantage to small institutions. As we have seen, this may not only be unwarranted from a prudential point of view but could also distort competition and prevent a necessary restructuring of the industry. Arguably, the latter effect may become particularly relevant when technological innovation is likely to disrupt the market . . . »

2.5 Tinkering with risk weights

The Commerce Commission study reinforces the widely held belief that the four Australian-owned banks enjoy an unfair advantage due to the system of risk weights. The Big 4 use the Internal Ratings-Based (IRB) approach to calculate risk weights, whereas other banks rely on the one-size-fits-all Standardised Approach (SA). The IRB approach allows banks to use internal models to match risk weights against their loan books, theoretically optimising risk management and capital use to . . . promote competition. However, the reputation of the IRB approach suffered after the GFC, leading regulators to tighten the qualifications for its use and limit its scope with so called 'floors.' This may be seen as regulatory overreach, especially in light of nuanced studies on internal models, such as this report by the European Banking Authority. But here we are.

Today, the use of the IRB approach is tightly regulated, complete with safeguarding floors. Against this background, it is concerning to see the Commerce Commission proposing to make it easier to acquire IRB accreditation.

Due to the use of floors, the differences between risk weights under the SA and the IRB approach have now decreased significantly. So much so that the Australian prudential regulator, APRA, in a recent study «estimates that the average pricing differential for housing lending due to differences in IRB and standardised capital requirements is 5 basis points.» That is negligible: Five basis points is 5% of one percent, which is clearly less than the current rate of inflation and the interest rate increases that mortgage holders face due to poorly managed inflation.

Unfortunately, the Commerce Commission uses an awkward method to quantify the differences between IRB and SA. In Table 7.1, the study shows the impact of the SA and the IRB approach on the amount of capital required for a one million dollar home loan, for banks before the RBNZ capital review. Using historical data on risk weighs assigned to SA and IRB portfolios (37%, respectively 28%) and a Common Equity Tier 1 requirement of 7%, the study shows that banks should hold $25,900 of CET1 capital under SA, and $19,600 under IRB, a difference of $6,300, which is 63 basis points of the loan.

Table 7.2 then shows the current situation, featuring the 85% RBNZ floor. Using the post-capital review CET1 requirement of 11.5%, the study shows that banks should hold $42,550 of CET1 capital using the SA, and $36,167.50 under the IRB approach with floor, a difference of $6,382.50. This is 64 basis points of the loan. The study then concludes that the floor has not changed much: namely 1 basis point (64 – 63 basis points, or $82.50 on a one million dollar loan).

There are some odd choices with the calculations in Tables 7.1 and 7.2. For example, they use CET1 requirements, but more relevant is the Total Capital Ratio requirement, which is 16% for non-systemically important banks (Non-D-SIBs) and 18% for systemically important banks (D-SIBs). See the table below.

Prior to Capital Review	Exposure	RW	RWE	Cap req	Capital
SA	1,000,000	37.0%	370,000	10.5%	38,850
IRB	1,000,000	28.0%	280,000	10.5%	29,400
					9,450
After Capital Review	**Exposure**	**RW**	**RWE**	**Cap req**	**Capital**
SA	1,000,000	37.00%	370,000	16%	**59,200**
IRB, with scalar	1,000,000	31.70%	317,000	18%	**57,060**
				A	2,140
IRB, with output floor	1,000,000	31.45%	314,500	18%	56,610
				B	2,590

Furthermore, the RBNZ also applies an IRB scalar, which multiplies the value of IRB loans by a factor of 1.2. The applicable risk weight is then the *higher of* credit risk RWA calculated under the IRB approach incorporating the IRB scalar (31.7%) and credit risk RWA under SA multiplied by the floor of 85%, which is 31.45 (85% of 37%). See these percentages in the lower panel of the table above.

Following the logic of the study and the fully implemented RBNZ capital rules, the applicable IRB percentage is therefore 31.7%: the higher of 31.45% and 31.7%. Using the Total Capital Ratio requirements, total capital required is one million dollars $\times$ 5.92% for SA banks (16% $\times$ 37%) and 5.71% for IRB banks (18% $\times$ 31.7%). The difference is $2,140 ($59,200 - $57,060), or 0.214% (A in the table). This is 21.4 basis points. This difference is significantly less than the 64 basis points shown in the study ($6,382.50). In other words, the combination of floor and scalar with the 16 and 18 percent Total Capital ratio requirements for small, respectively, large banks leads to a smaller difference in capital requirements for SA and IRB banks. The post-GFC strengthened governance around the use of the IRB approach seems to work!

Note that these numbers are all estimations using data observed by the Commerce Commission, and the calculations are probably different in reality using the applicable Basel II and Basel III formulae and modifications thereof; see, for example, the APRA study Demystifying credit risk capital requirements for housing loans. It relies on

$$RW = SF_{IRB} \times \max\left(0.05, SF_{HL} \times \left[LGD \times N\left(\frac{G(PD) + \sqrt{R} \times G(0.999)}{\sqrt{1-R}}\right) - PD \times LGD\right]\right) \times 12.5,$$

a function that shows that risk-weights for housing lending depend on multiple factors. Consequently, Tables 7.1. and 7.2 in the draft report are likely to compare apples and oranges, a conclusion also drawn in the aforementioned EBA study.

2.6 Bank capital and governance

The study makes some brave statements about the purpose of capital requirements: «it ensures that the owners of a bank have a meaningful stake in the business. The more its owners are exposed to bank losses, the more carefully they will manage the bank.»

Again, this statement deserves more nuance. As pointed out by Ross Levine in his comments on the RBNZ capital review, the role of capital in bank governance depends, for example, on the way bank executives are compensated: «Focusing more on incentives might also enhance the analyses of the comparative impact of the proposed capital regulations on the IRB and standardized banks. For example, to the extent the IRB banks are run primarily by executives who have a large part of their compensation in the form of options-type bonuses linked to ROE, this implies that (a) risk-taking incentives are especially strong, (b) capital regulations are unlikely to reduce, and might even increases risk-taking, suggesting that the capital cushions must be especially large. Moreover, under this example, complementing capital regulatory reforms with reforms of executive compensation schemes would be especially beneficial.»

3 The bigger picture

Hailing from the Netherlands, I am no stranger to a banking scene dominated by a select few. Despite three major players-ING, Rabobank, and ABN AMRO-controlling 85% of the market, there is surprisingly minimal pushback against their dominance. This suggests that concentration does not rule out trust and consumer satisfaction.

In this context, it is surprising that the Commerce Commission did not adopt a more optimistic stance on bank concentration and the role of large banks. Additionally, they seemed unwilling to entertain the notion that smaller banks could potentially hamper competition and innovation.

3.1 The game of banking bargains

It appears that the Commerce Commission deliberately biased the report in favour of Kiwibank and the smaller players, while simultaneously disregarding the importance of financial stability.

We have seen this before. To explain, it is worthwhile reading this paper by Charles Calomiris and Stephen Harber: The Political Foundations of Scarce and Unstable Credit. It was written in 2013, that is, before the Trump administration.[2]

Calomiris and Haber delve into how political forces, especially populism, have historically shaped the banking systems, with a focus on the U.S. They introduce the "game of banking bargains," explaining that banking

[2]Both authors also wrote the highly recommended book: "Fragile by design: The political origins of banking crises and scarce credit."

policies are the result of negotiations between governments and banks, which often reflect the prevailing populist sentiments. This game has led to various banking models, some more stable and inclusive than others.

The authors highlight a unique coalition in the US between agrarian populists, small bankers, and politicians, noting that such alliances have influenced banking policies to favour local interests, often at the cost of financial stability and efficiency. This coalition promoted a banking system that was non-competitive, fragile, and inefficient in credit allocation, emphasising local monopolies and limiting economic growth opportunities. The inefficiencies are still there, American banks still do paper checks.

Interestingly, the shift in banking policies during the 1990s, particularly with revisions to the Community Reinvestment Act under the Clinton administration, marked a significant change, pushing for a banking system that better supports low-income and minority communities, ensuring that everyone gets a fair shot at financial services.

We know how that ended:

3.2 Let's make New Zealand's small banks great!

Reiterating a line from the previous paragraph: "a banking system that better supports low-income and minority communities, ensuring that everyone gets a fair shot at financial services." This rings a bell. The previous Labour government tried that too. See this 2019 post from the NZ Labour Party: «We know saving for a house deposit is a massive hurdle for first home-buyers. That's why we've announced a new plan to lower the deposit required for a government-backed mortgage from 10% to 5%». And this article from some years earlier: «Labour steps up attack on mortgage changes: Labour continued its attack on the new mortgage lending restrictions coming into force tomorrow by inviting media to meet an aspiring first home buyer the party said would be affected.»

Furthermore, the suggestions in the Commerce Commission draft report in support of Kiwibank and the reduction of capital requirements for smaller banks tap into a populist theme: "Let's make Kiwibank great ~~again~~" and "It is time to take control from the Australian banks."

Drawing parallels with the Commerce Commission's recent report advocating for small banks, we can see how populist approaches to banking regulation, though well-intentioned, carry the risk of creating a fragile and fragmented banking sector (the Commission refers to a two-tier market). The US experience, as outlined by Calomiris and Haber, offers a cautionary tale of the complexities and potential pitfalls of populist banking policies, highlighting the importance of finding a balance that promotes stability, competition, and inclusion in the banking sector.

4 Conclusion

To understand why the Commerce Commission wrote this report, with proposals that could affect financial stability and enter the regulatory turf of the Reserve Bank, it seems that they aimed to appeal to the Labour electorate's preferences, borrowing strategies from the American banking experience. Considering that this comes a year after the fall of medium-sized "disrupter" Silicon Valley Bank and similar small entities, it raises some important questions about the authors' motivations for the report.